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THOUGHTS ABOUT THE EUROPEAN STABILITY AND GROWTH PACT

In November 2003, the Stability and Growth Pact was shaken. France and Germany have been criticized, in particular by euro-skeptic commentators, some of whom had, earlier on, denounced the European budgetary rules as arbitrary and even harmful.

What should we think of those reactions ? Are the budgetary slippages observed in France and Germany serious ? Are the fiscal norms contained in the Maastricht Treaty and in the Stability and Growth Pact adequate ? Are the European Monetary Union (EMU) fiscal constraints an exception ?

To shed some light on this debate, I shall :

- firstly, consider and assess the consequences of european fiscal slippages in a wider perspective ;
- secondly, reflect on the validity of a permanent mechanism of pre-set budgetary rules. In this regard, I shall try to explain why such frameworks are more and more widely adopted and show that EMU is, in fact, following a worldwide trend ;
- thirdly, I shall endeavor to evaluate the effectiveness of the present european fiscal rules. Are they adequate or should they be amended in the light of experience ?

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I. THE FRANCO-GERMAN FISCAL SLIPPAGES IN A WIDER PERSPECTIVE :

Traditionally, except in the case of wars, governments used to present balanced budgets to their Parliaments. The deficits incurred during recessions were offset by the surpluses generated by years of expansion. Public debt was, in general (albeit not in all countries), contained within rather modest limits over the long term. The executive branch had the responsibility of monitoring the stability of public finances and the moderation of public debt.

But things have profoundly changed.

1. The tendency for growing public expenditure :

Since World War II, structural evolutions have tended in most western-type democracies to increase public spending. The greater role of the State in the field of social welfare has been, from this point of view, an essential factor. More generally, public transfers and subsidies have grown fast whilst carrying out public missions (like education) has entailed heavier financing needs. In some countries, like France, the growth of public transfers and the more and more widely held idea that it is up to the state to cover social and economic risks, have favored the expansion of public expenditures. Thus, total public spending -which accounted for 39 % of French GDP in 1970- exceeds today 54 % (see Table I), which puts France in the highest position within the Euro zone[1]. By contrast, the "anglosaxon" countries have a ratio slightly higher than 30 %. Of course, the financing systems of pensions and health care account for a significant part of this difference. But, even after correcting these structural discrepancies, France stands out as a country with an extremely high level of public expenditure.

2. The dangers of this trend towards higher public expenditure :

The dangers are twofold.

a) the first danger stems from heavier taxation :

Tables I and II show -and that is not surprising- that public taxation (including social security contributions) is strongly correlated to public expenditures. In France, public taxation ("prélèvements obligatoires") accounts for more than 50 %[2] of GDP, which is ten percentage points more than in 1975, thus placing this country in the top league of the OECD. It is well known that, above a certain threshold, too heavy taxes discourage private initiative and lead to outsourcing of activities in countries that are less imposed. Many are the examples of investors -French or foreign- who put off their projects in France because of excessive taxation. In a world of free trade and capital movements, it is easy to imagine the damage that such a "fiscal exception" can entail in terms of growth, competitiveness and employment. All the painful consequences of these disincentives are not immediately apparent. But they will materialize eventually.

[1] The average of the Eurozone is 48,9 % with Germany at 49,4 %.
[2] Of which 16 % for social security contributions, see note 3 of table II.

b) <u>the second danger concerns the magnitude of fiscal deficits and of the related public indebtedness :</u>

If taxation increases in relation to public expenditure, the latter tends to exceed the growth of budgetary revenues. It is, indeed, politically easier to increase public expenditure than to overtax citizens. The result of this phenomenon has been, over the last twenty years, a tendency towards a growth of fiscal deficits. Indeed, fiscal deficits have increased spectacularly world wide especially since the beginning of the eighties (see Tables III and IV).

While a country like France used to run rather limited fiscal deficits in terms of GDP (less than 1 % on a yearly average over the period 1974-1981), a strong expansion of those deficits has been observed in subsequent years. Thus, the yearly average of French fiscal positions since 1980 is a deficit of 3,5 % of GDP (2,5 % for Germany).

This trend has inevitably led to a dramatic increase in the public debt of industrialized countries (see table V), increase that is all the more significant that inflation doesn't help anymore to reduce the burden of outstanding debt contrary to what happened in the past.

