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**Article**

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## A REFORM OF THE STABILITY AND GROWTH PACT?

### PRO: THE STABILITY AND GROWTH PACT SHOULD BE REFORMED

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The fiscal framework for the European Union, of which the Stability and Growth Pact (SGP) is a central part, is in a crisis. Two large euro-area countries, France and Germany, have clearly violated the three percent deficit limit of SGP and, according to the rules, the excessive deficit procedure with a recommendation for corrective measures in 2004 was initiated. However, in November 2003 the Ecofin Council voted against following the recommendation of the Commission to give notice to correct the deficits. A different and also serious problem of SGP has been the recent news that Greece reported blatantly false statistics in order to become a member of the euro area.

These two instances and the fact that several other EU countries also have fiscal deficits close to or above the three percent limit provide clear evidence that the SGP is not functioning properly. Fiscal developments since the start of the euro have been significantly worse than during the run-up to the euro, and the inability of Ecofin to initiate sanctions against violations of SGP are strong evidence about faults in the design of the SGP. Evidently, the SGP has not provided sufficient incentives for Euro area countries to continue improving their fiscal situations. In particular, the inability of Ecofin to enforce the SGP rules shows that probably the biggest problem is lack of ex-post rule enforcement, which in turn undermines the future of the entire pact. A political process for sanctioning is clearly inadequate.

These developments show that there is grave danger for the disintegration of the EU fiscal framework. It is quite possible that in the future the SGP rules will

not be respected and fiscal decision-making gradually becomes dominated by a highly politicized and discretionary system. This would not be a good outcome. There are good reasons for having some form of control of fiscal developments, since high public debts and fiscal deficits are a threat to monetary and financial stability. It seems desirable to attempt to improve the design of the SGP rather than to wait and see how the disintegration of an unchanged SGP gradually worsens.

#### Key principles for reform

There is no shortage of proposals for reforming the SGP. A problem with many of the suggestions is that they do not get at the heart of the current problems, namely the lack of rule enforcement and the missing incentives for enhancing fiscal stability.

The 2002–2004 Annual Reports on the European Economy by the European Economic Advisory Group at CESifo (EEAG) have outlined key principles for reforming the SGP. These are (i) a greater emphasis on the level of public debt, (ii) strengthening of the enforcement mechanisms in the SGP and (iii) strengthening of incentives for responsible fiscal policy at the national levels. Similar suggestions have come from other people as well.

As regards principle (i), the key idea is to allow for greater fiscal flexibility and higher deficits for countries that have low levels of public debt. This reform would introduce new incentives to lower public debt for EU member countries. These incentives existed in the run-up to the euro but have largely vanished with the low levels of interest rates after convergence. Principle (ii), improving enforcement of rules, is the most difficult part in reforming the SGP. EEAG has proposed that decisions on the applica-



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tion of the excessive deficit procedure should be made at a judicial level, i.e., the European Court rather than by a political body, the Ecofin Council. With respect to principle (iii), there are several possible ideas. The goal is to provide incentives for both fiscal discipline and improving the use of fiscal policy for stabilization by means of a transparent framework with clear medium-term targets, stabilization objectives and clear operating procedures.

The general objective in a reform of the SGP should be continued effort to have an improved rule-based system. This is important since fiscal decision-making is political by its nature. Discretionary policy-making can lead to large fiscal imbalances and debt, which in turn can threaten the euro system itself.