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The Euro, Public Expenditure and Taxation

by
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INTRODUCTION

The main purpose of this paper is to explore the probable consequences for public expenditure in the UK if Britain were to join the euro. It concentrates on the effects of sterling joining the euro (and the associated implications such as monetary policy being governed by the European Central Bank, the ECB), and does not consider any broader questions of the effects of membership of the European Union and the policies pursued by it and the European Commission.

As the fiscal stance of government (broadly government expenditure minus tax revenue) influences the level of demand in the economy, there are also important implications for the level of employment more generally. Whilst the general deflationary nature of the economic policy of the eurozone (especially the Stability and Growth pact discussed below) should not be overlooked, the focus of this paper is on the implications for public expenditure of the eurozone and the UK's possible entry into the euro.

MAASTRICHT TREATY AND CONVERGENCE CRITERIA

Under the conditions of the Maastricht Treaty, convergence criteria were established for judging whether a national currency should join the euro, whether at the time of the launch of the euro or to join subsequently. It is still relevant to consider these criteria, in part because they would in principle still apply to any application by the UK for sterling to join the euro. Further, these convergence criteria provide some insights to the concerns which featured in the construction of the euro--and to which concerns did not feature and were not reflected in the convergence criteria.

These criteria are:

1. The average exchange rate of the currency concerned not to deviate by more than 2.25 per cent from its central rate for at least the two years prior to membership, in what became known as the Exchange Rate Mechanism (ERM).

2. Inflation rate not to exceed the average rate of inflation of the three community nations with the lowest inflation rate by 1.5 per cent.

3. Long-term interest rates not to exceed the average interest rate of the three countries with the lowest inflation rate by 2 per cent.

4. Budget deficit not to exceed 3 per cent of its Gross Domestic Product (GDP).

5. Overall government (gross) debt not to exceed 60 per cent of its GDP.

Countries are also required to enact legislation for their Central Banks to become 'independent' from political or other influences in their decisions.

Although the application of these criteria for the 12 countries which entered the eurozone now lie in the past, they would still appear to apply for the UK's membership (and indeed the entry of Denmark and Sweden and of the future members of the European Union from Eastern and Southern Europe). At the present time, the UK would satisfy all of the criteria with the exception of the first though it may well be that the criteria would not be treated as binding in respect of ERM membership.

The UK does not belong to the ERM and the level of sterling has fluctuated to some degree against the euro. But more significantly the current high level of the exchange rate poses a considerable concern. If the UK is to enter in the near future, sterling must depreciate substantially (breaking the spirit if not the letter of the first of the criteria) or it will enter at a substantially over-valued exchange rate. Entry of sterling into the eurozone at anything like the current exchange rate of sterling would mean entry at a much overvalued rate: although estimates vary something in the range of 10 to 15 per cent over valuation is often cited. The deflationary consequences of such a high exchange rate would be substantial as prices in the UK would have to fall (relative to prices in the rest of the EU). The UK has experienced overvalued exchange rates before, notably when Britain returned to the Gold Standard in 1925 and when sterling joined the Exchange rate Mechanism in 1990. Both episodes ended ignominiously and with substantial damage to the British economy and society. The exchange rate at which sterling might join the euro is not an issue which is further addressed in this paper. But it should be noted that in the event of entry at an overvalued rate which had deflationary results, budget deficits would tend to rise, running into the barriers erected by the Stability and Growth Pact, a point which is returned to below.

It is worthwhile considering these convergence criteria and their significance for the nature of the 'euro project'. First, their thrust was deflationary--many countries were required to cut budget deficits or reduce public debt to meet the criteria, others had to reduce inflation. The relatively poor economic performance of many of the EU economies during the 1990s may to some degree be attributable to their striving to meet those criteria. From 1992 to 1999, the growth of national income averaged 1.7 per cent per annum in the eurozone countries, compared with the UK average of 2.5 per cent per annum. Over the same period, unemployment rate fell substantially in the UK (and also in USA, Canada), but tended to rise in the eurozone countries--notably in France, Germany and Italy (Ireland being the notable exception as unemployment fell dramatically). The average growth of the eurozone countries was around 1 percentage point lower during the 1990s than during the 1980s, whereas the UK's growth rate was much the same. The level of unemployment within the euro zone countries averaged just over 10 per cent in the mid 1980s, then fell by around 2 per cent, rose during the mid 1990s to over 11 per cent, declining to 8.9 per cent in 2000 and to 8.5 per cent at the time of writing in May 2002. The unemployment record in the UK is rather more volatile but the unemployment rate in the UK has been below the euro zone rate since 1993. The economic performance of the eurozone countries during the 1990s was rather poor. The frequently cited explanations of eurosclerosis, inflexible labour markets, etc. do not provide an explanation of the much poorer performance in the 1990s as compared with the 1980s. The striving of countries to meet the Maastricht Treaty convergence criteria was deflationary--it pushed countries to reduce expenditure, raise taxation, pay attention to reducing inflation without considering unemployment. When unemployment did fall towards the end of the 1990s, it was much stimulated by the low value of the European currencies that were to form the euro and the business upswing in the United States.

Second, in the application of those criteria, there was considerable 'fudging'. As we have shown in detail elsewhere (Arestis, Brown, and Sawyer 2001), various member states of the euro area resorted to accounting 'tricks' and the like in order to meet the criteria for entry into the single currency. Further, most of the counries which entered into the euro did not satisfy the letter of these convergence criteria--for example in a number of cases countries entering into the eurozone did so with a government debt substantially more than 60 per cent of GDP. In so far as the Maastricht criteria were designed to establish the credibility of the euro and the eurosystem in the eyes of the financial markets, the 'fudging' of the criteria can only have been a negative signal to those markets.

