A Possible Reform of the Fiscal Policy Framework in the EMU

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(Notes for the CEPR Economic Policy Roundtable, Athens, 19-20 May, 2003)

I. *Introduction*

There is a lot of concern now about the violation of the Maastricht criteria by a number of nations and about the right way to apply the SGP. In my opinion, some reforms of the SGP would be desirable. There are two important roadblocks in the way of any simple application of the Pact. One is a basic shortage of macroeconomic policy instruments in the member countries of EMU. The other is a conflict between the SGP and the principle of subsidiarity. I will suggest a set of reforms dealing with both problems. As regards the first problem, I propose that we might consider an automatic transfer mechanism in the EMU to respond to asymmetric shocks. The proposal is not new. But the transfer mechanism I have in mind would be operated differently than the one that has been advocated in the past. Previously, such a mechanism was defended strictly on grounds of insurance (though, some supporters favored it also for reasons of cohesion). Instead, I would justify the transfer mechanism largely as an extra tool of fiscal policy. In this case, a different mode of operation suggests itself. As regards the second problem, concerning subsidiarity, I will propose two specific revisions of the SGP. Introducing this set of revisions would make the SGP more effective and easier to apply.

Let me begin with a general word about the idea of an automatic transfer mechanism in the EMU; next, explain the sort of transfer mechanism that I have in mind; following, elucidate the importance of reconciling the SGP with the principle of subsidiarity; and finally, go on to my proposed reforms of the SGP.

II. *Some history*

When discussion of a common currency in Europe began, one objection was that the member countries would lack an important element of protection that monetary unions usually possess in the wealthy part of the world. This is the automatic receipt of help from the rest of the monetary union by regions in difficulty through net transfers operating via the central government budget. The MacDougall report of 1977 famously advocated the introduction of a similar transfer mechanism in the European Community along with monetary union. But the relevant transfers in the West depended on a large central-government budget. At first, it was thought that the same would be true in the European Community: the Commission would require a large budget too. This posed a major stumbling block. However, the problem was soon shown to be false. If the system operated via direct horizontal transfers from country to country, like the *finanzausgleich* system in Germany, moderate payments would suffice to provide a high level of protection against asymmetric shocks. But another objection proved more difficult to put aside. Macroeconomic time series are highly correlated, even in first differences, and any viable system, whether based on unemployment or output (especially unemployment), would lead to predictable and systematic redistribution. In other words, the system would be impossible to base strictly on principles of insurance. This matters since there is usually major opposition to a new program of redistribution in the European Union.

III. *The proposed transfer system*

Yet a relevant transfer mechanism can also be seen as an additional tool of macroeconomic policy. The interpretation is correct: such a mechanism would furnish not only an added fiscal policy tool, but one that yields, de facto, a better mix of fiscal policies among the member countries. Countries in recessions relative to the average would receive payments from the rest, which they could then use to increase their public expenditures or lower their tax receipts. They could do so without adding to their deficit spending, and therefore without entering into conflict with the 3% ceiling in the Maastricht Treaty. On the opposite side, countries paying the transfers would need to raise taxes to avoid higher deficit spending and possibly in order to keep within the limits of the Maastricht Treaty. Even if these other countries borrowed rather than taxing to finance the transfers, they would not raise the aggregate demand for goods at home. Thus, the mechanism would shift aggregate demand over the EMU as a whole toward the countries in a recession relative to the rest.

If we view the transfer mechanism in this fashion as an extra tool of fiscal policy, and not merely as self-insurance, it is difficult to see why the aided countries should not incur debts to the rest, and why these debts should not be interest bearing as well. This would put the right face on the proposal: there would no longer be any pretence that everyone receives full compensation from the prospects of being on the receiving end in the future. Two provisos would help. First, the interest should be payable only once the debtor countries entered into an expansionary phase. Second, the debts and credits associated with the transfers should not count in applying the Maastricht criteria. More precisely, the receipts of the transfers should be considered as government income rather borrowing in applying the Maastricht criteria, and the payment of the transfers should be considered as public spending rather than lending in applying these criteria. The two provisos would enhance the desired shift of demand toward the countries in difficulty.

In effect, each country would then gradually acquire a certain positive or negative balance in connection with the program once it got running. The creditor countries would be able to draw down their asset positions if ever they fell into a recession relative to the rest. Further, they would continually receive interest from those of the debtor countries that happened to be in an expansionary phase. (There could be a neutral band where no transfers took place.) The accumulated debts and claims in the system would then naturally depend, both, on the history of the asymmetries in the business cycle performance in the EMU, and the persistence of individual national positions in past business cycle asymmetries. Apart from the added ability to meet asymmetric shocks, a further benefit of the program would be to strengthen the SGP. Essentially, deficit countries would no longer bear the exclusive responsibility for coping with unusual difficulties at home. Consequently, it would be more difficult for them to find excuses for failing to adhere to the uniform rules of the Maastricht Treaty and the SGP.

