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FISCAL COMPACT BETWEEN GROWTH AND DEBT CRISIS RESOLUTION

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Abstract

The European Fiscal Compact binds the signatory States to ensure balanced budgets or in surplus; this condition is met if the annual structural fiscal deficit is below 0.5% of the nominal Gross Domestic Product (GDP) and the accrual deficit is below 3% of the nominal GDP. The compromise reached at the European Council held in Brussels, on the 9th of November 2011, includes decisions that significantly change the European fiscal policy. The Maastricht Treaty has granted to Member States exclusive competence on fiscal policy, but in the near future this competence will be shared with the European Commission. Fiscal consolidation will start with the vetting of national budgets by the European Commission and with the imposition of automatic penalties for those who ignore the new nominal budgetary criteria. The implementation of these measures can be seen as one small step towards the common fiscal policy dreamt of by the European federalists. This paper aims at showing that the Fiscal Compact has privileged the financial stability against the need for stronger growth. This paper will also hint at the fact that an abrupt fiscal adjustment as required by the Fiscal Compact could compromise the potential for future economic growth and the catching up objectives of the New Member States. This may happen as a result of the very rigid structure of the public expenditures. The option for a hasty fiscal adjustment would reduce the leeway for public investments and/or the government's capacity to create fiscal stimulus for growth.

Keywords: monetary union, growth, balanced budget, deficits

1. Introduction

The current European economic context has warranted the anxiety of classical economists about the excessive deficits caused by oversized government programs and the reduced spending in public investments with high social return. For these reasons, and fearing a debt crisis without solution, the European leaders have recently opted for the balanced budget rule, without however paying enough attention to the strong need of the New Member States to ensure higher economic growth, mostly based on growth-oriented public investments financed through budget deficits. One of the strongest criticisms against the balanced budget rule is that it amplifies the business cycle especially

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during recession by reducing the aggregate demand due to consequent tax contraction.

This article wants to provide a clearer perspective on the major potential effects of adoption of a stronger budgetary rule for the stability of public finances and for economic growth as well. In this respect, I have organized my study in two sections: in the first part, I review the main theories designed around the balanced budget rule; in the second part, I indicate the best way to reach fiscal sustainability and economic growth through a restrictive budgetary rule such as the one set forth by the European Fiscal Compact.

2. Rediscovering balanced budget rule

The earliest conception of a sustainable economic behavior can be easily identified in the Old Testament (*Genesis*, Chapter 41). Thus, the vague Pharaoh's dream about the seven fat and beautiful cows eaten by seven thin and ugly cows and seven good and filled ears eaten by seven thin and dry ears is the first paradigm of how to manage the surplus or deficit that result from human activities.

Joseph's interpretations of the dream give us the first example of a good governance principle, which accounts for the natural cyclicality of the economic activities. The Pharaoh accepts to follow up Joseph's advice, and during the first seven prosper years he had accumulated enough surpluses to survive the next seven years of poverty. In fact, the biblical parable does not differ too much from the balanced budget paradigm. The difference consists only in the surplus destination. In the Old Testament the surplus was materialized in food provisions. In the balanced budget paradigm, the surplus is intended to progressively reduce the public debt in order to create enough fiscal space that can be used in the difficult years.

Rising public deficits in almost all European Member States has triggered a renewed interest in the balanced budget rule as the only way to restrict the discretion of the main political actors on the budget. A budget rule provides a form of 'self control' to check on politicians' temptation to respond to societies which are much more permissive to larger budget deficits in the current period than they would have been before [1].

The '*political distortions*' on budget policy were wrongly considered as the exclusive feature of emerging economies and the main cause of large annual deficits [2]. Pro-cyclical temptation is no longer a special attribute of emerging countries; but is a feature of the developed economies as well, as a result of an overestimation of economic growth and of the potential resources that can be transferred to society.

