9. A credible Stability and Growth Pact: Raising the bar for budgetary transparency

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While the Stability and Growth Pact had good intentions, it failed because nothing happened when governments broke the rules. This essay proposes an enhanced Pact with increased fiscal transparency, an independent committee of fiscal experts, and a 1% tax on new debt above the 60% debt-to-GDP ratio. This would redistribute the costs of running Europe from the countries that have their house in order to those that don't.

In a few short weeks this spring, the Greek crisis transformed the environment for monetary policy in the Eurozone. To stabilise the markets, the ECB was forced to accept Greek public debt as collateral, ignoring its abysmal credit rating; it even went so far as to purchase this debt outright. How the world has changed. Just a year ago, the ECB was the rock of stability while the US Fed was propping up value of dodgy securitised debt, and bailing out troubled financial institutions.

This raises the question: What can be done to save the ECB and the euro?

The crisis teaches us three things

- Excessive fiscal deficits and large public debts pose serious risks to monetary and financial stability in the Eurozone and elsewhere.

It is now clear that a large contractionary shock can push heavily indebted governments to the brink of default even though debts appear manageable in good times (Reinhart and Rogoff 2009). To ensure that the euro remains a viable currency in this new environment, debts must be reduced, massively in some countries.

- While the Stability and Growth Pact had good intentions; it failed because nothing happened when governments broke the rules.

Yet once this rule was broken, another stability-oriented rule paradoxically created the potential for instability. A sovereign default by Greece, forced by the no-bailout rule, would have risked another Lehman-like wave of credit freeze-ups, instability in the European banking sector, and spillover to global financial markets. Simply put, the no-bailout rule stands in direct conflict with financial stability objectives and is therefore not credible.

- Precisely because the no-bailout rule is ineffectual, we need much stronger mechanisms to limit public sector debt in Europe.

While the Stability and Growth Pact was originally focused on deficits, recent events have shown that limiting government indebtedness is the key to achieving a credible and sustainable level of monetary stability in the Eurozone.

Redesigning the Stability and Growth Pact

To redesign the Stability and Growth Pact, we need to understand why it failed. The main reason was a lack of scrutiny of EU governments' budget plans and outcomes. The Pact blithely assumed that governments were in control of their revenue and spending at all times, and that they would set aside short-term political considerations in the interest of long-run fiscal stability. Violations, it was hoped, would be obvious to all and swiftly punished.

But in practice, budget outcomes depend on the business cycle. Recessions are inevitably associated with declining tax revenues and increasing expenditures on the unemployed. It can thus never be absolutely clear whether an observed "excessive deficit" is due to unexpectedly weak economic conditions or lax budget plans. This is particular true since there is plenty of scope for fraudulent bookkeeping and dubious financial transactions that can hide the real size of the deficits. This lack of clarity made it difficult to hold governments accountable, and created moral hazard problems.

Enforcement is further complicated by the "we all live in glass houses" syndrome. Governments with deficits just below 3% have little incentive to enforce the rules, since they may soon find themselves on the wrong side of the limits. Simple lines in the sand are just not credible – a fact that became crystal clear when the Schröder and Chirac governments simply ignored the Pact in 2004.

Institutional reforms

To save the euro, we need a new Stability and Growth Pact that significantly increases fiscal transparency. And there must be a party willing and able to take governments to task when they break the Pact. This would involve a higher level of EU involvement in national budgetary affairs, so many members may reject this. Yet objective evaluation of national budgets is the only way to restore credibility to the Pact.

- First, national budget plans and fiscal accounts must be audited annually by extra-national, non-political European experts.

This does not imply a loss of sovereignty since no government would be forced to accept the recommendations given. But such audits would significantly strengthen incentives for politicians to keep their fiscal house in order.

A thorough and public review of fiscal policy by outsiders would be embarrassing for misbehaving governments. And the outcome of the review would be used for other purposes. For instance, the ECB could link the haircut it demands on collateral to such reviews and even decide not to accept debt of sinner governments. Agricultural support payments and other EU transfers could be made contingent on passing the reviews as well.

- Second, to implement this proposal, an independent committee of fiscal experts is necessary.

Such a "Fiscal Stability Board" would monitor fiscal developments in the Eurozone, vet governments' justifications of fiscal deficits, and assess – and publicly comment on – proposed consolidations. It must be small and manageable, composed of legal scholars, former senior central bankers, and academic economists from across the Eurozone. But it would also need to be taken seriously in the political sphere, so some ex-finance ministers must also be included.

- Third, to rein in government debt, the new Pact needs teeth. A tax or surcharge on public debt is one option.

Borrowing costs of Eurozone governments are currently artificially low because they do not reflect the bailout insurance implicit in Eurozone membership. We propose a 1% surcharge per year on *new* debt above the 60% debt-to-GDP ratio set by the Pact. A government that exceeds that limit by 50%, as Greece does today, would pay 0.5% of GDP per year. Such a surcharge debt does not infringe on sovereignty since countries could continue to borrow as they see fit.

We propose that tax should be imposed on new debt only. As an illustration, Greece's public is about 110% of GDP with an average maturity of 7.7 years. If debt of 14% of GDP is rolled over each year, it will take four years and three months before the 60% of GDP limit is reached and the surcharge applies. In the following year, it would issue 14% of GDP in new bonds and pay 0.14% of GDP in charges. Once all the debt has been rolled over, the full surcharge will apply.

- Who would get the revenue? We propose it be paid to the Commission, which would return the proceeds to Eurozone government in a pro rata rebate of their annual contribution.

Our proposal would thus simply redistribute the costs of running Europe from the countries that have their fiscal house in order to those that don't.

References

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