Forbes

Are European Fiscal Rules a Greek Farce?

By Alberto Mingardi

2/23/2012

Now teetering on the edge of bankruptcy, Greece was first sanctioned for violating the European growth and stability pact in 2005. The euro crisis highlights the ineffectiveness of European fiscal rules in the recent past, and it is why European leaders have agreed on a new “fiscal compact” to target debt and deficit limits. But previous failures in enforcing fiscal rules might justify skepticism among international observers when it comes to the credibility of Europe’s leaders in setting these new targets.

The new targets will be credible only if the leaders find a way to rewrite their own pact with voters.

On paper, Europe has never experienced a shortage of fiscal rules. The Maastricht Treaty (Article 121) fixed numerical targets for states seeking accession to the European Union. EU states were to keep their government deficits below the reference value of 3 percent of gross domestic product (GDP), whereas debt should not exceed the threshold of 60 percent of GDP. In case of a higher debt ratio, the Treaty required it to show a decreasing trend.

These fiscal rules enjoyed a limited success. Of the 17 eurozone countries, only Finland and Luxembourg consistently complied with the Maastricht parameters. The very need for a new fiscal compact stems from previous failures in policing public finances. But can this time be different?

The euro crisis and the sorrows of Greece sparked a new urgency for fiscal responsibility. Since Germany introduced a debt bracket in 2009 that forbids the national government to run a deficit of more than 0.35 percent of GDP from 2016, other member-states have struggled to follow the German lead to restore their own credibility as debtors. This was the case of such profligates as Spain and Italy.

The Italian case is of particular interest, because it suggests that sometimes rules may be written with the explicit purpose of circumventing them.

The Italian public debt moved from 40.5 percent of GDP in 1970, to 60.1 percent in 1981, and to 121.8 percent in 1994. Over 150 years of history, Italy only ran a balanced budget twice. Its constitution did not explicitly refer to a balanced budget; however, it required new sources of revenues to be identified whenever new expenses were undertaken. It sounds like a simple rule of thumb, but it was knowingly never complied with.

In short, Italy is a country in which promises fueled by public spending were consistently used to build consensus among voters. Even when European-mandated fiscal consolidation measures helped to freeze the growth of public debt (it reached 103.6 percent of GDP in 2007), public expenditures, net of interest payments, steadily rose; in the last ten years, Italian public spending grew by 24.4 percent. A constitutional cap on debt thus seems to be the appropriate instrument to restrain the Italian political class' entrenched propensity towards excessive spending.

Unfortunately, the constitutional amendment provisionally approved by the Italian Parliament merely provides for an "equilibrium" of finances, allowing for local and national governments to borrow in the case of "unexpected events." No spending ceiling has been inserted in the constitution. The Italian legislators appear to have written a rule that aims to pave the way to exceptions.

Creativity is an Italian talent, but we are facing a problem that goes beyond my countrymen's approach to the art of legislating. For fiscal discipline to be embraced, you need citizens and constituencies to do so. Citizens must themselves demand, or at least consent to, a very different approach to public spending.

Any serious European fiscal compact will prove to be at odds with the unwritten social contract between European voters and European politicians: a social contract that is based upon public expenditures' "lubrication effect" on popular consensus.

In the face of a possible euro breakdown and of years of economic gloom and doom, virtually no European leader has talked about the need to rethink the so-called "European social model." How could European rulers enter a pact for fiscal sanity, when they continue to avoid rewriting the social contract between them and their voters?

This problem is neither Italian nor Greek, but spans the whole of Mediterranean Europe. Recently elected Spanish Prime Minister Mariano Rajoy already announced that his country will not run a balanced budget in 2012, and that his government will bail out indebted regions. No European leader, left or right, is calling for a major political shift of the kind that would allow them to permanently shrink public spending and, thus, keep within the new fiscal rules.

The "pacta sunt servanda" principle was a pillar of Roman law and also of the free-market economy. But we know that we have situations in which honoring pacts is a mere pretense: everybody is busy dishonoring them, and tricks and frauds subsequently multiply in the most egregious ways. These situations happen typically on stage, and are the essence of farce: a great Greek invention—but apparently popular throughout Europe.

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