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EU economic governance: Less might work better than more

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**EU Economic Governance:
Less Might Work Better Than More**

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EU Economic Governance: Less Might Work Better Than More¹

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Abstract: The European Commission has recently proposed a new package of reforms of the Stability and Growth Pact. The package contains a number of good proposals. In particular, the increased focus on debt ratios is a very positive suggestion though this should be strengthened further. However, some of the other proposals, such as the new principle of prudent fiscal management and the scoreboard for non-fiscal imbalances, are poorly thought out and perhaps unworkable. A smaller number of well-focused proposals may end up working better than this complex, and perhaps overly ambitious, package. And a coherent policy to allow for orderly sovereign defaults in Euro area member states would probably place more pressure, via bond markets, on states to get their fiscal houses in order than would the proposed system of fines.

¹ This is based on a briefing paper delivered by the author to the European Parliament's Committee on Economic and Monetary Affairs in his role as a member of an Expert Panel of advisors in relation to the Committee's Monetary Dialogue with the European Central Bank.

1. Introduction

The sovereign debt crisis that is currently affecting a number of Euro-area member states is partly due to a global financial crisis, the severity of which was not envisaged when European Monetary Union was designed. However, even when factoring in the scale of the recent financial crisis, it is clear that the Stability and Growth Pact (SGP), as implemented since the beginning of EMU, did little to prevent the emergence of serious fiscal problems. As a result, while the Euro area economy as a whole is returning to growth, alas stability is proving harder to obtain.

The period since the establishment of the European Financial Stability Facility in May of this year has seen an intense debate about the future of economic governance in Europe. The EU Council established the van Rompuy Task Force to examine options for how things could be done differently in the future. The Task Force has collaborated with the European Commission which in turn has consulted with the European Parliament. The result of these efforts has been a series of detailed legislative proposals aimed at strengthening the preventative and corrective arms of the SGP, improving national fiscal frameworks and introducing a new system for monitoring and correcting non-fiscal macroeconomic imbalances of EU member states.

The full set of legislative documents that has been put forward by the Council and the Parliament contains a wide range of proposals.² Indeed, the Task Force, the Commission and the Parliament are to be commended for having produced such an

² The full legislative package refers to the following set of Commission proposals (i) COM(2010) 526 amending Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (ii) COM(2010)522 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure (iii) COM(2010)523 on requirements for budgetary frameworks of the Member States (iv) COM(2010)524 on the effective enforcement of budgetary surveillance in the euro area (v) COM(2010)527 on the prevention and correction of macroeconomic imbalances and (vi) COM(2010)525 on enforcement measures to correct excessive macroeconomic imbalances in the euro area. The proposals can be found at http://ec.europa.eu/economy_finance/articles/eu_economic_situation/2010-09-eu_economic_governance_proposals_en.htm

impressive package of proposals in such a short time. However, my own assessment of these proposals is that a smaller amount of well-focused proposals may end up working better than this complex and, perhaps overly ambitious, package.

I will start by discussing those aspects of the package that I consider important positive developments. The increased focus on debt levels is to be commended, though I still think these proposals do not go far enough. The proposals on improved national fiscal frameworks are also a very positive step.

It is perhaps more important at this point, however, to pick out areas for improvement. In this paper, I will focus on two areas that appear to be poorly designed or unworkable. The first is perhaps the single biggest initiative in these proposals: A new principle of prudent fiscal management. Failure to adhere to the principle could trigger a Council recommendation for corrective action and, potentially, a fine. I argue that the concept of prudential fiscal management is not well defined, that it is asymmetric in focusing on expenditure more than taxation and that it would not have prevented the recent spate of fiscal crises.

The second is the proposal for monitoring and prevention of non-fiscal imbalances. While broader macroeconomic monitoring is welcome, these proposals have been formulated in an unworkable fashion and also have an unfortunate “mission creep” aspect to them by extending EU warnings into areas that are not clearly of common European interest.

Finally, I discuss the future role for bond market monitoring in preventing future crises and the need for a clear policy on sovereign debt defaults for Euro area member states.

2. Good Proposals

2.1 The Increased Focus on Debt: But This Should Be Stronger

Perhaps the biggest weakness in the way the Stability and Growth Pact has been implemented up to now has been an excessive focus on fiscal deficits rather than on debt levels. Article 126 of the Treaty on the Functioning of the European Union clearly sets out excessive deficits as being judged relative to compliance with both a reference value for the deficit ratio and also “whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.” However, a definition of “satisfactory pace” was never provided and in practice, high debt ratios were never invoked in the opening of Excessive Deficit Procedures. Indeed, the period after 1999 saw failures to meet the 60% reference value for the debt-GDP being about as common as compliance.

