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BENOÎT COEURÉ and JEAN PISANI-FERRY

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Towards a Sustainability and Growth Pact?

***Benoît Coeuré*[*] *and Jean Pisani-Ferry*[**]**

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Pact – we dub it SGP2 – relies significantly less on fixed rules and leans more towards discretion. What it will achieve therefore depends on its governance. Provided decisions are not driven by political horse-trading, a dose of flexibility would be welcome to help addressing the main challenges Europe is confronted with: ageing, enlargement and economic reform. To this end, we propose five building blocks towards an effective SGP2:

- *A better concept of sustainability*. We suggest that the Pact should focus on broader concepts than the current ones and propose to chose the net value of the government sector, i.e. the difference between its total assets and financial liabilities (excluding, at this stage, implicit liabilities such as commitments resulting from pension regimes);
- *Harmonised general government balance sheets.* The Maastricht accounts are incomplete. Eurostat should define an accounting framework for the publication of general government balance sheets, including assets, financial debt and information on implicit liabilities. Specifically, we suggest to add to those accounts the present value of Age-Related Net Implicit Liabilities (ARNIL);
- *Appropriate targets*. We propose that each government should target the net value of the government. We outline a method for taking into account implicit liabilities (ARNIL) in the determination of the target. Our main point is that countries with high ARNIL should set higher targets for the net value of the government;
- *Refined procedures.* We propose that surveillance of national policies be based on a set of measures consisting of a fiscal plan, a reform plan and a contingency plan. Thus, a more ambitious reform plan that has the potential of permanently increasing output and/or decreasing long term public deficits could justify a less ambitious fiscal plan in the short run;
- *Better institutions.* We do not support handing over the responsibility for fiscal policy to independent committees, but we support the creation of independent fiscal audit councils.

I. INTRODUCTION

The European Union has become a playground for experiments on the effectiveness of, and the frameworks for, fiscal policy. There are two reasons for that. First, while fiscal stabilisation has almost everywhere taken a secondary role to monetary policy, the European Economic and Monetary Union (EMU) combines a single monetary policy with national, independent fiscal policies that constitute the only macroeconomic instrument available at the country level. Second, the Europeans have put in place in the name of fiscal discipline a quasi-constitutional framework that goes a long way towards constraining the discretionary leeway of national governments.

The whole European discussion since the start of the EMU negotiations in the late 1980s (or even since the 1970 Werner committee report which blazed the trail for European monetary union) has thus been about the right balance between two contradictory aims: to ensure that national governments are not deprived of any significant macroeconomic stabilisation instrument to offset asymmetric shocks, and to ensure that they do not take advantage of the single currency to free-ride on collective discipline and build up mutually harmful, unsustainable fiscal positions.

The European fiscal framework has been in operation since 1999. It was designed in 1991 for inclusion in the Maastricht Treaty[1], refined in 1997 with the creation of the Stability and

II. REQUIREMENTS FOR THE EURO AREA'S FISCAL FRAMEWORK

The key features of EMU are well known (see *e.g.* Wyplosz, 1997 for an introduction). The countries that take part in it are economically diverse – and will become even more diverse as the eurozone enlarges. They have achieved a high (though not complete) degree of integration of their markets for capital and goods. Their services and, especially, labour with the choice between accommodating the build-up of public debt in a

2005). After all, a central bank is not a fiscal watchdog. In November 2005, the ECB reminded the market that it would restrict its eligible collateral to securities rated at least “A^{-}” by rating agencies, thereby

"shoulders against the wall" environment, reforms tend to be comprehensive and frequently involve a budgetary consolidation. Second, reforms can also be undertaken in better times and in a more gradualist fashion; in that case, fiscal support can be necessary to offset the macroeconomic costs, compensate the losers, and avoid building up judgement on the fiscal framework and its possible reforms must be based on these criteria.

With these conclusions in mind, we turn to the assessment of the achievements so far.

III. A RECAP ON FISCAL POLICY IN EMU

In this section, we survey fiscal policy in EMU since 1999 and assess the effectiveness of the Stability and Growth Pact. We then summarise the main proposals for reforming it, and the reform package agreed upon in March 2005 by the European Council (a more detailed discussion can be found in Pisani-Ferry, 2005).

