Stability and Growth Pact: An Index to Trigger an Early Warning Earlier?

by

Thierry Warin

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Thierry Warin [*]

Abstract

This paper addresses the question of a technical change in one the components of the Stability and Growth Pact (SGP). Indeed, the SGP is composed of (1) a political commitment, (2) a preventive element, and (3) a dissuasive element, and an improvement of the SGP efficacy can come from any of these three components. In this paper the author proposes a new early warning procedure, part of the preventive element. The ideal situation would be for the European Commission to be able to identify countries at risk as soon as they vote their national budgets. Although this is not possible, as the measures of the deficit are based on GDP forecasts, the conclusion this paper makes is that the EC should avoid relying on GDP forecasts by calculating a reference index.

Keywords: Europe, Fiscal rule, Stability and Growth Pact, political economics.

JEL Classification: E61, E62, E63, F02, F42.

[*] Thierry Warin, Assistant Professor, Department of Economics, Middlebury College, Vermont (USA), Fellow-in-residence at the Minda De Gunzburg Center for European Studies, Harvard University. The author would like to thank the following members of the European Commission: Karl Pichelmann, Heikki Oksanen, and Lars Jonung. A special thank to Kenneth Donahue, but the author remains solely responsible for any mistake or omission.

1. Introduction

Six years of governance by the Treaty of Maastricht, followed by five years under the rules of the Stability and Growth Pact (SGP) seem to adequately demonstrate the positive externalities created by the European fiscal packages on European countries' economies. However, some countries are breaching, or close to breaching the SGP. Using the revised numbers from Eurostat for Greece, the latter was above the 3% deficit ceiling since 2000. Portugal's deficit in 2001 was greater then 3%, followed by Germany's and France's from 2002 to 2004, as well as the subsequent breaches by Italy, U.K., and The Netherlands in 2004.

The stake is different for countries belonging to the Economic and Monetary Union (EMU), in light of the necessity for economic policy coordination. During the convergence period from 1993 to late 1998, it appeared that some coordination rules were needed once the first European countries were ready to enter into the EMU. To this end, Germany, in 1995, proposed the Stability Pact in order to extend the positive effects of the convergence period, and to prevent countries from contracting their public spending during this period, only to increase it later on. First drafted in Madrid in 1995, heavily debated in Florence and Dublin in 1996, and accepted by France the same year, the SGP, now backed by the two largest countries of the forthcoming EMU, was adopted in Amsterdam in 1997.

The SGP consists of extensions of the fiscal package of the Treaty of Maastricht. To comply with the SGP countries may have a budget deficit within 3% of GDP, or public debt lower than 60% of GDP, although the latter criterion seems to have a weaker timbre. (The 3% rule is less arbitrary than people sometimes believe. With an average nominal growth rate of 5%, and a targeted inflation of 2%, the real growth rate of 3% would balance the deficit of 3% of GDP).

Formally, the SGP consists of three elements: first is a political commitment by all parties involved in the SGP (Commission, Member States, Council) to the full and timely implementation of the budget surveillance process (European Council 1997a).

Second, there are preventive elements (European Council 1997c): (1) all Member States implement stability and convergence programmes; (2) there exists the possibility to trigger the "early warning" mechanism in the event of a significant slippage in the budgetary position of a Member State. The European Commission then makes recommendations to the Council. This has happened four times: 01/30/2002 for Portugal, and Germany; 11/19/2002 for France, and 04/28/2004 for Italy.

Third, there are dissuasive elements (European Council 1997b), which require Member States to take immediate corrective action and, if necessary, allow for the imposition of sanctions. If a country breaches the SGP, it exposes itself to penalties. These penalties are embodied in the SGP through article 104c of the Treaty of Maastricht via compulsory deposits that, after time, can be transformed into fines if governments do not take measures to decrease their deficits. The non-interest bearing deposits are made up of two elements: a fixed sum equal to 0.2% of GDP and a supplement of 0.1% of GDP for every percentage point by which the budget deficit exceeds the 3% reference level. Derogation is possible for "exceptional and temporary" circumstances, particularly in the case of a negative annual real growth rate. The exemption is automatic for countries if their GDP has declined by at least 2%, and if the excess deficit is temporary and small. Those countries in which the GDP has declined between 0.75% and 2% can also gain exemption from the rule with the consent of the Council.

