Changing the rules

Why we should not accede to EMU's current fiscal regime

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Entering EMU is not just about monetary policy and abolishing exchange rates. A key element is the Stability and Growth Pact (SGP), which lays down rules for the conduct of national fiscal policy – the balance between total government spending and taxation. The UK also has fiscal rules, but they are significantly different from those of the eurozone (see box). Before we can ask which are better, and what the consequences for the UK might be if we had to follow the SGP, we need to explore why rules are necessary in the first place.

EMU: Stability and Growth Pact

- *Maximum deficit of 3% of GDP*
- *Medium term budget close to balance or surplus*

UK government

- *Over the cycle, only borrow to invest (the golden rule)*
- *Over the cycle, debt to GDP should be stable, and preferably below 40%*

Do we need fiscal discipline?

Both sets of rules are intended to ensure budget sustainability. The same principle applies to household budgets – the aim is to match spending to income over the long term. There will be periods when expenditure is likely to rise above income (eg Christmas) but as long as these are balanced by other times when income exceeds expenditure no major problems need arise. In addition, when unexpected changes in income happen, the impact is spread by either borrowing or saving.

The difference between households and governments arise when things go wrong. An individual who persistently spends more than they earn, with no likelihood of this position being reversed, will eventually be declared bankrupt. A government will either raise taxes substantially for future generations, or allow inflation to rise significantly, effectively writing down the value of the government's debt (and savers' wealth). Clearly, neither outcome is desirable.

So budget sustainability is crucial, but how do we enforce it? It makes no sense to try and stop governments ever borrowing. Unexpected events occur, like booms and recessions, and the timing and magnitude of the economic cycle is unpredictable. As is well known, the budget deficit rises in a recession, because of higher unemployment benefits and lower taxes. These automatic stabilisers

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are a good thing: the extra spending or lower tax receipts help moderate the downturn. Targeting the deficit from year to year switches these stabilisers off, with undesirable consequences, as the UK has learnt from past experience.

Just before I left the Treasury, I was involved in the calculations in the run up to the 1981 Budget. As part of its Medium Term Financial Strategy, the government had chosen to include annual targets for public borrowing. As the recession deepened, Treasury forecasters watched in dismay as projections for public borrowing got worse and worse. The dismay was not because their earlier forecasts were wrong – all forecasters know that public deficits are impossible to predict in the short term. The dismay came from the knowledge that the government was going to raise taxes in the middle of a recession in order to meet its deficit targets.

The problem of the economic cycle is just one example, albeit an extremely important one, of a more general issue. Government borrowing is the difference between two very large numbers: total government spending and receipts. Both are subject to all kinds of short term shocks, some of which may be quite unrelated to the economic cycle. These shocks will move the government's deficit around from year to year, which is why it is so difficult to forecast. As most of these shocks are temporary, it makes sense to ignore them, as they tend to average out in the long run. But if the government has to meet annual targets for the deficit, it may find itself erratically raising or lowering taxes or spending. While short term volatility in the deficit harms no one, short term volatility in spending or taxes does do damage. Government debt is a 'buffer stock', helping to insulate the economy from those short term fluctuations.

So temporary government borrowing is desirable in many cases, as long as it is sustainable. The problem is, how do we know whether borrowing is sustainable? Governments are under constant pressure to spend more and tax less, and political incentives may work against desirable social outcomes. For any individual minister, higher departmental spending may be an important determinant of popularity in the party. Collectively politicians may be too focussed on short-term electability to prioritise longer term problems like debt sustainability.

The UK rules

Gordon Brown's fiscal rules have two clear features. The first is that they refer to an extended time period: the period of the macroeconomic cycle. This gives the government flexibility to spend more during a downturn as long as it spends less in a boom. The second is that borrowing for investment is explicitly sanctioned. This makes sense from an equity point of view. A new hospital will benefit current and future generations. If it is financed through borrowing, it is paid for over decades, rather than by today's taxpayers alone. It may even be the case that government projects could raise future growth, which would help pay back the extra borrowing.