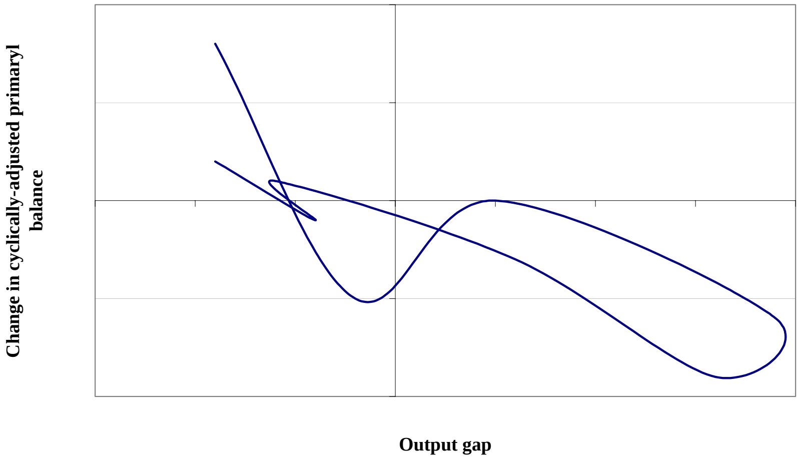
The Failure of SGP1

Germany, France and Italy bear most of the responsibility. Buti and Pench (2004) have identified four reasons why: proactive fiscal policies are thought to be more efficient in larger, relatively less open economies; potential growth is lower in these countries, making fiscal adjustment more difficult; peer pressure does not impress larger countries too much; and all three delegate fiscal responsibility to their Finance minister rather than building consensus at a cabinet level, making fiscal adjustment more difficult to enforce.

It has also been noted that many member countries have used loopholes in the European system of accounts to reduce the deficit reported to Eurostat rather than actually decrease spending, using "innovative" one-off transactions such as securitisation, financial derivatives, one-off payments by State-related entities, etc. We come back to this issue later.

The Pact eventually became dysfunctional when it appeared that the

Figure 2: The fiscal stance of the Eurozone



Source: European Commission, AMECO database

Finally, the Stability and Growth Pact did not help eurozone countries increase their long-term growth rate, in accordance with the goals of the Lisbon Summit of 2000. By treating all expenditures the same way, the Pact may have created a bias against public investment at a time where Europe should have increased its capital/labour ratio to catch-up with the US. It can be argued however that there is no clear evidence that Europe lacks public (as opposed to private) investment[14], and that the choice between current spending and investment is not changed by the Pact. Less directly but perhaps more importantly, by constraining fiscal policy in the short term, it has contributed to reinforcing the governments' myopia and has added to the difficulty of structural reforms, as these reforms tend to imply short-term macroeconomic and budgetary costs.

Ownership and Incentives

Why has SGP1 failed? Part of the explanation is certainly that it was poorly designed. Critics (Pisani-Ferry 1996, Eichengreen and Wyplosz 1998) pointed out early on the risks of a Pact focussed on headline rather than structural deficits, of the neglect of debts, or of the rough definition of the "extraordinary circumstances" (*i.e.* recessions) which could exempt excessive deficit countries from financial sanctions. All that proved to be true. But a more fundamental flaw proved to be the lack of incentives to comply with the spirit of the Pact and the lack of ownership of it in the main eurozone countries. In France, Germany or Italy, the Pact has not really been appropriated as a key feature of the fiscal policy framework. To the extent it has, it was more with reference to the 3% threshold than through the commitment to the "close to balance or in surplus" target. At

[14] As Jakob von Weiszäcker has pointed out to us, the lack of public investment in Germany has probably more to do with rising social expenditures than with any European constraint.

the peak of the cycle, the 3% limit gave rise to perverse incentives, as a deficit of 1.5% of GDP was considered safe and virtuous enough.

Furthermore, the very existence of the Pact may have discouraged the adoption of national fiscal frameworks such as the British "Code for Fiscal Stability" adopted in 1998. The focus of the discussion on the potentially harmful effects of fiscal laxity on a country's neighbours has distracted the policymakers' attention from generally more important issues such as the intergenerational redistribution involved in fiscal deficits or the composition of fiscal stabilisation. For example, in 2005 French Finance minister Thierry Breton could present the level and sustainability of public debt to the public as entirely novel issues.