For sure, an increased focus on debt would not have prevented some of the fiscal train-wrecks that we have observed. (For example, Ireland had a debt-GDP ratio of 25% in 2007.) However, a number of other member states entered into the global financial crisis with very high debt-GDP ratios, so that a severe recession was likely to push them into dangerous fiscal territory. For example, in 2007, Belgium had a debt-GDP ratio of 84%, Greece had a debt ratio of 96% and Italy’s debt ratio was 103%.³

The new proposals put forward a quantitative guideline as to what constitutes a satisfactory pace of progress towards the reference debt ratio. Progress is satisfactory if “the differential with respect to the reference value has reduced over the previous three years at a rate of the order of one-twentieth per year.” These guidelines will now

³ These figures are taken from page 184 of the Spring edition of the Statistical Annex to European Economy.

be combined with the previous focus on deficit levels when consideration is given to whether an Excessive Deficit Procedure should be opened.

This increased focus on debt is to be commended. Ultimately, it is excessive levels of debt, rather than high deficits, which trigger serious problems such as high sovereign borrowing rates as well as concerns about bailouts and defaults. Indeed, one could argue that a strong focus on obtaining target levels of debt would make explicit deficit targets almost unnecessary: Deficit targets would fall out from what was required in relation to meeting the debt target.

So while the increased focus on debt is a positive move, I believe it does not go far enough for a number of reasons.

Slow Pace of Progress: The one-twentieth per year rate of progress that is deemed satisfactory is still very slow. For example, consider a member state that started out with a debt-GDP ratio of 120%. Calculations on the next page show that this country would not reach a ratio of 70% for thirty-five years even if it adhered to the proposed “satisfactory progress” guideline. It is easy to imagine member states making progress towards the target for five years in a manner consistent with this guideline and then falling back most of the way to their initial position.

A guideline that encouraged stronger convergence would be more effective. The table on the next page provides an example of an alternative: A rule requiring convergence in the debt ratio of one percentage point plus one-twentieth of the gap relative to the reference value. This rule would see a country move from a 120% debt ratio to 70% in nineteen years, without requiring huge steps to be taken in any individual year.

Debt Ratios: Proposed Adjustment and Alternative Adding One Percent Per Year

Year	<i>Proposed Rule</i>	<i>Proposed Rule Plus One Percent Adjustment</i>
0	120	120
1	117	116
2	114	112
3	111	109
4	109	105
5	106	102
6	104	99
7	102	96
8	100	93
9	98	90
10	96	88
11	94	86
12	92	83
13	91	81
14	89	79
15	88	77
16	86	75
17	85	73
18	84	72
19	83	70
20	82	69
21	80	67
22	79	66
23	78	65
24	78	63
25	77	62
26	76	61
27	75	60
28	74	60
29	74	60
30	73	60
31	72	60
32	72	60
33	71	60
34	70	60
35	70	60

Relationship Between Debt and Deficit Rules: I would have preferred to see a more complete integration of the debt and deficit rules. The 3% deficit guideline is arbitrary. It may be consistent with an increasing debt ratio or a declining one, depending on underlying economic growth conditions. And while exceeding a 3% deficit may make a bad debt problem worse if a country already has a high debt ratio, such a deficit might not be a problem at all for a country that has a low debt ratio.

A greater focus on debt dynamics would promote the advantages of low debt ratios by making clear the greater flexibility that is offered by maintaining low debt levels. Countries with debt ratios below certain levels could be allowed to run larger deficits during recessions than those with high debt ratios. There is some suggestion that this may in fact occur in the future as the proposals indicate that “more consideration should be given to relevant factors in the event of non-compliance with the deficit criterion, if a country has a debt below the 60% of GDP threshold.” However, I would prefer to see a more explicit statement that the 3% deficit threshold need not apply to countries with low debt levels.

Will It Be Used?: The proposals still suggest a reluctance to give a primary focus to debt levels, perhaps because a focus on debt rather than deficits will increase the pressure more intensely on specific countries than others in a way that a deficit-oriented focus would not. While the proposals establish a numerical definition of satisfactory progress towards the reference level of debt, they apply a number of caveats when considering whether the numerical definition would actually be used in relation to an excessive deficit procedure. So we are told that *“The establishment of the existence of an excessive deficit based on the debt criterion and the steps leading to it should not be based solely on non-compliance with the numerical benchmark, but always take into account the whole range of relevant factors covered by the Commission report under*

Article 126(3) of the Treaty.” This could mean that, in practice, the debt ratio still plays a minor role in generating excessive deficit procedure.⁴

2.2. National Fiscal Frameworks

The proposals for improvements in national fiscal frameworks are to be welcomed. External enforcement of budgetary discipline by the EU is always likely to be politically controversial so it is preferable to encourage member states to make better fiscal decisions in the future. Each of the proposals put forward are sensible and, if put in place, may be more effective than all of the refinements of the Excessive Deficit Procedures that have been proposed.

Proposals for improved statistical reporting of fiscal data are required if a repeat of the experience with Greek fiscal statistics is to be avoided. Proposals for independent budgetary offices, national fiscal rules, and mandatory multi-year budgeting are also likely to help provide greater fiscal stability particularly in countries (such as Ireland) where pro-cyclical fiscal policy and politicisation of the budgetary cycle has been endemic.