The paper is organized the following way: section 2 recalls the economic rationale of the SGP; section 3 studies the potential weaknesses of the SGP; and section 4 examines the index proposed to trigger an "early warning" earlier.

2. The rationale of the Stability and Growth Pact

Firstly, several researchers deal with the question of the sustainability of the budget deficit (Bohn 1995, Mongelli 1999, Nielsen 1992, Perotti, Strauch and Von Hagen 1998), the bottom

line of which, is preventing idle governments from hampering European growth. In 1999, Amador emphasized both the role of fiscal policy, and the behavior of the budget deficit and the public debt over time (Amador 1999); an important feature of this model was the defining of sources of uncertainty as "stochastic processes."

Secondly, there is a policy-mix argument (Beetsma 2001), with other supporters of the SGP asserting that the advent of a central monetary authority was important in establishing the correct mix of fiscal and monetary policy in the Euro-zone (Issing 2002).

Thirdly, and different slightly, is the question of fiscal coordination among member countries. Here, the issue is not coordinating the monetary policy with a country-specific fiscal policy, but rather coordinating fiscal policies collectively. A lack of coordination could lead to asymmetric economic shocks on both the aggregate demand and aggregate supply in every country, as well as hindering the European convergence. However, coordination is not synonymous with convergence (Krugman 1993).

Fourth is the matter of free-riding. In 2002, Uhlig focused his discussion of free-riding and the SGP on the effects of centralized monetary policy combined with decentralized fiscal policy (Uhlig 2002). Uhlig regards the SGP as essential in preventing free-riding in the form of excessively high deficits. The cause for concern over debt levels hinges on the independence of the central bank, because excessive levels of debt might lead to a crisis in which the ECB might be morally, although not legally, bound to bail out insolvent countries. This defense of the SGP is not, however, without its opponents; a large share of the literature dissects the relationship between centralized monetary and decentralized fiscal policymakers, and finds that the SGP might not be needed under some conditions (Fourcans and Warin 2000, Leith and Wren-Lewis 2002, Vranceanu and Warin 2001).

The fifth issue is moral hazard, which differs from free riding to the extent that it is "post-contractual opportunism." In other words, once the pact is signed, countries' loss functions change. Dixit and Lambertini demonstrate that fiscal discretion leads to equilibrium

levels of output and inflation far different than Pareto-optimal choices (Dixit 2001, Dixit and Lambertini 2001).

The sixth consideration is structural externalities. In order to abide by the fiscal rules of the SGP, countries are forced to make needed structural reforms (Warin 2003). These changes occur in the form of how much and how governments raise taxes, and how much and how they allocate public expenditures.

A seventh reason is the maintenance of the credibility of the European central bank through insuring its leadership as the monetary authority. As noted by Buti and Van den Noord, the EMU is, "[commonly] seen as a regime of monetary leadership where fiscal policy is to support the central bank in its task to keep inflation in check," (Buti and Van Den Noord 2004). This power is drawn from the following European Council resolution which accompanies the Pact: "[it] is also necessary to ensure that national budgetary policies support stability oriented monetary policies." When the Maastricht Treaty was drafted, many observers believed that the European budgetary situation could undermine the credibility of the future European Central Bank (Beetsma and Bovenberg 1995). If a country's fiscal situation becomes unsustainable, other countries might be forced to a bail out of the insolvent national government. Alternatively, the European Central Bank may be forced to monetize national debts, and in so doing, create additional inflation in the EU. In 1999, Bolt summarizes this argument stating that, "It is in [the following] context that the Pact for Stability and Growth must be regarded: it seeks to supplement the common monetary policy framework within EMU with sound fiscal policies by the Member States so as to relieve the burden on the ECB's monetary policy and to leave room for the operation of the automatic stabilizers," [1] (Bolt 1999). Cooper and Kempf, nonetheless, call for some flexibility at the fiscal level, as the central bank lacks the tools necessary for stabilization in the presence of country specific shocks (Cooper and Kempf 2000).

[1] Bolt (1999), p. 1.