The Importance of Government Balance Sheets

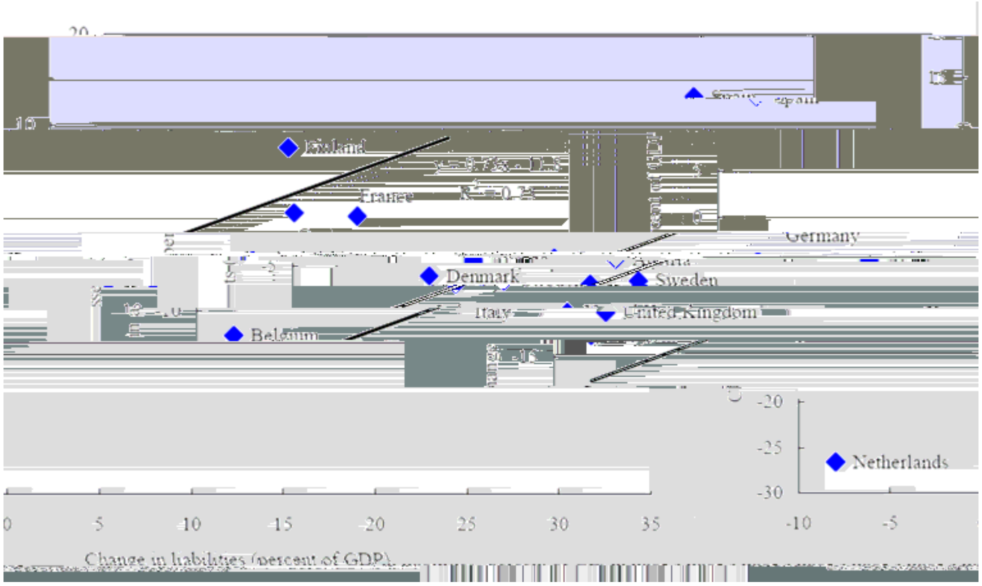
A less well-known feature of the Pact has been its focus on partial criteria such as deficit and debt, rather than on the full government balance sheet. Two topics deserve discussion here.

The first one is the notion of public finance sustainability. This raises issues of measurement. The literature on sustainability focuses on the balance between *net* government debt (*i.e.* financial debt less the value of financial and non-financial assets) and the sequence of future primary cash flows. Any notion of sustainability should therefore make reference to the structure of today's balance sheet and to future revenues or liabilities (see Buiter and Grafe, 2002, for an in-depth analysis of these issues).

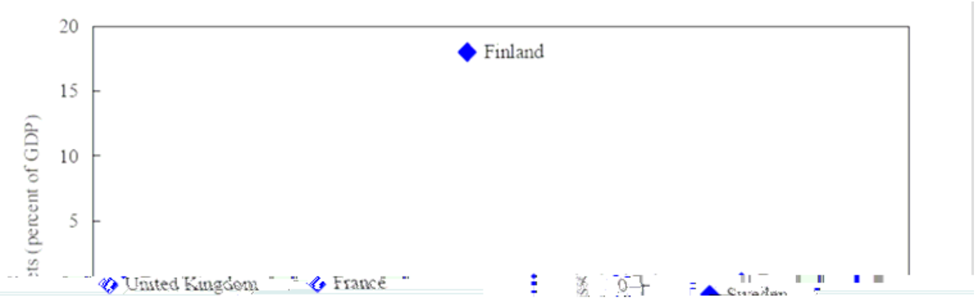
The other one is the increasing use by European governments of one-off revenue measures or of vehicles that allow spending without impacting the recorded deficit, leading to an increasing discrepancy between cumulated deficits and debt. This possibility had been pointed out at an early stage by Buiter, Corsetti and Roubini (1993) and the reality has exceeded expectations. Koen and Van Den Noord (2005) and Von Hagen and Wolff (2004) have provided evidence that one-off measures have been used more frequently since the inception of EMU and have proven that their probability has been correlated with the magnitude of the deficit. There have been outright disposals of public assets with the aim of lowering the gross debt (but without any improvement in the underlying net wealth). There have been more devious operations aimed at substituting on-balance debt for off-balance liabilities. Some countries have cashed in an immediate revenue in exchange either for additional pension liabilities (France Telecom and EDF transfers in France, postal pensions securitisation in Germany), or for lower future revenues (Italian, Portuguese or Greek securitisations). The former are mere balance sheet

The most elaborate attempt to investigate empirically the dynamics of EU governments' valuations was undertaken by Milesi-Ferretti and Moriyama (2004). In the absence of a harmonised set of balance sheet accounts for governments, they had to use yearly flows and to produce their own valuation of non-financial assets. They tracked the yearly changes in financial liabilities on the one hand, and in financial and non-financial assets on the other hand, and corrected for valuation effects. They uncovered a sharp contrast between the periods 1992-1997 and 1997-2002. In the first period, increases in general government liabilities were matched by changes in assets and the net value of governments was relatively stable. This was not the case in the second period (Figure 3): the SGP involved a perverse incentive to contain the rise in the gross public debt through asset sales, and EU governments were poorer in 2002 than in 1997.