One aspect of national fiscal frameworks that the proposals are relatively silent on is the timing and sequencing of budgetary decisions. I can certainly say that in the member state I most familiar with (Ireland) budgetary decisions tend to be presented as a fait accompli and passed quickly as a single bill on “Budget Day”. It is to be hoped that the demands for improved fiscal frameworks will lead to more detailed debate of fiscal measures.

⁴ An illustration of the general reluctance to prioritise the debt ratio is this curious comment from the explanatory memorandum accompanying COM(2010) 526 and other proposal documents: *“in practice the ‘3% of GDP’ threshold has been the almost exclusive focus of the EDP, with debt playing a marginal role so far. This owes to the less straightforward nature of the debt threshold compared to the deficit, including the ambiguity of the notion of sufficiently diminishing pace of reduction and the greater impact on the debt ratio of variables outside the control of the government, notably inflation.”* It is unclear to me why it is believed that inflation has a greater effect on debt ratios than it does on deficit ratios.

3. Prudential Fiscal Policy-Making

Other areas of the package of proposals strike me as being more problematic. The first problematic suggestion is the new proposed principle for prudential fiscal policy-making.

3.1. Definition and Implementation

The explanatory memorandum accompanying the proposals expresses dissatisfaction with the way the deficit criteria has been implemented in the preventative part of the SGP. Satisfactory progress towards meeting the medium-term budgetary objectives (MTO) has been measured in terms of improvements of 0.5% of GDP per year in the structural or cyclically adjusted budget deficit. The memorandum notes:

the structural balance has in practice proved an insufficient measure of a country's underlying fiscal position, owing to the difficulty of assessing the cyclical position of the economy in real time and to insufficient account being taken of revenue windfalls and shortfalls not directly related to the economic cycle (in particular housing and financial market developments). As a result, in a number of countries, even apparently sound budgetary positions before the crisis masked a strong reliance on windfall revenues to finance expenditure, the reversal of which contributed to soaring budget deficits.

To deal with the perceived shortcomings of the current approach, a new principle of prudent fiscal policy making (PFM) is to be introduced. This principle is described as follows:

This principle implies that annual expenditure growth should not exceed – and if the MTO has not been achieved should be clearly below – a prudent medium-term rate of growth of GDP, unless the MTO has been significantly overachieved or the excess of expenditure growth over the prudent medium-term rate is matched by discretionary

measures on the revenue side. The essential aim is to ensure that revenue windfalls are not spent but are instead allocated to debt reduction.

I think there are a number of serious problems with this principle. The first problem is that no definition of a prudent rate of medium-term growth has been provided. It is certainly true that it is difficult to assess the cyclical position of the economy in real time. However, it is also the case that reasonable people can differ as to what constitutes a prudent rate of growth. If adopted, this proposal will likely run into severe political controversy: One can easily imagine controversies involving the Commission's insistence that a particular member state's "prudent" growth rate of nominal GDP is 2.5% and thus expenditure growth of 3% is excessive while the member state's government insists that this rate of expenditure growth is perfectly consistent with long-run fiscal stability.

A second problem is that the asymmetry between expenditure and taxation in the PFM principle is also of dubious merit. The principle suggests that countries get into fiscal problems by spending too much during good times. However, it does not focus at all on the other route to fiscal problems: The introduction of unsustainable tax cuts. A country that raises expenditure in line with the prudent growth rate but cuts tax rates in a way that will make financing this expenditure growth difficult in the future, could pass the PFM principle with flying colours.

This asymmetry—focusing on the evils of excessive expenditure growth but failing to focus on unsustainable tax cuts—may be seen by some as stemming from a particular ideological viewpoint and this may add to the rule's unpopularity if it is invoked as the reason to launch an excessive deficit procedure.

