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Economics Revision Focus: 2004

A2 Economics

European Fiscal Stability Pact

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Revision Focus on the European Fiscal Stability Pact

A2 Syllabus Requirements:

Reform of the European Union
The advantages and disadvantages of harmonisation of taxes and the implementation of economic and social policies

What is the Fiscal Stability Pact?

1. The European Union **fiscal stability and growth pact** (FSG) was created in 1996 – some people regarded it as a form of "pre-marital agreement" between the countries that were signing up to the Euro
2. It is part of the process of achieving **fiscal policy harmonisation**
3. It was seen as a way of reinforcing the convergence criteria set down in the Maastricht Treaty and as part of a process of better **co-ordination of macroeconomic policies** within the single currency area (the Euro Zone)
4. The pact was intended to **control government borrowing** by the relatively poorer member states such as Ireland, Spain, Portugal and Greece. Germany, in particular, demanded the pact be signed before agreeing to participate in a monetary union with countries with a history of high national debt, such as Italy
5. The main problems have been with larger economies such as France and Germany whose budget deficits have exceeded the terms and conditions of the pact
6. **Britain** is technically required to stay within the terms of the stability pact – but the reality is that we have an **opt-out from the Euro** and the British government is committed instead to its own fiscal rules – including Brown's **Golden Rule** for government borrowing
7. The **accession countries** that joined the EU in May 2004 are required to join the single currency at some stage and therefore they will have to make further progress in getting government borrowing levels under control. Many (but not all) are struggling with high fiscal deficits at the moment, partly because of the financial costs to respective governments of meeting the standards required to be a member of the single market

The terms of the fiscal stability pact

1. The pact imposed a **3% ceiling on government budget deficits as a % of GDP**
2. Over the medium term (e.g. over the course of a cycle) each European Government had to seek to balance their budgets
3. The EU Commission could impose cash fines of up to ½% of a nation's GDP if budget deficit limits were breached and were not brought back under control within three years
4. The pact more or less ruled out the **active use of fiscal policy** as a tool of Keynesian macroeconomic demand management e.g. delivering a huge fiscal stimulus to an economy where output is well below potential and where unemployment is rising by raising government spending, cutting taxation and increasing government borrowing

Supporters of the fiscal stability pact argue that the long term health of the European economy is supported if governments successfully control government debt/GDP ratios at reasonable levels because too high a level of debt and borrowing can lead to higher interest rates and an increase in the overall

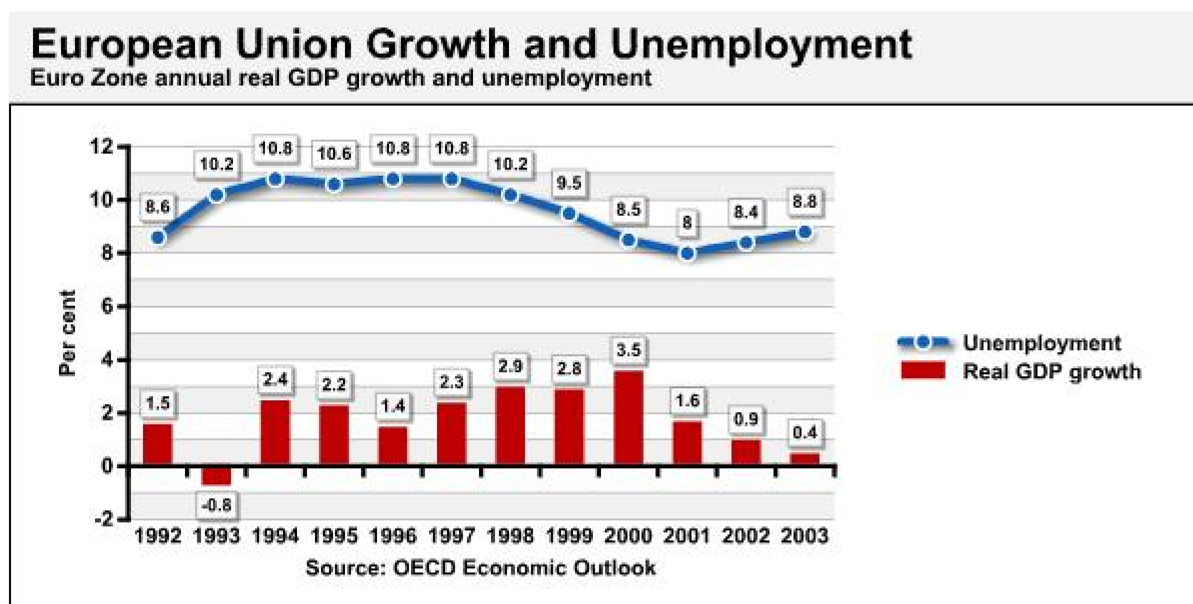
burden taxation – both of which could be damaging to investment, consumption and work incentives in individual countries. This is often called the **"crowding-out hypothesis"**

Budget deficit problems

Budget balance as a % of GDP	2003	(-ve shows a budget deficit)	2003
Estonia	2.6	Netherlands	-3.0
Finland	2.3	Greece	-3.2
Denmark	1.5	United Kingdom	-3.2
Sweden	0.7	Slovakia	-3.6
Spain	0.3	Germany	-3.9
Belgium	0.2	France	-4.1
Ireland	0.2	Poland	-4.1
Austria	-1.1	United States	-4.9
Lithuania	-1.7	Hungary	-5.9
Latvia	-1.8	Cyprus	-6.3
Slovenia	-1.8	Japan	-7.4
Italy	-2.4	Malta	-9.7
Euro-zone	**-2.7**	Czech Republic	-12.9
Portugal	-2.8		

Why have budget deficits increased within the Euro Zone?