Italy, Belgium and Ireland have, in particular, seen a true explosion of their public debt during the seventies and the eighties. Their ratio of public debt to GDP has, indeed, exceeded 100 % in the early nineties.

But the "good pupils" have also tended to be contamined. Thus, in France, where public debt to GDP was below 20 % in 1980, the ratio is 62 % today, a trebbling in real terms over twenty years. How could France -whose public indebtedness was traditionally moderate-, join, in less than two decades, the group of countries who have exceeded the 60 % alarm limit ? The answer is simple : by letting public expenditures and deficits slip year after year in an environment of less buoyant economic growth.

The negative consequences of this situation are obvious. On the one hand, public deficits have absorbed a growing share of private savings, which has consequently reduced financing resources available for private productive investment (crowding out). Table III shows that deficits of the general government have tapped, on a yearly average basis, some 40 % of French net private savings form 1980 to 2003. On the other hand, as table VII shows, the cost of servicing the public debt has grown significantly.

Does public opinion realize that, in spite of presently low interest rates, the annual payment of interests on the French public debt amounts to close to 3 % of GDP, and that this, in turn, accounts for three quarters of the 2003 fiscal deficit ? Is it normal, from the standpoint of "households economics", that the state should borrow every year to finance the interests of its debt ? In order to avoid the snowballing effect of such a situation, the budget would have to generate, for a number of years, a primary surplus of 3 % of DGP. We are far from it !

One realizes that budgetary authorities have lost a significant part of their flexibility since they have to allocate such large resources to servicing public debt. The general reductions of interest rates over the last years has, of course, tended to moderate the magnitude of this phenomenon. But we should never forget that markets eventually sanction -through higher long term interest rates- systematic deficit spending policies. One has observed recently a manifestation of what I am stressing. Graph VIII shows how Spanish government bonds have recently performed versus French and German bonds. Because of a more responsible fiscal policy in Madrid, the Spanish spreads -traditionally higher than those of Germany and France because of the "southern European" risk premium- have, in the summer of 2003, for the first time, reached a slightly lower level than those of its two large neighbors.

It is well known that beyond a certain level, public debt becomes "unsustainable". Thus, a country like Brazil (whose public gross debt accounts for 78 % of GDP and where the risk premium is still high) has to generate each year a primary surplus of more than 4 % of its GDP in order to stabilize its public debt.

Lower interest rates have no doubt encouraged deficit spending over the last years[3]. But in an environment of slow economic growth, the real value of public indebtedness continues to increase. Accumulating, year after year, fiscal deficits of 3 to 4 % of GDP when growth hovers around 1 to 2 %, is a dangerous snowballing process. Furthermore, there is no guarantee that long term interest rates will remain permanently at the present low levels.

Graph VIIIbis illustrates vividly the explosion of world public indebtedness over the last twenty years. The fall in interest rates observed since the early nineties has, globally, been accompanied by an expansion of public debt which now reaches more than 50 % of world GDP (against 25 % in 1980).

[3] Lower interest rates, which reduce the burden of debt service, should normally have led to a reduction of public expenditure and deficits. In fact, the fall in interest rates has been, in part, offset, in France, for example, by an increase of other public expenditures items. Other countries (like Spain, the United Kingdom, the Netherlands….) have better taken advantage of the lower interest rates (see Table I).

This phenomenon is all the more serious that - and fortunately so- inflation is no more a solution. For too long in the past, governments have repaid their debts in depreciated currencies. In fact, real interest rates on sovereign bonds were, in those times, negative ex-post. But such a "monetary illusion" has disappeared. Now that capital movements are free, investors can place their savings in financial instruments that carry a positive remuneration in real terms. If inflationary expectations were to reappear, long term interest rates would rise and over extended states would have to pay in "real money" the consequences of their past laxity.

In this respect, one should also have in mind the Domar theorem which states : "If the nominal interest rate is higher than the nominal rate of growth of GDP (which is, for instance, the case of France nowadays) the ratio debt/GDP will grow infinitely whatever the level of the deficit". In other words, inconsiderate borrowing destined to transfer on future generations of tax payers the cost of present current expenditures, leads to a deadlock in a world characterized by moderate growth, and positive real interest rates due to low inflation.

It is therefore necessary to correct the present situation and to reduce significantly budgetary deficits as well as public debt when the latter appears excessive. This action is all the more indispensable that the horizon is clouded by the massive financial consequences -yet to be properly calculated- stemming from the demographic decline of most industrialized countries especially in Europe. With aging populations (less working tax payers and contributors versus more entitlements), future public finance problems will only compound the consequences of fiscal slippages of the past twenty years.