3.2. Would the PFM Principle Have Helped?

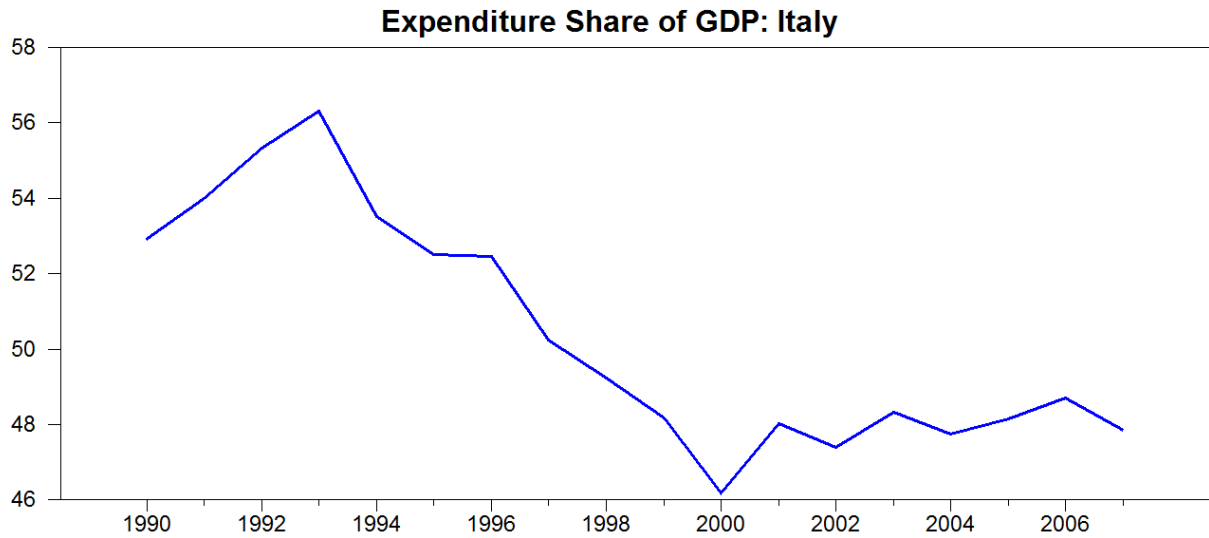
That the PFM principle is somewhat arbitrary and may prove controversial would not necessarily be a bad thing if the principle turned out to be useful in preventing fiscal crises. However, looking back at the historical data for four countries with serious current budgetary problems (Greece, Italy, Ireland and Spain) suggests that it would not.

The next few pages show some charts of expenditure and tax shares of GDP for these four countries. They start by focusing, like the PFM principle, on public expenditure. However the prudent growth rate is defined, it is likely that countries that violate the PFM principle will be observed to be increasing their public expenditure share of GDP: Expenditures will be rising at a faster pace than GDP over a period of a number of years.

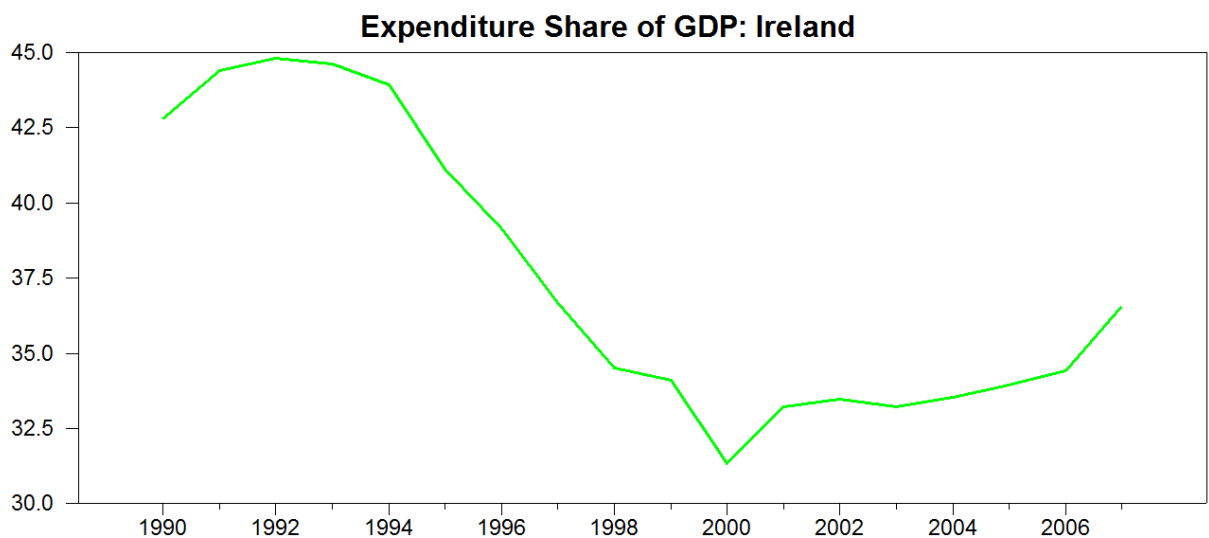
Let's take a look first at Greece and Italy. Here's the graph for the Greek public expenditure share up to 2007. It shows no trend in the expenditure share. Indeed, the share had roughly trended downwards in the years prior to 2008.