In these two respects the UK rules represent a clear advance over annual borrowing targets. To these I would add the following innovation, which I regard as equally important. For the last two years, as part of the November statement, the Treasury has published estimates of government income and spending up to 2050. Although such estimates may seem heroic from a forecasting point of view, they are precisely what sustainability is all about. In particular, we know that for some European countries, generous state pension arrangements mean that their current position is not sustainable: future taxes will have to be significantly higher than they are today. At present the UK appears to have much less of a problem in this respect, partly as a result of the move to indexing state pensions to prices rather than earnings in the 1980s.

While this focus on borrowing over the cycle and the longer term is laudable, it does raise an issue of verification. Exactly how do we define 'over the cycle'? What is to prevent the government fixing up its forecasts by making over optimistic assumptions about the future? At the very least, we need some form of independent verification – a point I shall return to below.

The SGP rules

Before comparing the UK rules to the SGP, we should first ask why this should be a European concern, rather than just a national one. The answer is that lack of fiscal discipline in one Euro member state could force the European Central Bank to bail that state out by printing money, which would have adverse consequences for all other members. Alternatively, if the central bank stands firm, interest rates will rise in the entire eurozone. So concern at the European level is justified, although as I shall argue below, it does not necessarily require uniform rules for each country.

Although the first of the Pact's two rules – the annual deficit limit – tends to get the more attention, the second has a long run implication that is bizarre. If the budget is on average balanced or in surplus, then economic growth and inflation will steadily reduce the *ratio* of government debt to GDP. With no new borrowing, the value of debt will not increase, even though total output is steadily rising and there is no good reason why this should be a policy goal. While defining the optimal debt to GDP ratio is difficult, the fact that the government owns capital (such as hospitals) suggests that there should be significant government debt. The 40 per cent figure in the second UK rule is fairly arbitrary, but it makes a lot more sense than a target that gradually declines towards zero.

The first SGP rule is an annual deficit limit, and so in principle is subject to the criticism of any short term deficit target. However the Commission among others have argued that if governments were really pursuing the second rule, then the chances of them hitting this limit would be small, even in an economic downturn. The first rule can therefore be seen as a way of ensuring that the second rule is followed. Think of it as an overdraft limit for a current account that on average is in balance.

The SGP rules are designed to catch the irresponsible borrower, but the structure is all wrong. At present the first rule means that pressure is applied only during a cyclical downturn. Governments will generally find it easier to raise taxes or cut spending in a boom rather than in a recession, so it would be much more effective for the Pact to apply pressure on governments when times are good, not when times are bad. It would also make more sense on counter-cyclical grounds.