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II. OECD INDUSTRIALIZED COUNTRIES HAVE MOVED TOWARDS BUDGETARY CONSTRAINING FRAMEWORKS; THIS IS IN NO WAY A SPECIFIC TRAIT OF THE EMU :

As the horizon of politicians is, often, limited to the next elections, it is difficult for them to conceive and enforce a medium term fiscal strategy. Cutting back public expenditure is never popular, because it reduces, by definition, the benefits and entitlements of a number of citizens even if it leads to a global betterment for the community at large. Reducing, year after year, public expenditure is obviously politically difficult.

This reality has led a growing number of OECD States to resort to "rules-based" fiscal policies. Such rules are meant to better contain deficits and public expenditure over the medium term and to stabilize or, if needed, reduce public indebtedness.

The common thread of the many legislations that have been voted in this field is that fiscal discipline -once it has been laid out by Parliament in a medium term framework- is easier to enforce steadily. Or course, new majorities can always undo what has been established earlier on. But experience shows that it is easier politically to reach "bi-partisan" agreements on fiscal codes of conduct, than to obtain year after year new austerity measures.

The IMF has recently published a study[4] on the subject. I shall briefly summarize its findings regarding a selection of countries.

a) <u>Australia-New Zeland :</u>

- in Australia, under the "Budget Honesty Act" (1996), the government must lay out its fiscal objectives and its medium term strategy in each annual budget. The budget must be consistent with the principle of fiscal balance over the course of the economic cycle ;
- in New Zeland, the "fiscal responsibility Control Act" (1994) goes further. In particular, it establishes the principle that operating surpluses must be achieved each year until prudent levels of public debt are attained. In a longer perspective, the objective is to achieve an average surplus over the cycle sufficient to ensure that gross public debt remains below 30 % of GDP and that old age pension commitments will be met.

In both cases, the results of this medium term policy have been spectacular. In Australia, the fiscal position has shifted form a deficit of 4 % in 1992-93 to a surplus of 2 % in 1999/2000. Public expenditure has been contained and the tax burden has remained constant. In New Zeland, the public debt (74 % of GDP in 1987) has been halved and public expenditure has been significantly reduced in real terms.

In both countries, governments must explain, each year, how their budget proposals are consistent with the medium term strategy.

b) <u>Canada :</u>

In the eighties, the Canadian public debt hovered around 35 to 40 % of GDP. But the declining growth in the early eighties has entailed significant budget

[4] See IMF - Occasional Paper n° 225 by Teresa Daban, Enrica Detragiache, Gabriel di Bella, Gian Maria Milesi-Ferretti and Steven Symansky, Washington 2003.

deficits which culminated to 6 % of GDP in 1993. As a result, public debt increased markedly to 70 % of GDP in 1992.

These slippages led the Canadian Government to ask Parliament to adopt in 1992 the "Fiscal Spending Control Act" that established a nominal expenditure limit for 1992-1996. Furthermore, the government decided in 1995 to set up a "contingency reserve" to finance forecasting errors and unpredictable events. If not needed, the contingency reserve can be used to pay down debt. In 1998, the government committed itself to repay public debt which implied surplus budgets during the following two years. A contingency reserve of CAN$ 3 billion a year was to be used to pay down the debt.

This policy was successful : the cap on public expenditures was observed, the budgetary position shifted from a deficit of 5 % of GDP to a surplus of more than 1 % in 1999. The outstanding public debt was brought down from 70 % of GDP in 1994 to 52 % in 2000. Most of these improvements came from structural measures.

c) <u>Sweden :</u>

Following the recession of the early nineties, Swedish public finances had severely deteriorated. The deficit accounted for 10.5 % of GDP in 1994 and public expenditures had reached the record level of 65 % of GDP. Furthermore, public debt had doubled between 1990 and 1994, reaching almost 74 % of GDP.

The Swedish government issued a three-year-consolidation program with adjustment measures equivalent to 7,5 % of GDP to be implemented in 1995-1998.

Besides, the Swedish Parliament adopted a government budgetary plan on a four-year basis. Expenditure ceilings for the public sector were introduced.