3. Some reasons why the SGP faces difficulties

The question of free-riding is at the forefront of this issue. German and French advocacy of fiscal restraints, as well as their prominence relative to other European economies, makes it hard to believe that they intended to benefit from the others by running high deficits (Warin and Wolff 2004).

Secondly, we must consider that the issue is not free riding, but rather a lack of political incentives (Buti and Van Den Noord 2004). Maastricht was tough on countries; any breach of the deficit rule, precluded their entrance. Yet, once a member of the EMU, a country understands that the letter of the SGP's law is far looser than its spirit, and that some room for manoeuvring exists. Why does this interpretation exist? In contrast to Buti and Giudice in 2002, we are not going to look for different political incentives within countries (Buti and Giudice 2002), but rather take a look at the intent of the SGP. In spirit, the SGP is tough on countries, having very fixed criteria for compliance. Yet, the application is more difficult than the criteria, and the dynamics of the pact generate unforeseen effects. Because the SGP is calculated over GDP and countries cannot know the precise level of future gross domestic products, it is almost impossible for countries to target a deficit of 3% GDP. Consequently, the SGP is an *ex post facto* rule. This characteristic makes it rather difficult, if not impossible, for a country to abide by the rule without knowing precisely what its end of the year GDP will be.[2] When a country decides its spending, it approximates its revenue by considering a forecast of the GDP growth rate. Hence, if for any reason the actual GDP is lower than the forcasted GDP,[3] the country may breach the pact. While it might be argued in defense of the pact that a country should choose a minimum margin approach instead of a truly optimistic one, political considerations make this improbable. Given the impact of economic language on people's confidence, a policymaker may continue to forecast a higher GDP growth rate, and consider an actual deficit cap lower than the 3% rule. Politicians, however, for

[2] For instance, France in 2002 breached the SGP with a deficit of 3.1% of GDP.
[3] See Jonung, L., Larch, M. 2004. Improving Fiscal Policy in the EU: The Case for Independent Forecasts. *European Economy Economic Papers*. 210.

whom the life-cycle is very short, may consider the vagueness of such an approach a loophole. This intrinsic *ex post facto* feature of the SGP is one important reason why the political incentive to abide by the pact is reduced.

4. A useful tool to trigger an early warning procedure

The purpose of this section is to try to find a scenario that may be "easily" implemented, compared to other rules, to respond to the many demands from the economic literature.

One can try to give the benefit of the doubt to European countries' policymakers, as the implementation of the SGP is not easy. The SGP is based an *ex post facto* measure of the GDP, relying on the forecasting capacity of the national administration, or its ability to fine-tune its spending – something that is almost impossible once the budget is voted. Implicitly, if the administration is not certain of its GDP forecast, it should target lower spending in order to abide by the rule. Yet, this introduces some unfairness in the rule across countries, as well as ambiguity. If the scale of the error is minor, ambiguity in the policy making is not desirable. Indeed, a country can always take a chance hoping that the actual GDP will be higher than the forecast.

A realistic and effective response would be to issue an early warning earlier! In that respect, the European Commission needs a useful tool to identify the riskier budgets very early, and ideally, as soon as they are voted by the national parliaments. In order to do so, the EC should take into consideration the issues in the Pact definition, and simulate a virtual SGP (SGP II). The simulated SGP could consist of (1) keeping the deficit rule, (2) enforcing the debt criterion of the SGP, and (3) calculating the 3% deficit based on the GDP introducing a lag of one year.

In doing so during the first quarter or 2001, the EC would have a better approximation of a country's GDP for 2000 than in early 2000. Over the summer of 2001, the country works on its budget, knowing exactly how much to spend in billions of euros, and pushes

for its acceptance by the national parliament in late 2001. This figure would serve as an index.

Consequently, if the EC sees that the actual deficit is greater than the index using the SGP II procedure, it shows that the country is at risk of breaching the deficit ceiling. The EC could group the countries at risk according to this index, and issue earlier during the current year, an "early warning."

The legal basis for such an "early warning" is Article 99(4) (ex Article 103(4)) of the EC Treaty, which allows for the Council, acting by a qualified majority on a recommendation from the Commission, to address a recommendation to any Member State diverging from the medium-term budgetary objective. Acting through a qualified majority of all Member States (including the Member State concerned), the Council may decide to make its recommendation public. One of the advantages of the index is that it puts a number on the "medium-term budgetary objective."

