Contra: The Commission and the Stability Pact[1]

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When large numbers of drivers ignore the speed limit, it is good practice to reconsider its rationale and, if reaffirmed, to tighten enforcement, especially if the frequency of accidents increases. Hence, the EU Commission was right in launching a debate about the Stability and Growth Pact (SGP), which has been violated by an increasing number of EMU member countries. Unfortunately, however, the Commission's proposals for reform risk watering down the Pact, resulting in an erosion of fiscal discipline. In essence, the proposals by the Commission give the impression that the disobedient drivers might have a point and that drivers with better engineered cars need not be held so strictly to the limit. We are of the opposite opinion: The case to be made for a consolidation of government finances against the background of present and prospective demographic changes is actually stronger than ever before.

The longer-term outlook for the European economy and SGP reform

The SGP was created in order to make the general prohibition of "excessive" deficits in the Maastricht Treaty operational. The Treaty, which introduced the constraints on fiscal policy, started from the assumption that nominal GDP would grow at 5 percent per year on trend and that a debt ratio of 60 percent of GDP was bearable. Consistent with these assumptions, it stipulated that government budget deficits must not exceed 3 percent of GDP.

In hindsight, this deficit limit appears rather generous. Real potential growth is probably now only around 1 3/4 percent in Euroland, and the ECB's inflation target is less than 2 percent. A more realistic assumption for Euroland nominal trend growth is thus around 3 1/2 percent. To stabilise the debt ratio at 60 percent of GDP, the deficit would therefore have to be capped at 2.1 percent. Moreover, the ageing of the Euroland population raises government liabilities not included in the debt ratio in the Maastricht definition. Hence, to keep governments solvent, the latter should decline over time, ensuring that total government liabilities do not increase on trend over the next half century. These facts are generally accepted. However, neither they, nor their obvious implication that the conditions in the SGP should be tightened rather than loosened, are reflected in the Commission's Communication of 3 September 2004. Surprisingly, the Commission seems also to have ignored a key argument in favour of raising the threshold for invoking exceptional circumstances. With the potential growth rate having declined in most euro area countries, it is much more likely that countries will experience phases during which growth is "low" by historical standards. Hence, when potential growth is slowing, authorities need to continuously update their view about what is exceptionally "sluggish" growth. For example, a growth rate of 1.5 percent would most likely be considered 'sluggish' by politicians when compared to the goal of 3 percent as agreed at the Lisbon summit. However, growth of 1.5 percent might already be very close to (and for some countries above) potential growth in reality, and should thus not constitute an excuse to delay fiscal consolidation because of "sluggish" growth.

[1] Based on CEPS Policy Brief No. 58.

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