Even though they have been in place for only a few years, these measures have produced remarkable results : the ratio -still very high- of public expenditure to GDP has fallen from 65 % to less than 53 %. Budgets have shown steady surpluses since 1998. The gross public debt to GDP ratio is forecast to decrease from 74 % in 1996 to below 51 % in 2003. This gives an idea of the magnitude of the adjustment implemented over the last seven years.

d) <u>the Netherlands :</u>

The Netherlands have a long tradition of carefully planned fiscal policy. In the sixties, the Dutch government had adopted a "structural fiscal policy" based on the principle that the budget deficit should be constant as a proportion of "trend GDP" (i.e. the potential growth that the economy can afford in the medium run without inflationary risks). The system performed well until the early seventies when the authorities substantially overestimated trend GDP which led to substantial increases in fiscal deficits. In 1982, the general government deficit reached 7 % of GDP. The government reacted and abandoned this trend GDP rule and adopted a multiyear deficit reduction target which had serious pro-cyclical drawbacks.

In 1994, the government returned to a structural policy (Trend Based Fiscal Policy). According to this policy, -which in essence has been maintained up to now- budgets establish specific ceilings (in constant prices) on public expenditures including social security for a four-year period. The secret of the success of this policy lies in the very cautious growth assumptions that underline the government budgetary proposals. When public revenues exceed forecasts (high growth periods), the revenue overshoot can be used in part to reduce taxes as long as the fiscal deficit remains below 2,25 % of GDP. If revenues are below forecasts (economic slowdown), the shortfall increases the deficit as long as it does not exceed 2,25 % of GDP.

These policies, very detailed and medium term oriented, have considerably improved public finances in the Netherlands. The deficit of 4.2 % of GDP in 1995 has shifted to a surplus of 1.5 % in 2000, while the outstanding public debt was reduced from 74 % to 56 % of DGP over the same period. The use of prudent assumptions and the improvement of the economic situation have obviously enhanced the process of fiscal consolidation.

e) United Kingdom :

The United Kingdom's fiscal policy was characterized by substantial deficits since the seventies (average of fiscal deficits : 3,3 % of GDP per year from 1979 to 1996, and more than 4 % in 1997). The authorities reacted by instituting discretionary restrictions which compounded budgetary procyclicality and harmed public investment.

Therefore, the government got the Parliament to approve in 1997, the "Code for Fiscal Stability" which encompasses the principles and rules which now govern public finances in the United Kingdom.

The essential objective of this policy is to reach a balance, over the cycle, between current revenues and current expenditures. As a result, the government is authorized to borrow only to invest ("golden rule"). Furthermore, the second rule (the "Sustainable Investment Rule") establishes that the public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level (i.e. in the order of 40 %).

This policy has produced positive results : the ratio of public debt has shifted from 43,7 % of GDP in 1996 to 31, 5 % of GDP in 2001. The deficit of 4.4 % of GDP in 1996 has given way to a surplus of 0,9 % in 2001. During this period, the structural balance has improved. British public finances have nonetheless deteriorated in 2002-2003 because of conjunctural reasons and because of increases in some public expenditure investments (education, health, transport).[5]

f) United States :

One knows the rather erratic fiscal performance of the United States and the "twin deficits" that have in the past -and also now- characterized the budgetary situation of that country. It is noticeable that the fiscal deficit reached 6 % of GDP in 1983 (around 5 % in 2003). The ratio of public debt to GDP has shifted from 25 % in the early seventies to 45 % thirty years later and continues to deteriorate.

This poor performance has led to rules-based pieces of legislation destined to reduce public deficits and to control the increase in public debt. The most publicised of these laws is the "Gramm-Rudman-Hollings Act" of 1985.

The US experience, in contrast to the ones described above, was not successful. Mandatory spending reductions imposed by the Act were ruled unconstitutional with regard to the separation of powers. In 1990, because of the war with Iraq, the President and Congress agreed to postpone balancing the budget (as prescribed in Gramm-Rudman-Hollings II). The 1990 Budget Enforcement Act has focused on nominal caps on discretionary spending over the period 1990-95. In fact, the improvement of US fiscal accounts from 1997 to 2001 was largely the reflection of the upswing in the economy. But spending limits established under the Budget Enforcement Act were systematically circumvented.

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These examples, except for the United States, show that a medium term fiscal policy is not only possible, but most often effective as long as Parliaments and governments display a clear political will.

One can add that the fiscal improvements resulting from these policies have not, in the medium term, harmed the economic situation of the countries concerned.