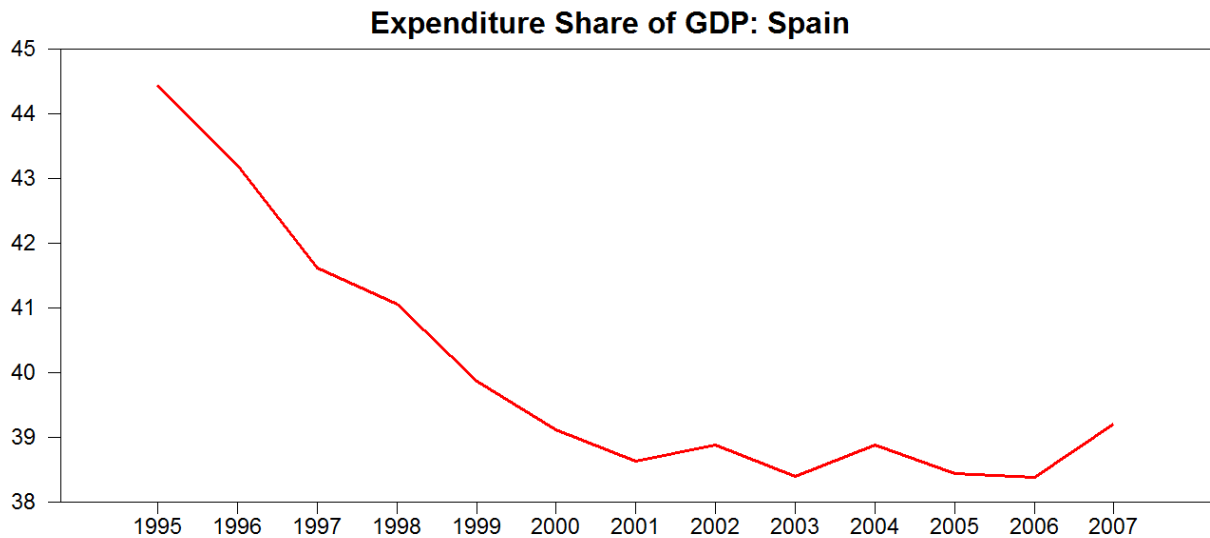
Here's the Italian share. This series was essentially flat during the period since 1999. The expenditure share of GDP was 48.1% in 1999 and 47.8% in 2007.



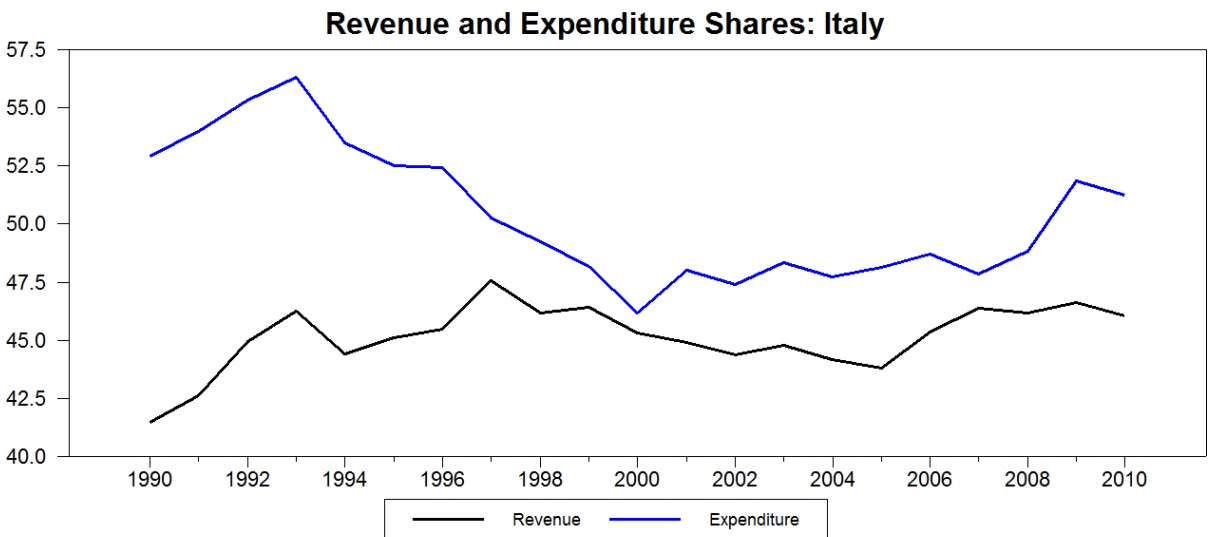
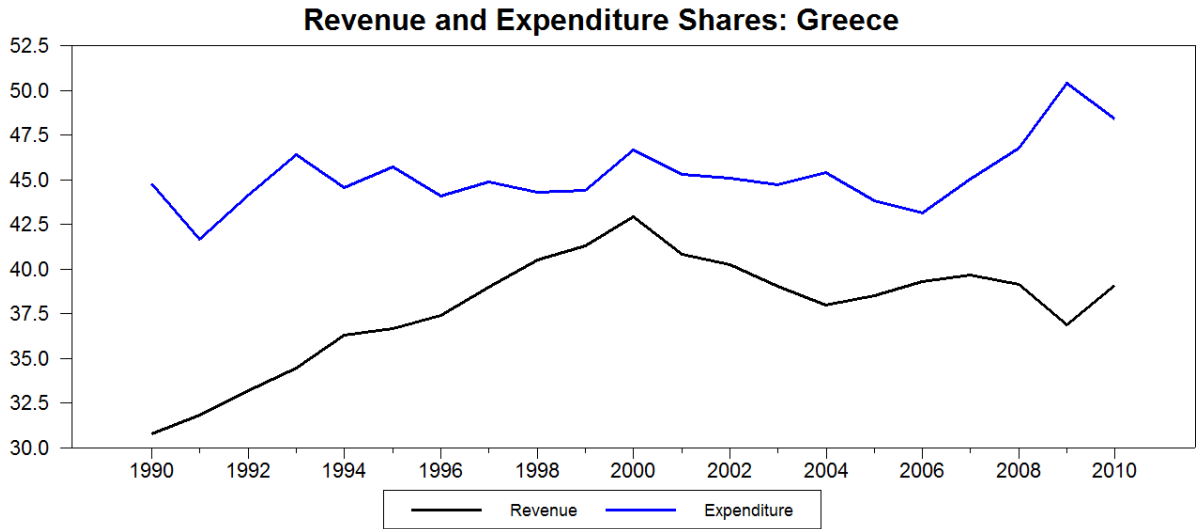
Here's the same graph for Ireland. The series is essentially flat at 34% for much of the post-1999 period before a small uptick is seen in 2007 as the Irish economy started to slow somewhat earlier than the rest of the Euro area.