The technical change would work the following way: the country would use the 2000 GDP as a reference value to calculate the 2002 deficit. A country would still use a GDP forecast to approximate the changes in expenditure and revenue, but the EC would calculate the "deficit reference value" in euros using the new "GDP reference value." Obviously, the actual amount of the public revenue, as well as the actual amount of the public expenditure in 2002 would rely on the 2002 GDP.

In case of positive GDP growth rates – slowdown or not compared to the previous year – there is no issue, since the 2002 GDP will be higher than the index that serves as a "2000 GDP reference value".

In a recession two possibilities would occur. First, if the 2002 GDP is lower than the 2000 GDP that is used to calculate the index, then a larger deficit divided by a lower GDP would render the country in breach of the 3% ceiling. Although the index would not have put the country in the group at risk, we should keep in mind that a country can still breach the deficit ceiling two years in a row.

Second, if the 2002 GDP is lower than 2001, but not 2000, it is likely that there is no issue again. The index that serves as a "reference value for the 2002 deficit" was calculated in euros by taking 3% over the 2000 GDP reference value. If the 2002 deficit in euros was greater than the deficit based upon the index, because of automatic stabilizers, then even a minor positive growth rate from 2000 to 2002, in terms of GDP and considering the size of the GDP, would likely compensate for the discrepancy in the deficit. If not, the country is still allowed to breach the ceiling two years in a row.

For instance, in looking at the following table (see Table 1), we see that Germany, Greece, France, and Italy face an improvement in their GDP levels from 2000 to 2003. Furthermore, Greece breaches the deficit ceiling from 2000 to 2003. Germany and France breach the deficit ceiling in 2002, and 2003. If we calculate the deficit under the simulated SGP (SGP II) in 2002 using the index value from the *ante penultimate* year, we see that the index that would have triggered an early warning for Germany would have been -60.90 billion euros as opposed to the –77.97 billion euros when Germany realised the issue.

Table 1. Calculation of the reference deficit index. *Source: Eurostat, 2004; and own calculations.*

Germany	2000	2001	2002	2003
GDP (Bn euros)	2030.00	2074.00	2107.30	2128.19
Deficit (Bn euros)	26.39	-58.07	-77.97	-80.87
Deficit (% GDP)	1.30	-2.80	-3.70	-3.80
Index (Bn euros)			-60.90	-62.22
Index (% GDP)			-2.89	-2.92

Greece	2000	2001	2002	2003
GDP (Bn euros)	123.20	131.30	141.50	153.00
Deficit (Bn euros)	-5.05	-4.86	-5.24	-7.04
Deficit (% GDP)	-4.10	-3.70	-3.70	-4.60
Index (Bn euros)			-3.70	-3.94
Index (% GDP)			-2.61	-2.57

France	2000	2001	2002	2003
GDP (Bn euros)	1420.09	1475.59	1526.79	1557.20
Deficit (Bn euros)	-19.88	-22.13	-48.86	-63.85
Deficit (% GDP)	-1.40	-1.50	-3.20	-4.10
Index (Bn euros)			-42.60	-44.27
Index (% GDP)			-2.79	-2.84

Italy	2000	2001	2002	2003
GDP (Bn euros)	1166.50	1218.50	1260.40	1300.90
Deficit (Bn euros)	-7.00	-31.68	-28.99	-31.22
Deficit (% GDP)	-0.60	-2.60	-2.30	-2.40
Index (Bn euros)			-35.00	-36.56
Index (% GDP)			-2.78	-2.81

5. Conclusion

In retrospect, the economic literature often looks at the SGP from a severe perspective; as it faces difficulties, however, economists should find a more optimal fiscal rule. If the SGP faces issues, it comes also from its design.

The SGP is an economic rule embedded in an economic policy for its implementation. The SGP, as an economic policy, has three features: (1) a political commitment, (2) a preventive part, and (3) a dissuasive element. Here, the author addressed the question of how to improve the preventive part. The calculation of an index helps the EC in the identification of countries that are at risk of breaching the

deficit ceiling. In other words, this index provides a useful tool that allows the EC to issue earlier "early warnings."

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