[5] The "Golden Rule" could be seriously breached according the National Institute of Economic and Social Research (Financial Times, Jan. 30, 2004).

On the contrary, structural adjustment measures have had positive effects on potential growth.

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III. How can one assess EMU's fiscal rules ? Are they adequate or should they be amended ?

We have seen that EMU is no exception as far as fiscal frameworks are concerned. Many countries have adopted similar -or stricter- rules that most often have been successful.

There is an additional justification for a fiscal framework in a monetary zone. As monetary policy is, by definition, common to all members of the Union, fiscal policies must be consistent. If some members were allowed to run high deficits, this would entail consequences for the whole Union, all the more so if the slippages came from countries carrying a significant economic weight. Systematic deficit spending eventually leads to higher prices and interest rates, and therefore distorts economic and financial conditions in the Union. So, besides national reasons that justify prudent fiscal policies, there is a need for members of a monetary Union to behave consistently and in a mutually responsible way. This implies solidarity and the respect by all of common rules.

Given the November 2003 crisis, one has to examine the question : are the fiscal European rules adequate or should they be changed ?

1. The thrust of European fiscal rules :

European norms are the combination of the Maastricht Treaty rules (signed on February 7, 1992) and those laid out, later on, by the Stability and Growth Pact (June-July 1997).

One should analyze how these rules complement each other and what are their respective justifications.

The Maastricht Treaty rules (fiscal deficits must not exceed a limit of 3 % of GDP, and public debt should not exceed 60 % of GDP) should be related to the history of EMU : the main objective, in the early nineties, was to determine the accession criteria for the future members of the Monetary Union. Some countries like Spain, Italy or Greece, were running, at the time, fiscal deficits well above 3 % of GDP. The norm was intended to encourage them into the convergence process. As for the countries whose public debt exceeded 60 % of GDP (Italy, Belgium…), the Treaty called on them to rein in their deficits (below 3 %) so that they could gradually, but visibly, come back to the 60 % norm.

Given the growth and price environment prevailing in Europe, those limits are internally consistent. They had the merit of laying out a simple framework for convergence which, eventually, has been a great success. Let us not forget that Southern European countries have all, eventually, managed to meet the Maastricht criteria and to join EMU.

The creation of the euro in 1999 has led to a common monetary Union in Europe. This has eliminated the nagging problem of exchange rate fluctuations among members of the Union. In turn, this has led to an intensification of trade relations within the zone and to the almost elimination of interest rate differentials which used to penalize the countries perceived by the markets as too far away from economic convergence.

The Stability and Growth Pact -which lays out the procedure of "excessive deficits"- should be understood in a different perspective. Its objective is not intended to establish accession criteria but to determine the rules which, in the medium term, will ensure that member-states fiscal discipline will be pursued after the accession and the creation of the euro. It is in this context that the Pact prescribes that member-states must reach a balanced fiscal position over the cycle.

2. The Stability and Growth Pact rules and their implementation :

a) The rules :

The argument in favor of a medium term balanced fiscal position is well known : during recessions, fiscal balances tend to deteriorate (less revenues while social spending increases). The Pact allows these "automatic stabilizers" to operate within the limit of - 3 % of GDP. During expansionary years, the upswing in the cycle improves budgetary conditions for symmetrical reasons : then the stabilizers lead to fiscal surpluses. Over the whole cycle, the budget position is close to balance.

In order to enforce this fundamental rule, the Pact has planned a very precise set of procedures :

- EMU member-states must present a medium term stability program (the targets are updated every year) ; these programs are the basis for the multilateral surveillance exercised by the Council of Ministers ;

- in case of slippage, the Council can address a recommendation to the interested member-state ; this recommendation can be made public ;

- if the fiscal deficit of a member-state exceeds the limit of 3 % of GDP, the "excessive fiscal deficit" procedure is triggered. In such a case, the Council sends to the interested member-state a recommendation to take the appropriate measures in order to put an end to the "excessive" deficit. If the state does not conform to the recommendation or does not take the remedial measures, the Council may decide to take sanctions again the member (constitution of a non-interest bearing deposit and, if the "excessive" deficit has not been corrected in the two following years, the deposit may be converted into a fine).

b) <u>Their implementation :</u>

Ireland (who was criticized for reducing its taxes and for increasing its public expenditure at a time of overheating, although the country was running a fiscal surplus) has been the object of a recommendation by the Council in 2001 to improve its policy mix.