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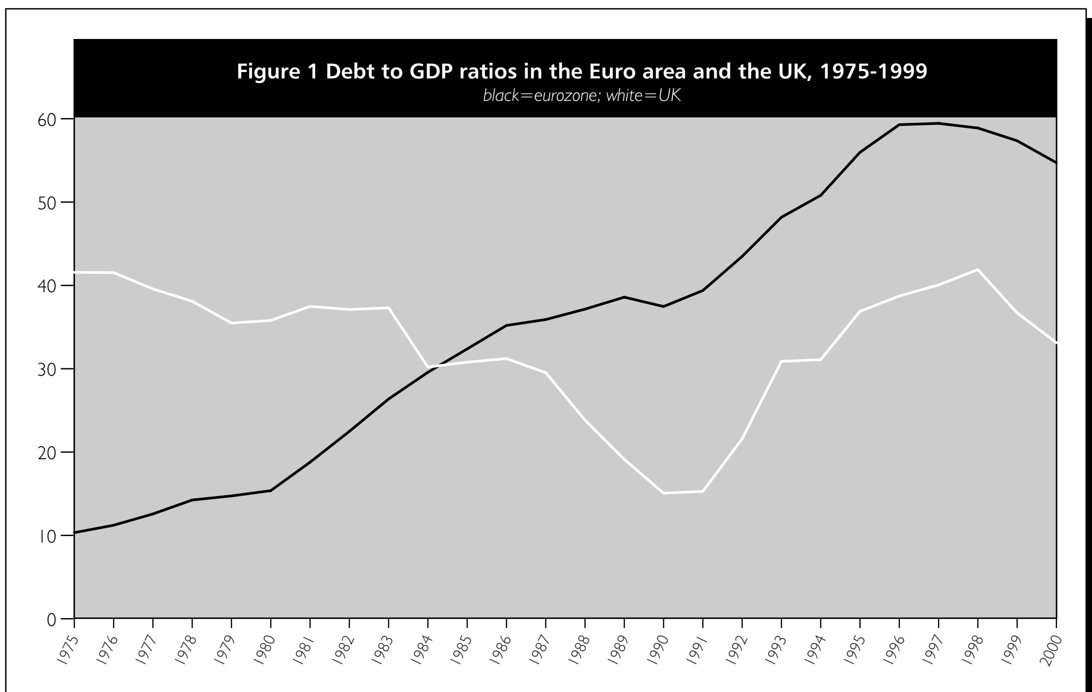
This in itself might not be a major issue for the current UK government, which does appear to follow prudent rules. The problem lies in the second SGP rule, which contradicts the UK rules in two ways. First, the long run SGP target is an ever-shrinking level of debt to GDP, which is much 'tougher' than the second UK rule. So switching to the SGP rule would mean spending less or raising taxes, for no reason that makes any economic sense. Second, additional borrowing for government investment, which can be justified in terms of intergenerational equity and possibly future growth, would be ruled out. This is obviously of particular concern to the UK at present, as it tries to undo the effects of decades of under-investment.

One size does not fit all

So the key stumbling block for the UK is the SGP medium term target of budget balance, which implies a gradual reduction of debt relative to GDP. Following this rule, rather than the government's own, will at some stage imply either higher UK taxes or lower spending. When this will occur depends on many factors, including the short term outlook for the UK economy. As there is no economic logic behind this target, adhering to it is a pure cost.

But if the target makes no sense in itself, why was it imposed in the first place, and could it be changed? We can only guess at answers to the first of these two questions, because the economic logic behind medium term zero balance has never been articulated. One answer may, however, lie in the trends depicted in Figure 1, which plots the debt to GDP ratio in the eurozone and the UK. In the Euro countries on average, debt has steadily risen over the last 25 years, a process that has only begun to be reversed in the last few years. In contrast, there has been no trend in the UK. If this increase in Euro debt had financed investment which would benefit future generations then it might have made sense, but if it did not, then future generations will be paying higher taxes to service the debt with no additional benefit. Furthermore, as we noted above, future pension liabilities in many European countries may mean yet higher taxes. Given this background, we can see why some in Europe would have wanted to reverse the trend through a rule that implies a steady reduction in the debt to GDP ratio.

Nevertheless, the medium term balance target is still a very inefficient method of achieving long run sustainability and intergenerational equity. Even within the eurozone, the position of some countries is very different from others. The debt to GDP ratio differs substantially among the Euro members: in Belgium net debt was nearly equal to GDP at the end of 2001, while in Sweden it is tiny. A 'one size fits all' policy makes no economic sense, and it is clearly inappropriate for the UK.



The prospects for reform

With the President of the Commission reportedly describing the pact as 'stupid', is it likely to be reformed in ways that might make it more acceptable to the UK? Most of the public discussion has focused on the three per cent deficit limit and the fact that it tends to bite during economic downturns when fiscal contraction is both politically difficult and economically inappropriate. One possibility that has been widely canvassed is to move to cyclically-adjusted deficit targets.