And here's Spain. Again, the share of GDP accounted for by public expenditure was essentially flat during the years prior to 2007. These charts show pretty clearly that the PFM principle would not have helped to prevent any of these countries falling into the fiscal difficulties that they now face.



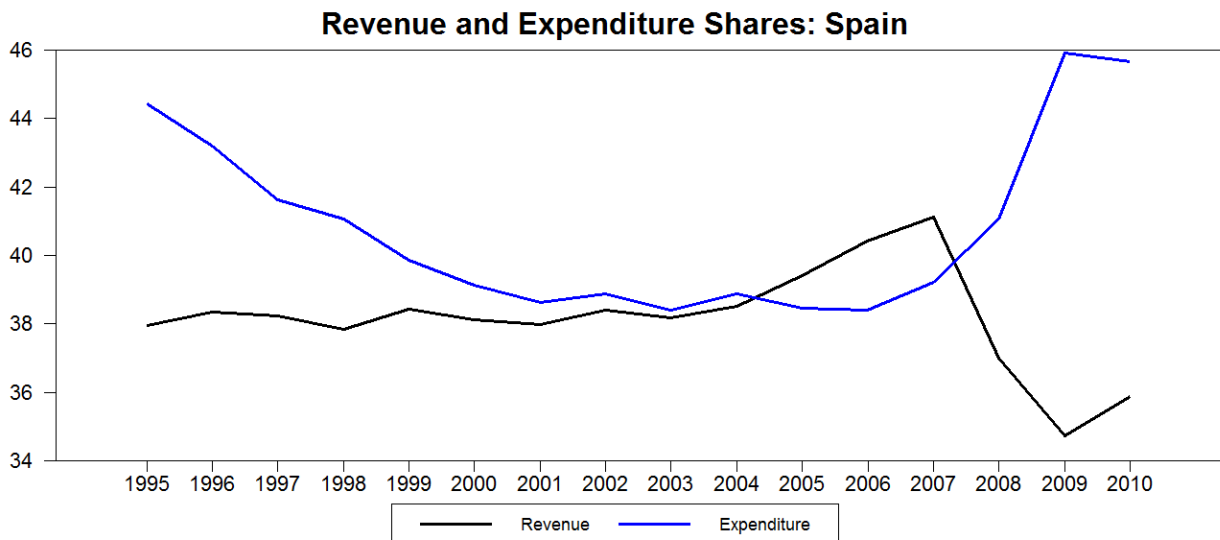
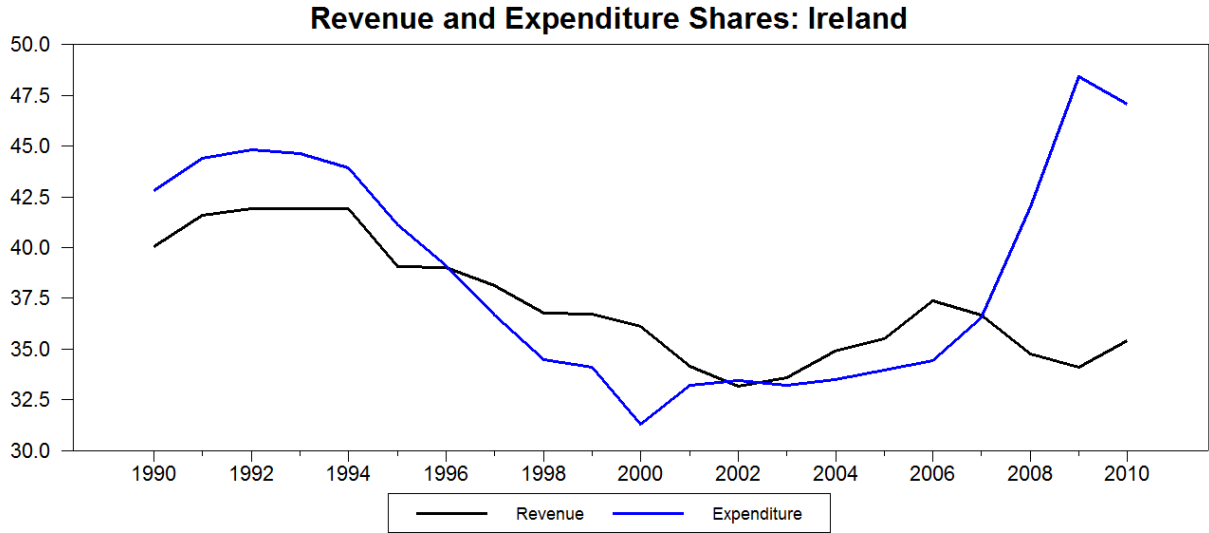
It is easier to understand the fiscal difficulties these countries are in if we add the revenue share of GDP and also roll the series forward a couple of years to include the projections for 2010. The next graphs show revenue and expenditure shares for Greece and Italy. These graphs show that despite flat expenditure shares in the years leading up to 2007, both Greece and Italy ended up opening sizeable deficits. This occurred because both countries entered the recession with fiscal deficits (Greece's deficit in 2007 was already 5.1% of GDP) and then the recession led to reduced tax revenues and increased spending because of higher welfare costs.