Portugal (whose fiscal deficit was estimated at 2,2 % in 2001 which exceeded the stability program of this country) did not receive a formal recommendation by the Council contrary to a proposal by the Commission. But, the fiscal position of Portugal further deteriorated (the 2001 deficit was revised at 4,1 % of GDP) and the Commission -while underlining that the slippage was not caused by a severe recession- triggered the "excessive deficit" procedure. The Council followed this proposal in November 2002. Portugal was invited to bring its deficit under the limit of 3 % of GDP in 2003.

Concerning Germany (whose fiscal deficit had reached 2,7 % of GDP in 2001, thus significantly exceeding the revised objective of its stability program), the Commission had proposed, in February 2002, to engage the early warning procedure. But the German government having committed itself to respect the 3 % limit in 2002, the Council did not go along with he Commission's proposal. In fact, the German fiscal deficit in 2002 reached 3,6 % of GDP under the influence of the slowing down of the economy. Therefore the Council, in January 2003, -under the "excessive deficit" procedure- issued a recommendation inviting Germany to take the necessary measures to bring the deficit under the 3 % limit. In fact, because of a worsening of the economic environment, the deficit further deteriorated in 2003 (estimates : - 4,2 %) which has led the Commission to propose strict recommendations and sanctions. It is well known that the Council decided, in November 2003, to "suspend" the procedure concerning Germany as well as France.

France, for its part, had been the object of an early warning procedure in January 2003, because it had exceeded in 2002 the targets laid out in its stability plan (-2,7 % instead of - 1,4 %). Like in Germany, the French economic situation had deteriorated : the fiscal deficit for 2002 was revised at - 3,1 % and is estimated at - 4,2 % for 2003 (Commission's estimates, January 2004).

In the meanwhile, according to a decision taken by the "Eurogroup" at the end of 2002, the EMU members states (including Germany and France) had committed to reduce their structural deficits by at least 0,5 % of GDP per year from 2003 onwards (2004 for France).

In this context, with an economic growth forecast of 1,7 % for 2004, the reduction in the structural deficit that has been accepted by the French government is to reach 0,7 % of GDP (the Commission wanted 1 %) which would result in a nominal deficit of 3,5 % of GDP in 2004. For 2005, with a growth forecast of 2,5 %, the reduction by 0,6 % of the structural deficit in terms of GDP would lead to a nominal deficit slightly below the 3 % limit (2,9 % forecast).

Germany, on the other hand, has accepted to reduce by 0,6 % of GDP its structural deficit and, like France, has committed to rein in its fiscal deficit under 3 % in 2005. Progress made by these two countries will be examined on a six month basis.

This episode shows, in sum, that neither the Council nor the Commission have wished to take the risk to endanger the present nascent recovery by tightening too severely fiscal policy (the differences between the Commission and the two member-states regarding the reductions of structural deficits for 2004-2005 are, in fact, rather modest). The real problem is therefore not so much a legal matter. It lies in the insufficient redressment of the fiscal positions of these two countries during the previous years of growth and in the behavior that has characterized the relationship between governments and Brussels on budgetary subjects.

c) <u>How can one assess the Stability and Growth Pact fiscal rules :</u>

In the present environment, given the lawsuit engaged by the Commission in the Court of Justice of Luxembourg to question the legality of the Council's decision to "suspend" the sanctions recommended by the Commission, it seems appropriate to try and evaluate, in the light of experience, the fiscal rules of the Pact and their implementation :

- ***as far as the <u>fundamental</u> <u>objective</u> of the Pact is concerned, its validity seems well founded :***

Requiring European States <u>to ensure a fiscal balance over the cycle</u>, seems, indeed, a prudent rule. Some could object, nonetheless, that such a rule would tend to lead in the long run to an elimination of public indebtedness (because of the positive trend for GDP growth), which would have an unnecessary restrictive effect on the economy and would hamper an optimal allocation of savings. To this argument -that has some validity in theory- one can object, however, that European countries fiscal horizon is so clouded by the consequences of demographic changes on long term public commitments that it is only prudent to try and build some margins for future, inevitable, increases in indebtedness. In this respect, requiring an "over-the-cycle fiscal balance", as laid out by the Pact, especially for countries whose public debt exceeds 40 to 50 % of GDP is, for the future, a good house-keeping measure[6]. Many are the countries who, outside EMU, abide by such rules.