IV. *The Principle of Subsidiarity*

There is no need to harp on the current opposition between the SGP and the principle of subsidiary. Evidently, as the pact now stands, countries may be subject to fines for excessive deficits at times when they cannot be said to endanger anyone but themselves. As long as the member countries agree to such interference, all is well. But once they question the rules, as is increasingly the case, it is of no avail to argue, as defenders of the Pact now do, that the Pact is in the members' own interests, and the system provides them adequate flexibility. Whatever the truth of these claims, and however much all the members of EMU may truly benefit from fiscal discipline, the critics can always retort that individual countries are the best judges of their own interests. It is also useless to pretend that the Pact is a "done deal". The SGP won approval from national representatives under German pressure in many countries and with hardly any popular discussion anywhere. There was never broad popular approval of the Pact, and it is clearly open to amendment. Under the pressure of criticism, I believe that the supporting argument for the Pact that will carry weight is the one that says that lack of fiscal discipline by any member of EMU poses problems for all the rest. In other words, the case for the Pact must rest on externalities: the reasoning must appeal to the principle of subsidiarity. In my opinion, the right sort of argument for the SGP can be made. It is certainly arguable that a monetary union between sovereign states with decentralized national fiscal-policy decision-making requires some protection against fiscal misbehavior by the individual members. This is the proper defense. But in that case, two amendments of the SGP would help.

V. *A 60 percent watermark*

Any lack of fiscal discipline by an individual member of EMU can only pose a threat to the rest because of the risk of a bailout, and via this risk, the possible repercussions for monetary policy. But any risk of a bailout is obviously remote when a country has hardly any debt to begin with, no matter how large its current deficit spending. Moreover, there are important welfare arguments for some public debt in every country on grounds of intergenerational equity and the ability of governments to borrow on better terms than its citizens can. Because of these arguments, it is then difficult even to raise any issue of fiscal discipline when a deficit country has a low enough ratio of public debt to output. It is still more difficult to argue that the country's lack of fiscal discipline poses a threat to others. Consequently, any penalties for deficits in excess of 3% should be confined to countries with high enough initial debt. I would have the penalties apply once debt/output ratios exceed 60%. This number seems the obvious choice, since the figure is already enshrined in the Maastricht Treaty.

Quite notably, a number of observers have recently criticized the Maastricht Treaty and the SGP for failing to provide the right incentives to members for getting their debt/output ratios down below the 60% level. My proposal essentially agrees with theirs, but is simpler. What could be simpler than to exonerate countries that observe the limit from any penalties? And what better incentive could there be to lower the debt/output ratio below 60% and to keep it there?[1]

VI. *Insisting on Deviant behavior*

My second proposed revision would be to make the penalties depend on exceeding the deficit limit by some notable amount – at least 0.5 of one percent of GDP – more than the average in the EMU. It is very difficult to argue that a country poses a danger to others by exceeding the 3% limit if all the other members of the system are doing the same. Indeed, as the SGP stands, the application of the penalties is only possible to understand properly as a way to punish deviant behavior. There is little sense in confiscating the deposits of a country when there are hardly any potential recipients of the deposits since everyone is an offender. It would even be difficult to apply the penalties for merely crossing the 3% line when most of the other members of the EMU teetered on the verge of doing the same. In some sense, therefore, the pro-

[1] These other critics' proposals are also more intrusive than mine and they aggravate the violation of subsidiarity. See, for example, the interesting Chapter 2 of the CES-IFO *Report on the European Economy 2003*, and the many references therein.

posed reform makes explicit something latent.[2] Notwithstanding, explicit reference to deviant behavior would make it easier to appeal to externalities and the principle of subsidiarity. But there is also an independent argument for the reform. One can easily imagine cases where large shocks would call for the members of EMU to exceed the 3% limit collectively. Applying the penalties only in the event of deviant behavior is a way to recognize the possibility of such cases. In close conjunction, a third reform of the SGP that may deserve consideration would be to admit the temporary suspension of the 3% ceiling in unusual circumstances affecting everyone.

VII. *Conclusion*

An extra instrument dealing with asymmetric shocks, as such, would evidently make a significant contribution to the arsenal of tools of macroeconomic stabilization in the EMU. In addition, some recognition – even if indirect – of the possible need for collective responses of fiscal policy to major symmetric shocks would be salutary. But in closing, let me emphasize my view that the proposals would help to make the SGP work. Consider a country facing a penalty under the terms of the revisions. The country would not experience a greater than 2% fall in annual output, since that would suffice to nullify the penalties as things stand, apart from the proposed reforms. Next, as far as the country's economic performance was exceptionally poor, it would receive aid from the rest. In addition, this aid would not contribute in any way to the deficit figure in the SGP relating to penalties. Further still, the country would also be in breach of the 3% ceiling by a significant margin in relation to the rest. Finally, the country's outstanding debt/output ratio would be difficult to justify on grounds of sound public management. Hence, general concern about the country's fiscal behavior would seem readily defensible. Penalties would be easier to justify before the general public. The application of the sanctions in the Pact might then become quasi-automatic, and the incentive to avoid such circumstances in the first place would be strong.

April 9, 2003

[2] Note that my proposed reform would likely not hamper the application of the penalties today. Even though four member countries of the EU are currently either in violation or near violation of the 3% limit, the weighted-average ratio of deficits to output in the EU (based on output weights) is 1.9% and the straight-line average ratio is 0.6% (if we include the UK, Denmark, and Sweden, the three non-members of EMU).