Moreover, there is no genuine political opposition to the new government programs which continued to proliferate, unlimited by the budgetary constraints, or by fundamental ideological opposition [3].

Government deficits may also arise from the lack of transparency in political decisions or as a result of government's failure to guarantee long-term commitments [4]. In most cases, large annual deficits, leading to a higher public debt, could cause higher interest rates, lower levels of private investment and lower growth opportunity in the future [5].

The dismissal of deficits is not at all a new concept in the theories about the sustainability of public finances. The classical economists have strongly rejected the idea of government borrowings for regular expenditures. They were not so much opposed to the potential use of deficits for the capitalization of the economy, but rather opposed to the temptation to give an unproductive use to the resources that were borrowed.

In the twentieth century, Arthur Cecil Pigou, one of the economists who considered that a well-organized economy can cover its current expenditures by taxes only, without loans, admits however that there are exceptions. The exceptions that Pigou had anticipated included spending for counteractive the negative consequences of wars or natural disasters that could seriously harm the capacity of the '*fiscal machinery*' to collect taxes from the economy for a determined period of time [6]. Pigou also recognizes that the deficits made for the accumulation or production of capital goods should not be seen as dangerous.

It should be said that the balanced budget rule was adopted in the US since the 1980s, in response to large federal deficits, but its effectiveness is questionable according to recent assessments of American economists.

James Buchanan believes that the balanced budget rule should essentially be an attitude about how governments manage the fiscal affairs, and he calls into question the efficiency of converting the constitutional rules in the fiscal rules. He argued that, in the nineteenth century and the early twentieth century, the United States' fiscal policy remained in economic equilibrium without any fiscal principle enshrined in constitutional law, but this equilibrium was just lost with the adoption of the balanced budget amendment [7].

Balassone and Franco recommend that a budgetary distinction between ordinary expenses and capital expenditures must be made [8]. This different view, which propose that the budget for regular expenses must be in balance or in surplus, and which accept that the budget for public investments and capital accumulation can operate with deficits, is in fact the budget policy that found practical application into so called 'Golden rule' adopted by the British Treasury in 1998, which was later abandoned as the abdication from the principles.

Jean Pisani-Ferry considers that the focus of the European financial stability should be the public debt to GDP ratio and not the potential restriction of budget deficits [9], while Charles Wyplosz minimizes budget control efficiency as a fiscal rule in the European Monetary Union (EMU) and considers that the delegation of fiscal powers to an independent fiscal commission for coordination of both fiscal and monetary policies would be much more efficient [10].

3. Stability or growth? How to get them both?

3.1. What's new in the Fiscal Compact?

The main provision of Fiscal Compact consists in the adoption of the balanced or in surplus budget rule and the creation of an automatic budgetary mechanism for achieving the necessary corrective actions. According to the Fiscal Compact, the budgetary rule is considered to be respected if the annual structural balance of the general government is at its country-specific medium-term objective as defined in the revised Stability and Growth Pact (SGP) with a lower limit of a structural deficit of 0.5% of the gross domestic product at market prices for those countries with public debt of more than 60% of GDP and lower limit of a structural deficit of 1% of GDP for countries with a public debt level 'significantly lower' to 60% of GDP.

Given the failure of the Stability and Growth Pact (SGP), whose strength was only supranational, the Fiscal Compact wants to use the power of national constitutions by including the budgetary rule into constitutions or laws with constitutional status. Also, the Fiscal Compact, formally called 'The Treaty on Stability, Coordination and Governance in the EMU', sets automatic financial penalties of up to 0,1% of GDP for violation of budgetary targets, sanctions applied by the European Court of Justice. The balanced budget rule was also stipulated in the Stability and Growth Pact, but everyone seems to agree that without sanctions for excessive deficits this rule was inoperable.

