Project Syndicate

Europe's Empty Fiscal Compact
February 2012

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CAMBRIDGE – The driving force of Europe's economic policy is the "European project" of political integration. That goal is reflected in the European Union's current focus on creating a "fiscal compact," which would constitutionalize member states' commitment to supposedly inviolable deficit ceilings. Unfortunately, the compact is likely to be another example of Europe's subordination of economic reality to politicians' desire for bragging rights about progress toward "ever closer union."

The plans for a fiscal compact have evolved rapidly in recent months, shifting from a politically unpopular "transfer union" to a dangerous plan for fiscal austerity and, finally, to a modified version of the defunct Stability and Growth Pact of 1997. In the end, the agreement that will emerge later this year will do little, if anything, to change economic conditions in Europe.

German Chancellor Angela Merkel initially proposed the "transfer union," in which Germany and other strong eurozone economies would transfer funds year after year to Greece and other needy countries, in exchange for the authority to regulate and supervise the recipient countries' budgets and tax collections. The German public rejected the idea of permanent transfers from German taxpayers to Greece, while Greek officials and the Greek public rejected the idea of German control over their country's fiscal policy.

The next step was the fiscal plan that was agreed in Brussels at the end of last year, which completely abandoned the idea of a transfer union in favor of an agreement that each eurozone country would balance its budget. Under this scheme, a financial penalty would "automatically" be imposed on any country that violated that obligation. With balanced budgets everywhere, there would be no need for fiscal transfers.

But how, exactly, should the balanced budget requirement be defined? In a letter to the officials negotiating the formal agreement, Jorg Asmussen, the German member of the European Central Bank's Executive Council, stressed that a balanced budget meant just that. Even if a country ran budget deficit because a cyclical downturn caused a fall in tax revenue and an increase in social transfers, it should be required to raise taxes or cut spending to restore a balanced budget.

If this proposal were actually implemented, it would have the effect of turning small recessions into major economic downturns. Fortunately, this recipe for creating future European depressions was rapidly dropped.

The most likely form of the fiscal compact now seems to be a very mild agreement requiring each country to "balance its budgets over the business cycle." Although failure to comply would in principle lead to automatic financial penalties, it is difficult to imagine how such failure could be determined in a country like Spain. At what future point would Spain, with a persistent unemployment rate of more than 15%, be required to raise taxes and cut social transfers? Ordering Spain to do so might rest with the European Commission, making it a political decision, rather than the "automatic" technical requirement that its proponents promise.

If this is the essence of the fiscal compact that is eventually agreed, it will have no predictable effect on eurozone countries’ behavior. Its only effect will be to allow the eurozone’s political leaders to claim that they have created a fiscal union, and thus that they have moved Europe closer to the political union that is their ultimate goal.

But a fiscal union conceived in this way is completely different from how most people understand the term. In the United States, for example, the central government collects about 20% of the country’s GDP and pays out a similar amount. That centralization of taxes and spending creates an automatic stabilizer for any region that experiences an economic downturn: the affected region’s residents send less money to Washington and receive more in transfers.

There is no similar process in the eurozone, where taxes and spending occur at the national level. The centralized fiscal role in the US also allows all of the individual states to operate with true balanced budgets, modified only by relatively small “rainy day” funds.

But, although the current European political process will not create strong fiscal discipline, financial markets are likely to force eurozone governments to reduce their sovereign debts and limit their fiscal deficits. During the single currency’s first decade, private investors’ belief in the equality of all eurozone sovereign bonds kept interest rates low in the peripheral countries, even as their governments ran up large deficits and accumulated massive debt. Investors will not repeat that mistake: once bitten, twice shy.

For eurozone governments, that means that financial markets will now enforce what the political process cannot achieve. The EU’s fiscal compact, whatever its final form, will be little more than a sideshow.

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