- ***as far as the processes and their implementation are concerned, several suggestions can be made :***

<u>A. Automatic stabilizers should operate both ways :</u>

It is normal that, within certain limits (and in this respect, the 3 % reference is an acceptable order of magnitude, even if it implies an inevitable element of arbitrariness), fiscal deficits deteriorate when the economy slows down. But what is not normal, is that in periods of growth, the additional revenues are not used to reduce deficits significantly more than has been the case in the past for a number of member states.

France and Germany are typical "counter-examples" as the following table shows :

		1998	1999	2000	2001	2002	2003 (estimates)
France	GDP growth	3,5 %	3 %	3,4 %	2 %	1,2 %	0,2 %
	Public deficit/ GDP	- 2,6 %	- 1,8 %	- 1, 4 %	- 1,5 %	- 3,1 %	- 4,2 %
	Structural deficit/ GDP	- 1,6 %	- 1,2 %	- 1,6 %	- 1,7 %	-3,0 %	- 3,0 %
Germany	GDP growth	2 %	1,8 %	3 %	0,8 %	0,2 %	- 0,1 %
	Public deficit/ GDP	- 2,2 %	- 1,5 %	- 1,4 %	- 2,8 %	- 3,6 %	- 4,2 %
	Structural	- 1,4 %	- 0,9 %	- 1,4 %	- 2,6 %	- 2,6 %	- 2,3 %

[6] On the fiscal impact of aging populations , see Peter S. Heller :"Who will pay ?" (IMF 2003).

	deficit/ GDP						

Thus, over the whole cycle (1998-2003), these two countries, far form reaching a "position close to balance" as required by the Pact, have respectively accumulated 14,6 % (France) and 15,7 % (Germany) fiscal deficits in terms of GDP. The basic idea of any "discipline oriented" fiscal framework, i.e. that economic expansion should lead to significant fiscal improvement, has not been applied by the largest member-states of EMU. The heated debate that took place in France a few years ago, on the use of revenue surpluses (the "cagnotte" or "kitty"), shows how the authorities and the general public are still far from reaching an informal consensus on this crucial subject[7].

The more virtuous example of Spain helps to understand how the cycle can be used, in fiscal terms, without endangering economic growth.

		1998	1999	2000	2001	2002	2003 (estimates)	2004 (forecast)
Spain	GDP growth	4,3 %	4 %	4,1 %	2,7 %	2,6 %	2,8 %	2,9 %
	Fiscal balances	- 0,6 %	- 1,2 %	- 0,8 %	- 0,1 %	- 0,1 %	0	+ 0,1 %
	Structural positions	- 2,3 %	- 1,0 %	- 1,3 %	- 0,4 %	+ 0,2 %	+ 0,5 %	+ 0,4 %

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The experience described above shows that the 3 % Maastricht criteria has been misinterpreted. Far from being a target, below which governments would feel comfortable, the limit should only operate "in bad weather". It is during periods of growth that EMU member-states should -better than has been achieved in the past-, reduce deficits or generate surpluses. Letting the automatic stabilizers operate both ways should become an obligation (see, for example, the case of the Netherlands described above). In this respect, the deficits incurred by France from 1998-2000 -years of strong growth- compound the present fiscal situation and have made it all the more difficult to rein in imbalances in years of declining activity, because margins of maneuver have not been built during the "good years". In other words, it is during the periods of expansion that fiscal surveillance should show its muscle, more than in times of recession.

[7] If public Administration were to compute -as corporations do- the total amount of their contractual liabilities and those that will be contracted in the future in the field of pensions, one would observe figures of total liabilities (net of contributions) much higher than those reflected in usual indebtedness statistics. This is not too serious a problem in a situation of constant demography. But with aging populations, wisdom requires to compute and provision these future spending obligations (see Peter Heller).

B. Structural deficits should be reduced :

Hence, at the end of 2002, the Commission has given more importance to the cycle in its proposals to adapt the Pact. It has stressed the need to let the stabilizers operate symmetrically. In this respect, it has proposed an annual target to reduce structural deficits, which is indeed the only proper way to implement the medium term stability objective. Table IX shows that, except for Japan and the Untied States, France runs the highest structural deficit among OECD countries (- 2,9 % of GDP in 2003). It is therefore indispensable to engage in a policy geared to the reduction of those deficits. This is of the essence, not only for the sake of the Pact, but for the future of the French public finances and the ability of the country to face the challenges for growth and employment in a open and non-inflationary environment.