The new Fiscal Treaty does not remove the SGP nominal criteria on budgetary deficits (3% of GDP, calculated according accrual methodology) and on public debt (up to 60% of GDP). The ceilings remain at the same level, although the criteria for the New Member States should be reviewed and determined differently, depending on their growth needs and the pace of structural reform. At the same time, sanctions against states that do not meet the budgetary criteria have been set in the excessive deficit procedure of SGP, but they were never implemented, although Greece and Italy have frequently violated these rules.

The balanced or in surplus budget rule over the economic cycle is based on a new criterion: the structural budget deficit should be under 0.5%-1%, unlike in the Stability and Growth Pact, which was based on current budget deficit of 3% of GDP (accrual methodology). Also, the excessive deficit procedure is substituted by the establishment of automatic financial penalties (paid into the European Mechanism of Financial Stability or into the common budget) up to 0.1% of GDP.

The excessive deficit procedure was highly ambiguous in reference to the adjustments applied by the States faced with excessive deficit, as it only set a timetable for adjustments and some potential sanctions embodied in limitation on European decisions.

The Fiscal Compact instead establishes the obligation to shape one or more correction mechanisms of budget deficit, based on taxes or spending, in order to act in a more flexible budgetary environment.

3.2. Hesitant steps toward a common fiscal policy

Certainly the biggest innovation of the Fiscal Treaty is the first step taken towards a common fiscal policy. If the Maastricht Treaty and the Stability and Growth Pact have granted to the Member States an exclusive competence in the budgetary and fiscal field, the Fiscal Pact introduces the novelty of power sharing between Member States and the European Commission. Once the Treaty is ratified, the Member States shall require the approval of the European Commission on their draft budget before adoption at national level, and the implementation of budgets will be monitored continuously. In addition, any national loan will be approved *ex ante* by the European Commission, according to the necessity and the opportunity of the loan. The implementation of these measures can be considered as a small step towards the common fiscal policy so much wanted by the European federalists. Their view entails a common fiscal authority, a common strong budget and a common taxation policy.

It is also true that a common fiscal authority may be more efficient and faster in the implementation of budgetary adjustment measures, may increase the trust in the Euro zone and may drive easier to financial stability. It has been already shown that different systems of taxation have stimulated fiscal dumping, especially in Eastern Europe, as one way of attracting foreign direct investments. For this reason, it is necessary, to the extent possible, to unify the taxation systems inside the European Union. If this goal seems to be unreachable right now, a unification of taxation systems can be started in several stages.

A first step towards the unification of the taxation would be the implementation of a band of oscillation/a fiscal tunnel with comfortable amplitude (+/- 2.5%) for the most common European taxes: VAT, income taxes, profit taxes and others.

I do not believe that we should contemplate the construction of a new fiscal and budgetary authority from scratch, as long as the European Commission already exists and has enough democratic legitimacy, legal instruments and experience to act in a multinational context. The European Commission has already been effective for many years in other European economic sectors like competition, agriculture, transports and others.

What the European Commission is missing and should consider acquiring in the near future is a real fiscal and budgetary authority. First of all, the European Commission lacks the fiscal and budgetary powers transferred from the European Union Member States. The transfer of monetary powers to the European Central Bank has already shown that yielding the sovereignty to European institutions is possible, despite the fact that the national currency was once the most important symbol of national states.

A common European budget should also be a stronger financial statement, by increasing transfers to up to 5% of the GDP of each Member State, compared to current contribution limited to up to 1.1% of the GDP, even though members like Germany, Italy, France or U.K. would become donors. A strong budget could increase the transfer capacity to less developed members and so the economic cohesion would be achieved and positive effects would be felt throughout the whole European Union.

However, we should not ignore that a stronger European budget needs a clearer definition of levels of administration or, in other words, more administrative decentralization, to be able to separate the areas under the remit of the European budget and areas that will remain in the responsibility of local communities.