This reform would not solve the fundamental problem embodied in the second rule. In addition, it would still be inferior to the UK approach in the following sense. A cyclically-adjusted deficit target allows the automatic stabilisers to work, but it leaves no room for the government to take positive action to counteract a recession. In a monetary union, fiscal policy is the only means governments have to counteract economic shocks that impact on them differently from other member states. Targeting deficits over the course of the cycle allows countercyclical fiscal policy. There are a number of reasons for believing that such discretionary fiscal action could be effective in moderating the economic cycle (see Calmfors 2003, for example).

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A step in the wrong direction

What about the second SGP rule? Here there appears to be some hope, because of the imminent entry of many countries that have a need for public infrastructure investment at least as great as the UK's. However, the eurozone has two options available to solve this problem and the signs are that it is opting for the wrong one.

Recently the European Commission has suggested some detailed revisions to the SGP rules. They involve taking account of the structure of the budget and the level of debt in setting the medium term target. Leeway may also be given to countries undertaking 'structural reforms'. While such changes will certainly make the Pact more flexible, this flexibility has a major cost. It will require the Commission to become much more involved in the detail of national fiscal policy, and make enforcement of the Pact much more open to political bargaining.

Take the example of borrowing for investment, for example. Defining what is investment in the area of public spending can be very difficult. Is defence spending investment (in future security)? Would it have been right to pay for the infamous Dome by borrowing, for example? Difficult though these issues are, two things seem clear: they are highly political, and they are issues that should be decided at the national level. The great danger in any reform of the second SGP rule is that it is modified on a case-by-case basis, with each country having to justify exemption from the second rule in a process of political negotiation. This would amount to political interference by Europe in affairs where subsidiarity should apply.

A better option

There is, however, an alternative path for reforming the Pact, which puts the emphasis back on subsidiarity. National governments should be allowed to establish and follow their own fiscal rules. If these rules are sufficient to ensure long term sustainability, then these governments should be exempted from the Pact. If exemption was granted, then the Commission's role would change: it would simply monitor whether the government's own national rules were being followed. As

long as a government was following its own rules, the Commission would do nothing. If the government appeared to be ignoring its own rules, Europe would have the power to end that country's exemption from the Pact.

This approach makes sense for the following basic reason. It is clearly in a country's own interests to ensure that its fiscal plans are sustainable. However, there are many different ways of ensuring sustainability, and no one approach is obviously better than another (see Buiter 2003). In some cases, for example, governments may wish to make institutional changes, where a delegated agency is charged with monitoring or even enforcing sustainability (see Wren-Lewis 1996 or Wyplosz 2002), or for carrying out temporary fiscal actions aimed at demand stabilisation (Wren-Lewis 2002). Different approaches may be relevant to different countries faced by different institutional structures and initial debt levels. Here one size is unlikely to fit all, and individual governments should be free to make their own choices.

In the case of the UK, for example, the Commission could first note that the UK's fiscal rules ensure sustainability (which in practice they almost certainly do). As a result, the UK would become exempt from the Pact's fiscal rules, so long as its own rules were followed. The Commission would then monitor whether the UK rules were being followed. In less politically-charged times, such monitoring might be welcomed by the public as a safeguard against rules being distorted by over-optimistic projections or creative accounting. The Commission would be able to take a position on, for example, the recent debate over how to determine when a cycle begins or ends.

If the SGP adopted this reform policy, whereby countries that established their own rules or institutions for ensuring sustainability would no longer be bound by the SGP rules, then joining EMU would be no threat to national fiscal autonomy. Unfortunately there is no sign that reform of this kind is contemplated. Instead, there is a clear danger that reform of the SGP will take the wrong direction, with greater European interference in the detail of national fiscal plans as the price for periodic exemption from the existing SGP rules.

In the short term the costs for the UK could be high, with either higher taxes or the partial abandonment of Labour's ambitious plans for the NHS and other public services. Even if the UK did manage to save these plans as part of negotiations for EMU entry, a pact based on the existing model makes it difficult for countries to respond to macroeconomic shocks, and risks a significant erosion of the principle of subsidiarity □

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