C. It is necessary to better adapt fiscal policies to the nature and the sources of the problems experienced by different members-states :

This case by case adaptation is, in principle, taken into account in the national stability programs. But this endeavor should be more systematically followed up by the Union. The recommended fiscal adjustments should be more "tailor-made" and influenced by factors like the level of public debt or the burden of public spending (current versus investment) of individual member-countries.

Thus, a country like France which is characterized, as shown above, by a very high level of public spending and taxation, should decisively engage in reducing public expenditures and taxes and improve the efficiency of public administration.

Countries like Italy, Belgium, Greece who have very high levels of public debt (respectively in 2003 : 106,4 %, 103,5 % and 100,6 % of GDP) well beyond the European average, should also be required to carry out a more significant reduction of their structural deficits.

D. One should shape the fiscal strategy in a longer term demographic perspective :

The aging of European populations is bound to increase the burden of pensions and healthcare. These impacts and their timing vary from country to country. For example, table X, computed by the Ecofin, shows that in the "heaviest" year of the central scenario -2030 for France and Italy, 2040 for Germany, 2050 for Spain- the public expenditure "overruns" vis a vis 2000 stemming from pensions alone, will be, on average, of a magnitude of 4,5 % of GDP for that group of countries (4 % for France, 5 % for Germany)….

If structural reforms (lengthening of retirement age, reductions in entitlements, pension schemes…) cannot, by themselves, resolve all the problems, it is prudent to consider that the public finances of those countries will have to make some additional contribution. This means that it is imperative to "mend" fiscal policies well ahead of the most critical years, so that, when times come, debt sustainability is not put in jeopardy.

Therefore, taking into account -as countries like Australia, New Zealand and United Kingdom do systematically- the demographic evolutions on the long run is an indispensable exercise. This would perhaps facilitate the educational process aimed at getting public opinions better aware of the need for medium term fiscal discipline.

E. Lastly, European budgetary discussions should be "depoliticized" :

On several occasions, as has been shown above, the Commission has, without success, recommended to the Council of Ministers to trigger early warning procedures.

The events have shown that the Commission had been right and that, because of the more "political" stance of the Council, fiscal situations had been allowed to deteriorate. Had the Commission been followed, fiscal corrective actions might have been taken earlier and the Pact would have been better observed.

With hindsight, it appears also that member-states have often based their budgetary projections on too optimistic growth assumptions. This bias affects the European procedures. One should pay much more attention to this issue. A "rule of prudence" should be established and followed up meticulously (perhaps by a group of independent experts).

Lastly, member-states should not consider the Stability and Growth Pact as a sort of external imposition. They have all approved the Pact and should, therefore, feel responsible of its implementation. A number of democratic states abide, on a voluntary basis, by similar (and more often stricter) rules. It is time that governments and parliaments make those rules really "theirs" and, if needed, adapt them to their own situations as long as this "personalization" doesn't weaken the Pact (see, for example, the case of the Netherlands where rules are stricter than those of the Pact).

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In sum, the Maastricht and Stability and Growth Pact rules are, in no way, specific to Europe. They are in line with a worldwide trend that is justified by the need to correct decades of fiscal slippages. The experience of countries that have been particularly successful in this effort should be usefully exploited.

Perhaps the five suggestions above could provide some "adaptation" to present procedures. This might help to get out of the present deadlock and to make the process more efficient and better understood. But it is no way a call for putting the system in question. Far from seeking to change well founded rules when they appear uncomfortable, it is necessary -for the stability and consistency of EMU as well as for the future growth of the member-states themselves- to implement those rules along the cycle with impartiality, vigilance, steadiness and intelligence, taking into account the nature and seriousness of the problems of each country. These issues should not become the object of legal or judiciary confrontations, but should be dealt with constructively in a spirit of impartiality and political consensus.

This is not a debate between "monetarists" and "keynesians". The issue is to repair a crucial instrument of economic policy, the fiscal one, which has been spoiled by more than twenty years of laxity. Indeed, this tool has been abused and overextended leading to worrisome indebtedness and heavy spending and taxation rates in many countries. As one of the best French authors of public finances, Levy Mirepoix, wrote in 1819 :"The ancient proverb says that the revenge of Gods slowly follows the crime but, in the end, catches up with it. As far as indebtedness is concerned, vengeance does not hobble along, it gallops to clamp down on the culprit".