3.3. How to reach the long-term economic growth?

The choice for the structural deficit as the best barometer of the sustainability of public finances should be welcomed, because it reflects better the fiscal position of European economies through removing the economic cycle influences on the budget balance. However, we should not mystify the role of the new nominal criterion, and falsely believe that once it is implemented, all structural problems of the European Member States will disappear.

It is obvious that European countries need today more than ever a restoration of the fiscal discipline and a regain of the global credit market trust. The Fiscal Compact seems to be very appropriate in this regard, if we keep in mind the negative dynamic of European public debts. Robert Barro considers that a high public debt will be, sooner or later, moved into taxation field, leading to a higher taxation which will reduce the potential economic growth [11]. The painful experience of recent years has confirmed Barro's view, as almost all the EU member states have raised the taxes and have reduced the economic growth forecast.

Unfortunately, the Fiscal Compact follows only one side of the relation between the budget deficit and the GDP, aiming at the elimination of the budget deficit in order to reduce the public debt. But if one seriously considers the other side - the real GDP growth, the objective of stabilization and possible reduction of public debt would be more easily achieved. A higher GDP reduces the deficit and debt rates reported to this. Therefore, in pursuit of fiscal stability, equal consideration to both the budget discipline and growth target should be given.

A better way to achieve both objectives would be the adoption of the British model of the so-called ‘Golden rule’. This budgetary rule stipulated in the British Pre-budget Report 1997 states that over the economic cycle, the government will borrow only to invest. If the government spends for projects that produce a yield in the future, the gross debt burden could be offset by the expenses, so that the gross yield net result would be quite positive [12].

The golden rule will be met if the average annual surplus on the current budget expressed as a ratio to GDP, measured from the year in which the economic cycle begins up to and including the year in which the economic cycle ends is in balance or surplus. The second government's fiscal rule regards the sustainable investment rule which requires that the public sector net debt as a proportion of GDP must be held over the economic cycle at a stable and prudent level to below 40% of GDP over the economic cycle.

The golden rule seems to respond better to the need of emergent economies to create fiscal stimuli through taxes or public investments than the balanced budget rule that enforces rigorous limitations of fiscal package.

For these reasons, the public investments have been always the strongest argument used by the new EU Member States to justify their excessive deficits. Even if we cannot say exactly if there is a strong relationship between a higher fiscal deficit and public investment levels in the new Member States [13], they need stronger public investments with best social return and best multipliers.

It must be said that, especially in the new Member States, the nominal convergence was privileged in relation to the real convergence, even if the fulfillment of the fiscal criteria had been negatively influencing the real economic variables. In fact, the two processes, the real and the nominal convergence, are complementary. Even though the nominal convergence produces a deceleration of the real economic performance, fulfilling all the Maastricht criteria ensures a greater economic stability and a solid economic growth on the long run. For example, reducing the inflation rate will lead to higher economic performances and to the increase of the real convergence of the revenues. Lower interest rates will also stimulate the growth of the investments, the growth of the real GDP and reduce the probability of occurrence of the crowding out phenomenon.

It is very important to know that a possible abrupt fiscal adjustment aiming at achieving a structural deficit at below 0.5% or at the maximum level of 1% of the GDP in a short time could compromise the future economic growth.

The abrupt budget adjustment would also seriously affect the catching up objectives for the new Member States. Knowing that the economic disparities between EU15 and the new Member States are still significant, the next fiscal measures that aim at the financial stability should also respond to the needs of catching up. The catching up process must be based on a higher rate of economic growth rather than on the average growth of the most developed economies of European Union. In these conditions that limit the capacity to promote fiscal stimulus through internal resources, the only chance for stronger growth in these economies, and for reducing the gaps, remains the increase of transfers to the new members from 4% of GDP to up to 6% of GDP. Although at first glance this decision would disadvantage the developed economies, the increase of the real convergence would reflect in a stronger, more convergent, more competitive, and less vulnerable European Union and remove any tensions between members, caused especially by the spread of negative effects of economic imbalances between them.

Table 1. Three catching up scenarios.