FIGURE 3: Changes in Government Assets and Liabilities 1992-1997



1997-2002


ets (percent of GDP)
20
15
10
5
Finland
United Kingdom
France
Sweden

protracted period of low growth relative to the potential growth rate, giving in effect member countries an extended deadline to correct their excessive deficits. When the deficit is marginally above 3%, the Commission will also take into account what is called in the treaty ‘other relevant factors’, a modest term for a host of possible exemptions such as R&D expenditures, development aid, or else the financing of European (read: German) unification.

The Council also emphasised the need to associate national Parliaments more closely, and to improve the reliability and timeliness of budgetary forecasts and statistics. The Commission’s initial proposals, to build stability programmes based on Commission forecasts and to establish independent monitoring bodies, were rejected.

The main features of ‘SGP2’ are the new emphasis on public finance sustainability, and the added flexibility given to member countries in economic slowdowns (see Box 1). The most important change may be in the governance of the Pact. First, a consensus has emerged to give to the Commission the right to bark and bite, *i.e.* to send an early warning to a member countries without the approval of the Council[16]. This is a welcome step towards distinguishing assessment from decision. Second, with SGP2, the eurozone has moved aw

IV. Towards a "Sustainability and Growth Pact"

What should a sensible *modus operandi* of SGP2 look like? In our view, it should (a) reconcile long-term sustainability and short-term stabilisation; (b) approach sustainability in a way which is economically sound and does not give too much leeway to political discretion; and (c) foster, or at least avoid to discourage, growth-enhancing economic reforms. While fulfilling these requirements, it should also be instrumental in helping the eurozone face its current priorities.

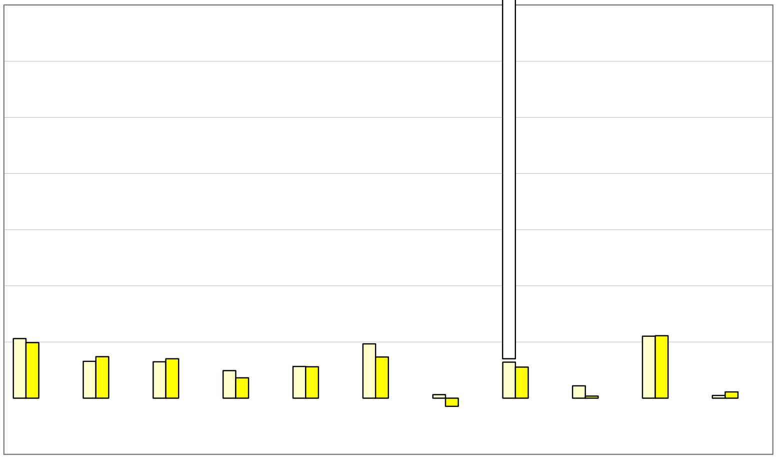
In the remainder of this paper, we elaborate on our previous work (Coeuré and Pisani-Ferry, 2005) to make the case for a "Sustainability and Growth Pact" which would meet these requirements, and we sketch out its main building blocks.

Present Priorities

The eurozone faces three priority challenges: ageing populations, enlargement, and the need for growth-enhancing reforms. A Sustainability and Growth Pact should help on all three fronts.

Ageing. According to the UN, the share of the working-age population in the total population will fall from 66% in 2005 to 56% in 2050 in the four big European countries, while it will only decline from 67% to 62% in the US. The additional burden of pensions, health and long-term care will be only partially offset by lower education costs and, possibly, reduced unemployment benefits. This will have immense consequences on Europe's economic performance and public finances.

FIGURE 4: General Government Debt Trajectories in the Absence of Fiscal Consolidation, 2004-2050



Source: European Commission (2005)

The best source so far for assessing the magnitude of the problem is the report by the Economic Policy Committee working group on ageing (Economic Policy Committee, 2003, hereafter "AWG")[17]. According to the working group, public spending will increase by 3 to 7% of GDP in most member states by 2050 if no corrective action is taken[18]. The working go(h)-7i7.000.6

The relevant scope should be the general government (*i.e.* central government, local government and social security), as has been the case since the Maastricht Treaty, because most countries have organised transfers between government sub-sectors, and because all government entities are by definition funded by taxes. It would in theory make sense to include the national central bank to account for seigniorage revenue, but within EMU we can make the assumption that seigniorage does not depend on government policies.