The main reason is the **slowdown in economic growth** that has led to a slower growth of tax revenues (from direct and indirect taxes) and led to increasing pressure on state welfare benefits. **Persistently high unemployment** (much of it long-term and structural) has added to government spending and reduced the level of tax receipts. **Consumer spending and company profits** have also been weak in many EZ countries. This has caused a downturn in tax revenues from indirect taxes and corporation taxation.

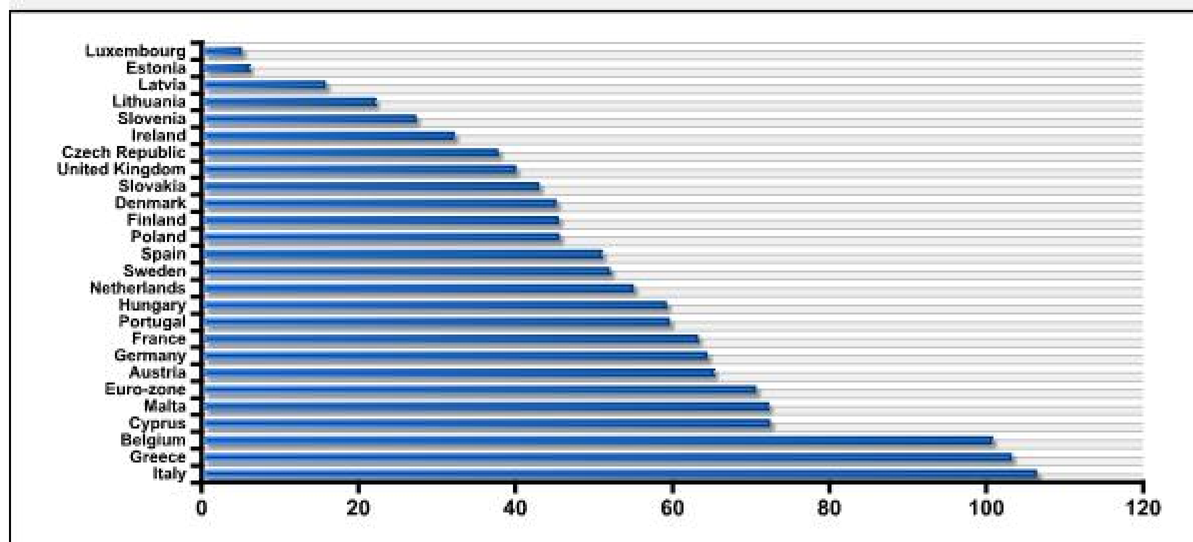


Criticisms of the European Fiscal Stability Pact

Effectively the fiscal stability pact came to an end in November 2003 when France and Germany persuaded a meeting of EU Finance Ministers to suspend the sanctions mechanism enshrined within the pact.

The stability pact came under criticism from several quarters. Romano Prodi, the president of the European Commission, once famously termed the pact "stupid"!

1. **Fixed rules creates a fiscal straight-jacket:** The main criticism of the fiscal stability pact was that it provided a straight-jacket for countries that wanted the freedom to run an expansionary fiscal policy at times of prolonged economic weakness – e.g. rising unemployment, low business and consumer confidence and a negative output gap. Gordon Brown has argued on a number of occasions that the stability pact rules are "too rigid" and must be applied with more flexibility if they are to be effective
2. **No adjustment for the business cycle**: The deficit ceiling made no adjustment for the effect on borrowing of fluctuations in the economic cycle. A fiscal rule expressed over the cycle would mean that a government still has room to allow the automatic stabilisers to operate - such as increased spending on unemployment benefits – in order to dampen fluctuations in real GDP and unemployment resulting for example from external economic shocks
3. **Structural reforms cost money**: Another criticism is that some countries are running larger than permitted fiscal deficits because their governments are committed to supply-side reforms, improvements in national infrastructure – all of which costs money in the short term but which should bring long term economic benefits for the whole of the European Union
4. **Debt to GDP ratios may be more important:** The pact did not take into account for each nation, the ratio of public debt to GDP. Expressing fiscal rules in this way might have provided a country like Germany, whose public (government) debt is 60% of GDP, compared with over 100% in Italy, more room to support its economy by boosting government spending (e.g. higher state investment in public services)



What next?

It is highly unlikely that the euro-zone countries will dissolve the Stability Pact partly for political reasons and also for more pragmatic economic reasons. Euro countries with a more expansive fiscal policy (i.e. a higher budget deficit) would eventually have to pay higher interest on their government bonds. As this would be the situation that is in fact currently faced by the large economies of Germany and France, interest rates would be pushed upwards throughout the euro-zone – and this would damage further prospects for economic growth.

Britain is in favour of reforming the stability and growth pact before any further progress is made in terms of our potential entry into the single currency