The message I take from these figures is that a focus on the underlying deficit, and in particular the underlying debt ratio, is far more important in preventing fiscal crisis than attempting to make public expenditure follow a particular path relative to GDP.

The charts below show the expenditure and revenue ratios for Ireland and Spain. In relation to the PFM principle, the proposals tell us that “The essential aim is to ensure that revenue windfalls are not spent but are instead allocated to debt reduction.” If this is the case, then Ireland and Spain would appear to provide the relevant test cases. Both

countries had substantial housing booms: In 2007, construction accounted for over 13% of employment in both countries, compared with an average of 7.9% for the Euro area.



These temporary and unsustainable housing booms generated substantial windfall tax revenues for both countries. As the charts show, however, once the recession started and construction activity collapsed, both countries saw declines in revenue shares (the Irish decline occurred despite substantial increases in income tax rates to offset the loss of construction-related revenue) and increases in expenditure shares as large numbers of construction workers became unemployed.

Despite these countries being clear examples of cases where revenue windfalls were not saved, the PFM principle would probably not have seen anything wrong with their conduct of fiscal policy because revenue was growing in line with GDP. (One could perhaps argue that Irish GDP growth rates in the years prior to 2007 were above a “long-run prudent” rate. However, the observed growth rates for this period were very close to the EU Commission’s estimates of Ireland’s potential growth rate.⁵)

These examples lead me to conclude that the Prudential Fiscal Policy-Making principle will have serious implementation problems, will cause political controversy, and ultimately would not help much to prevent future fiscal crises.

Furthermore, the Irish and Spanish cases show that despite the well-known difficulties involved in assessing cyclically-adjusted budget deficits, this work is still essential if we want to understand whether fiscal positions that appear to be strong are, in fact, hiding potentially serious future problems. It is now clear that the Commission’s methodology for constructing cyclically adjusted budget deficits underestimated the transitory nature of the housing-related economic activity in these economies and that it also underestimated the sensitivity of tax revenues to declines in construction activities.

One positive suggestion in this area is that the Commission improve its work on cyclical sensitivities of tax revenues. As I understand it, the methodology currently employed is based a highly aggregated level of detail (personal tax, corporate tax, social contributions and indirect taxes). A move to a more detailed approach, based on co-operation with member state Finance Departments, could allow for a closer examination of the relationship between tax revenues and movements in the cyclically sensitive housing sector.

⁵ Very helpfully, the Commission has made all the materials relating to potential output calculations available on a website at <http://circa.europa.eu/Public/irc/ecfin/outgaps/library>.

4. Monitoring of Non-Fiscal Imbalances

In addition to the proposals for improved monitoring of fiscal policy, the package contains a series of proposals relating to surveillance and correction of non-fiscal macroeconomic imbalances. The surveillance element will be based upon a scoreboard of economic indicators which could include current account balances, real effective exchange rates and developments in private sector debt. A poor score could trigger an in-depth review. And then:

If the in-depth review points to severe imbalances or imbalances that jeopardise the proper functioning of the Economic and Monetary Union in a specific Member State, the Council may, on a recommendation from the Commission, adopt recommendations in accordance with Article 121(4) of the Treaty declaring the existence of an excessive imbalance and recommending the Member State concerned to take corrective action within a specified deadline and to present its policy intentions in a corrective action plan.

Finally, if corrective action is not taken, this could trigger a fine of 0.1% of GDP.

There is a lot to be said for a deeper monitoring by the EU of macroeconomic developments in member states. As the discussion of the Irish and Spanish cases above illustrated, the EU would perhaps have had a much better understanding of the fiscal fragilities of these countries if it had carried out more detailed analysis of developments in their property markets and banking systems. However, to the extent that the proposals focus on financial stability analysis, there is likely to be a large degree of overlap with the proposed work of the European Systemic Risk Board.