The relevant state variable should be the net value of the government sector, *i.e.* the difference between its total assets and financial liabilities (excluding implicit liabilities). This is the closest equivalent to a company's equity. Non-financial government assets are known to be difficult to define, inventory and value: think of the Tower of London or the North Sea oilfields. They are frequently non-marketable, and when they are, valuing them on the basis of their future cash flows or of their liquidation value makes quite a difference. However, no sound fiscal policy can ignore the proper management of the government's balance sheet, and as already discussed, monitoring gross debt creates an incentive to hold a fire sale of puis isassets 349wkn0.000-5(h)5ffeggreg tie-5 -5 -5-6.1(

present Treaty since it is only another, economically more sensible, way of interpreting the “close to balance or in surplus” requirement.

Accounts

EU statistical institutes currently produce a set of quarterly and annual national accounts, and they release general government deficit and gross debt numbers on a yearly basis. They should be required to produce a limited number of government balance sheet items such as a breakdown of financial debt (distinguishing credit lines, bills and bonds), financial assets (distinguishing gold, cash, equity, and loans) and non-financial assets (including real estate)[23]. Accounts should be audited by Eurostat or by private auditing companies.

This is less heroic than it sounds. Several EU governments are publishing or are committed to publish their assets and liabilities under international accounting standards, following pioneering countries outside the eurozone (notably, New Zealand, Australia, the US, the UK and Sweden). France will publish an opening financial statement as of 1/1/2006. Table 2 gives an example of such a balance sheet, in national accounting (which may slightly differ from private accounting). The French general government “equity”, *i.e.* its net value, was €308bn or 19.4% of GDP as of 31/12/2003.

In addition, the EU should build on the AWG work and agree on a

governments can be supposed to have permanent access to financial markets. V could in principle be negative since it can be backed by a sequence of future surpluses. In the absence of a normative theory of government balance sheet management, in view of the illiquidity of a large part of the government assets and to provide a safety margin, it is safer to take V to be positive.

To set these parameters, further empirical calibration based on actual numbers would certainly be required. Here, we make an illustrative back-of-the envelope numerical application in the French case, where the assets and liabilities figures are available as of 31/12/2003. The ageing working group expected age-related costs in France to go up from 26.4% of GDP in 2003 to 30.5% in 2050 (Economic Policy Committee, 2003). We take 2% for the discount rate – note that since age-related costs are measured in proportion to GDP, the discount rate is commensurate with the difference between the equilibrium real interest rate and the growth rate. Assuming that the costs are stabilised from 2050 onwards, the AWG projection implies that ARNIL was equal to 155.4% of GDP at end-2003. With V = 0, λ = 0.25 and θ = 0.5, we find V*2008 = 34 % of GDP against V2003 = 19.4% (Table 2). The unambitious target of a zero net value of the government would thus imply an adjustment of almost 3% of GDP per year in the period between 2003 and 2008!

Obviously, the results depend on the parameters. This is an unavoidable consequence of working with present values (as illustrated by the current debate on the burden of corporate defined-benefits pension phepec-5.46(t)-5.1Tc0.eWith

Á The reform plan would underpin the growth trajectory beneath the fiscal plan. It would resemble the existing “national reform plans”, but with a stronger link to budgetary policy. An ambitious reform plan that has the potential to permanently increase output could justify a less ambitious fiscal plan. Every year, the Commission would review the implementation of the plans: countries that breached their deficit target would be expected to be warned, and eventually sanctioned, especially if they also failed to deliver the promised reforms.

Á The contingency plan would describe how budgetary policy would respond to shocks – good and bad, such as an unexpected increase in tax revenues or a recession. It would expand on elements that have been introduced in the stability prog

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and let ARNIL be age-related net implicit liabilities:

(8) $ARNIL_t = -\sum_{i=}^{+\infty} \quad + r \quad ^{-i} S_{t+i}^{a}$

Sustainability can now be written: (9)

$$V_t \quad \geq V_t \quad = ARNIL_t - \sum_{i=}^{+\infty} \quad + r \quad ^{-i} \left[S_{t+i}^{na} - rA_{t+i-} \quad \right]$$

The sustainable net value is the sum of two components: ARNIL, and the net present value of all other future expenditures, including the opportunity cost of holding government assets rather than buying back debt.