Opinion

The unending saga of the Stability Pact

In areas like justice or governance, the European Union has requested that national institutions be changed to meet common standards. This ought to be the case with fiscal discipline as well.

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The Maastricht Treaty of 1991 that established the European Union included the obligation for member countries to keep their budget deficits below 3% of GDP and their public debts below 60%. The details were left to the Stability and Growth Pact, which was adopted in 1997, just two years before the launch of the euro. While the need for fiscal discipline is undisputable, the numerical limits never made sense and their enforcement through fines to be levied on recalcitrant governments was politically illusory. In spite of frequent violations of the rules, no country was ever fined. As a result, the pact has failed to deliver fiscal discipline within the euro area. With an average debt at about 100% of GDP and much larger levels in several countries – a clear sign of failure – the 60% limit is clearly out of reach.

The failure is now generally recognized but it has been manifest since the beginning. As a result, the pact has gone through several reforms. In 2005, after the two largest countries, France and Germany, essentially ignored their obligations under the pact and were not fined, a first reform introduced provisions designed to recognize that the numeric rules were far too rigid as they failed to acknowledge prevailing circumstances. The debt crisis that started in 2010 showed that these provisions did not help. A new reform, adopted in 2011, enhanced the supervision mechanism conducted by the European Commission. It was reformed again in 2013 to provide the Commission with additional monitoring tools and to try and strengthen domestic budgetary procedures in member countries. Following the onset of the Covid pandemic, the pact was suspended in 2020. It was agreed that a new reform would be adopted before the end of 2023 when the suspension period is over. That is where we now stand, and we still don't know what the reform will look like.

The pact faces two constraints that are irreconcilable. The first one is that budgets are a national prerogative, in the hands of national governments and their parliaments. The second one is that member countries must be fiscally disciplined for the euro area to operate smoothly. The Commission, which is in charge of implementing the pact, does not have the means to force governments to act accordingly and its power ultimately rests on the threat of sanctions, which are politically out of reach. In federal states, like Switzerland and Germany, the federal government has the authority to constrain the sub-governments, cantons and länder, but the euro area is not a federal arrangement and the Commission has no such authority. The various reforms have strived to break this contradiction, but this looks like mission impossible.

Establishing a multi-year path

In late 2022, the Commission has tabled a reform proposal. In a landmark step, it has implicitly recognized that numerical rules make no economic sense and that it is hopeless to try to impose them flexibly in its annual supervision exercise. Instead, it has finally accepted that fiscal discipline is about long-run debt sustainability, not about year-by-year obligations. It proposes to establish a multi-year, up to seven years ahead, path for the debt to move in the right direction, taking into ac-

gress. It could allow a country to run «excessive» deficits because it is in a recession or because it is facing a severe shock – like the pandemic or the energy crisis – as long as the debt eventually reaches a level that is deemed sustainable. But who will determine the debt paths and who will decide what is a sustainable debt level? The proposal is to give the Commission such an authority, and that is where the proposal is currently facing severe headwinds.

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The obvious difficulty is that national sovereignty in budgetary matters is incompatible with granting the Commission that authority that it seeks. Because debt sustainability is an imprecise concept and because there are many possible paths to eventually reach any debt level, any member country can disagree with the choices of the Commission. In addition, much can happen over a seven-year period, so that the agreed-upon debt objective and path both stand to become obsolete, giving member countries a good reason to challenge the Commission's initial decisions. It is enough to remember the last seven years to imagine the complexity of the discussions that can arise. The fundamental contradiction of the pact is not resolved.

The Commission's proposal has been discussed quietly among government, and disagreements are now surfacing. The German Finance Minister has made his dissatisfaction publicly known. Unsurprisingly, he opposes the bigger role that the Commission is seeking for itself. Backed by other frugal countries, he is concerned that the Commission will bargain with delinquent countries and end up agreeing to unimpressive debt paths and targets that will undercut again fiscal discipline. Instead, he promotes the traditional German approach. He wants non-negotiable numeric rules on closing down deficits above 3% and reducing debts toward 60%. In short, the reform that he envisions is more of the same, just tighter. Unsurprisingly as well, the high-debt countries have endorsed the Commission's proposal, for the opposite reasons. Politically, each camp is currently trying to recruit supporters.

Budget sovereignty vs. collective responsibility

From the economic viewpoint, it is disappointing that the solid logic of the propo is ignored at the political level. Once more, the debate is between the perceived robustness and flexibility of the rules. In many ways, the Commission's attempt to increase its authority has triggered this debate since its proposal depends on how it will play the game. The key challenge of how to make budget sovereignty and collective responsibility compatible is set aside. With sharply conflicting views, the most likely result will be a classical European compromise that satisfies no one and produces yet another ineffective reform. A historical opportunity to make progress after three decades could be missed.

The clash between sovereignty and collective needs rests on the view that some countries are «naturally» fiscally disciplined while others are «naturally» fiscally undisciplined. This view ignores the fact that fiscal discipline is driven by institutions. The clash would disappear if every member country were equipped with its own fiscal discipline institutions. In many other areas, like justice or governance, the European Union has requested that national institutions be changed to meet common standards, and there is no reason to believe that this cannot be the case with fiscal discipline. After all, the budget constraint is not a matter of choice, every government faces it. Surely, it would require a change in the treaties, which seems to be out of reach. Call it a lack of ambition.

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