In addition, while deeper and more considered macroeconomic monitoring is a good idea, the same cannot be said for the “imbalance scoreboard”. The linkages between the various indicators that could go in the scoreboard (current account deficits, debt

growth, competitiveness) are subtle and complex and a scoreboard would be an unhelpful simplification.

The explanatory memorandum accompanying the proposals shows some understanding of the difficulties associated with the scorecard approach. It includes the following discussion:

For instance, a current account deficit of 3 % may be considered acceptable in a converging country with strong investment needs but not in a more advanced country with a rapidly ageing population. The thresholds should therefore be seen as indicative values to guide the assessment, but should not be interpreted in a mechanical way; they should be supplemented by economic judgment and country-specific expertise.

The appeal to economic and judgment and country-specific expertise is, I'm afraid, expecting far too much of the economic experts available to Commission. There is simply not going to be any way to assess exactly what the "right" current account deficit (or surplus) should be. Furthermore, it will not be at all easy to spell out the mechanisms through which a country that has "too large" a current account deficit is supposed to be threatening the effective functioning of EMU.

Extending the monitoring exercise to focus on measures of competitiveness is also questionable. One suggestion for an item in the scoreboard is whether real wage growth has been running ahead of trends in productivity growth. This appears to assume that the Commission can highlight what the ideal level of real wage growth should be relative to productivity growth. Since the ratio of real wage (W/P) to labour productivity (Y/L) is the same thing as the labour share of national income (WL/PY) this would place the Commission squarely in the middle of ideological debates about the appropriate distribution of income between capital and labour. Labour shares in Europe increased a lot in the 1970s and have declined a lot since then, for reasons that are not very well

understood: Why should the European Commission believe it knows what the right value should be for this share. Again, I have concerns that this approach is assuming that European bureaucrats understand “how to run an economy” better than any macroeconomic experts that I know.

The fact that the scoreboard seems likely to combine a whole series of unrelated indicators means that it is likely to be subjected to the criticism that, rather than being “reasonably simple and underpinned by economic rationale” as these proposals suggest, it could be viewed as complex, incoherent and without sound underpinnings. I would recommend that the scoreboard be dispensed with.

5. The Role of Sovereign Bond Markets

While many of the proposals here make sense, the package as a whole feels a bit like an elaborate exercise to secure the barn door long after the horses have bolted. Even with the improvements suggested in these proposals, there are likely to be limits on how effective monitoring from the European Commission can be in preventing future fiscal crises.

Sovereign bond markets also did little to prevent the current crisis. Indeed, the low rates that the sovereign bond markets offered to all Euro area countries—apparently based on the belief that no Euro area country could default—were a key factor enabling some of the Euro area member states to dig themselves into serious fiscal holes.

It is likely, however, that this is an area where the future will differ from the past, independent of the European Union’s efforts to maintain budgetary stability through monitoring and fines. Sovereign bond markets have now realised that Euro area member states may well end up defaulting on their sovereign debt. The German

government's recent position on this matter, if adopted, will ensure that sovereign debt markets are likely to monitor fiscal policy sustainability much more closely than in the past.

Bond market monitoring is likely to prove more effective incentive than fines from the European Union. The European Union could require a country to provide an interest-bearing deposit of 0.2% of GDP if the EU Council decides to issue a recommendation to take corrective action. This could escalate to become a non-interest-bearing deposit if, after a complex set of deliberations, an Excessive Deficit Procedure is opened. Finally, this could escalate to be a fine of 0.2% of GDP if the member state fails to comply with initial recommendation to correct the deficit.

Compare this process with the negative effects of worsening bond market sentiment. For example, consider a country with a debt-GDP ratio of 100% that is failing to reduce this debt at an adequate speed. An increase in bond spreads of 1% would cost this country an additional 1% of GDP in interest costs. This would likely be a far greater incentive for the member state to get its fiscal house in order than the threat of relatively modest fines from the EU.

For these reasons, clarification of the Euro area's position in relation to sovereign default is perhaps more important priority in the coming years than refinements to the enforcement of the Stability and Growth Pact.

6. Less May Work Better Than More

The goals of the Commission's package of measures—to avoid future fiscal crises through more effective monitoring and correction of fiscal and non-fiscal imbalances—are laudable. However, I think the package foresees a future in which the EU tries to do too many things.

Simpler, less complex solutions may be more effective than the proposals in this package:

- A program of fiscal monitoring and correction that focuses heavily on getting debt ratios down to reasonable levels would work better than complex strategies involving arbitrary definitions of prudent fiscal monitoring.
- A more detailed assessment of the sustainability of macroeconomic trends in Euro area member states is a good idea but arbitrary “imbalance scoreboards” are not.
- A simple but well-articulated Euro area policy on sovereign default would help more than a complex and politically controversial fines process.

To summarise, I suggest that this is a situation where less may work better than more.

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