	EU15 real growth of GDP*	New Member States real growth of GDP*	Time required for catch up
First scenario	2%	4%	26 years
Second scenario	2%	5%	17 years
Third scenario	2%	6%	13 years

* *Own calculation based on real growth of GDP average over the next economic cycle*

Taking into account these three scenarios, we may say that the EU founders and the new members have to work together as a two-speed Europe, in terms of economic growth, faster for the new members in order to catch up to the EU15, but without exceeding the potential of growth.

Moreover, the steady decline of competitiveness of the European economies has directly contributed to a slowing down of potential growth and also to the deterioration of macroeconomic balances. The competitiveness seems to best respond today to the world states' concerns about higher growth rates and higher standard of living for their population. The standard of living comparisons are usually made using the GDP per capita index. So, a higher GDP per capita means a higher standard of living. Common sense would suggest that a country with a high GDP per capita must be competitive at least in the sense that its economy is capable of generating a high level of welfare for its citizens. Competitiveness is essential to help the EU grow faster and more sustainably in the medium and long term, to produce higher levels of income for citizens. Unfortunately, the EU real growth, in the latest economic cycle, was lower than previous expectations and lower than the medium growth in the U.S.A. or China. It must also be noted that there are still very large competitiveness gaps inside the European Union and it will be an illusion to believe that the budgetary discipline will solve the development and competitiveness gaps. These gaps were clearly reflected in the fiscal position of the European member states during the latest economic cycle.

4. Conclusions

Beyond any potential criticism about the Fiscal Treaty and many technical suggestions for better fiscal consolidation of the EU Member States, the Fiscal Compact is a very useful tool in restoring fiscal discipline in the EU. In this respect, the Fiscal Compact should be improved with specific provisions containing differentiated terms of adjustments, depending on each Member State's fiscal position, because the relative corrections need long time and the fast adjustments' effects may be important. The reform of public pensions requested by the expected budgetary consequences of population ageing in the next decades, the reform of public services, the improvement of local budgets and the decentralization of administration cannot be achieved instantaneously.

Unfortunately, the Fiscal Compact follows the fiscal consolidation only through the limitation of structural budget deficit and it does not pay any attention to optimal structure of public expenditures or to their appropriateness and efficiency. In this context, one may want to analyze the proposal of Olivier Blanchard, who lobbies for the establishment of supervisory bodies for monitoring the efficiency and opportunity of public investments. Even if the automatic adjustment mechanisms of deficits have not yet been defined, their future design must take into account the need for convergence of the business cycle and the amortization of any potential asymmetric shocks.

It must be said that the amendment of national constitutions with Fiscal Compact provisions was overestimated because the macroeconomic stability does not depend entirely on this changes of the constitutional laws. The budgetary stability and the strengthening of fiscal policy should be overall an attitude about the design and implementation of fiscal and budgetary policy. The limitation of deficits by constitutional laws will certainly affect the economic growth in the new Member States, given the impossibility of creating fiscal stimuli or public investments.

Currently, the European Union is faced with more than budgetary imbalances and public debt crisis. The high private sector debt, the fast growth of the unit labor costs, the rigidity of the labor market and the increasing rates of unemployment, the steady decline of exports' market share are also other major issues which EU should address.

There are a lot of potential solutions, which - despite their unpopularity - may reduce the gap of development and competitiveness inside or outside of the EU. For example, the abolishment of the habitual indexation of wages regardless of the productivity gains could be the first step to price competitiveness. The labor market must be reformed especially to insure greater flexibility through the general recognition of qualifications and the real mobility of workers - issue defined in most theories on the optimum currency areas. All the movements towards a more competitive Europe must be permanently monitored following at least few competitiveness key indexes, such as the price competitiveness, the rate of investments (in various fields like research, development, education and infrastructure, as a value fixed at x% of GDP), and the stability of public finances (especially the sustainability of public debt).

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