Third, these convergence criteria related to what could be called nominal variables--they were concerned over the convergence of inflation rates, interests rates and budget deficits. There is some rationale for some concern over convergence of inflation and interest rates if a single currency is to be formed, since a single currency area will have a single monetary policy (and hence single Central Bank interest rate). It is also unlikely that a single currency area could function with substantial differences in the rate of inflation within the area. But any rationale for the inclusion of the convergence of budget deficits to less than 3 per cent of GDP and for government debt to be less than 60 per cent of GDP has been generally lacking.

It is also evident that there is no reference to what may be termed real convergence, that is the convergence of economic growth, unemployment levels, level of national income per head, the business cycles and the like. Indeed there remain massive differences in living standards and unemployment rates across the EU. The disparities between the regions of the eurozone (which number 65) and the states of the United States of America may provide a reasonable basis for comparison. For the USA, unemployment rates between states ranged from 2.2 per cent to 5.9 per cent in 2000, and per capita disposable income from $18,467 (Mississippi) to $31,697 (Connecticut) in 1999. For the eurozone, unemployment rates ranged from 3 per cent to 37 per cent, and GDP per head (in 1998) from 6536 euros per head (Ipieros, Greece) to 40353 euros per head (Hamburg), i.e. by a factor of 1:6.

The economic criteria for sterling's entry into the euro laid down by the British government are rather different in tone from the Maastricht convergence criteria. They are:

1. 'whether there can be sustainable convergence between Britain and the economies of a single currency' ;

2. 'whether there is sufficient flexibility to cope with economic change' ;

3. 'the effect on investment' ;

4. 'the impact on our financial services industry' ;

5. 'whether it is good for employment'.

These criteria have the merit on focusing on the issues such as employment and investment, which are noticeable by their absence in the Maastricht convergence criteria. There is, thus, a substantial difference between the two sets of criteria. The Maastricht ones are all 'nominal' criteria while the British government's are in terms of 'real' variables. This difference can have significant implications for economic activity. In the case of the Maastricht criteria, unemployment is adversely affected when countries strive to meet the criteria. In the case of the British government's criteria, they are forward rather than backward looking, and focus on real variables.

The Maastricht convergence criteria required most countries to reduce budget deficits and public debt levels from the levels prevailing in the early 1990s. It put into place a stress on reducing budget deficits which have been carried over into the Stability and Growth Pact, albeit in a more stringent form.

STABILITY AND GROWTH PACT

The introduction of the euro has been accompanied by the adoption of the Stability and Growth Pact (SGP). This pact governs the economic policies of the member countries that have joined the single currency and constrains the economic policy of those who have not joined. Member countries of the EMU must keep their budget deficits within 3 per cent of gross domestic product; it also prescribes that all EU members keep their budgets 'close to balance or in surplus' in the medium term. The economic effects of sterling joining the euro will be much affected by the operation of the SGP, and its terms are crucial for understanding the effects of the euro for public expenditure.

The lack of trust between Northern and Southern EU states produced the *Stability and Growth Pact* which increases the restrictions imposed on the freedom of EU countries to use fiscal policy. The 'growth' part in the *Stability and Growth Pact* was merely cosmetic. It was added to conciliate the French authorities who insisted on the inclusion of growth and other economic activity variables in the Pact. They also managed to change the German proposal that any budget revenues should be used to pay off debts, to one which requires government financial positions to be close to zero or in surplus in the medium term.

The Stability and Growth Pact created four rules for macro-economic policy within the eurozone, and it is this pact that would govern the conduct of macro-economic policy in the UK if sterling were merged into the euro. The first rule is that the European Central Bank (ECB) operates with independence from political influence which includes independence from member governments, the European Commission and the European Parliament; it also means independence from national central banks, although they comprise one of the 'operating' arms of the ESCB (European System of Central Banks). The second is the rule of 'no bail out' of national government deficits: that is the European Union and the ECB would not come to the rescue of a government which could not meet its debt obligations. The third is that the monetary financing of government deficits is prohibited: that is a government's budget deficit has to be financed through borrowing (usually on the bond market). Thus the ECB cannot issue money which is used to finance any national government's budget deficits.

The fourth is that member states have to avoid running 'excessive budget deficits' which are defined as deficits of more than 3 per cent of GDP. It is this fourth rule which has most implications for public expenditure. This final rule has been seen to imply a balanced budget or slight surplus over the course of the business cycle (given that the 3 per cent deficit cannot be exceeded during a downswing). In the words of the European Council 'Adherence to the objective of sound budgetary positions close to balance or in surplus will allow all Member States to deal with normal cyclical fluctuations while keeping the government deficit within the reference value of 3 per cent of GDP'. Further, 'Member States commit themselves to respect the medium-term budgetary objective of positions close to balance or in surplus set out in their stability of convergence programmes and to take the corrective budgetary action they deem necessary to meet the objectives of their stability or convergence programmes, whenever they have information indicating actual or expected significant divergence from those objectives' (Resolution of the European Council on the Stability and Growth

Pact, Amsterdam 17 June 1997).

In the event of an economic downturn in which output has fallen by more than 2 per cent, then the member state escapes any sanction automatically, but the budget deficit should be corrected (i.e. public expenditure cut or taxation raised) once the recession has finished. A fall of output by more than 2 per cent would be a very severe recession indeed: in the UK, output (on a year to year basis) has only fallen by 2 per cent or more once in the post war era (1979/1980). However, if output falls between 0.75 and 2 percent then the Council of Ministers can use discretion when making a decision on an 'excessive' deficit, other factors will be taken into account such as the abruptness of the downturn, the accumulated loss of output relative to past trends and whether the government deficit exceeds government investment expenditure.

A country's budgetary data become available for the Commission to scrutinise on 1 March each year when the stability programmes are submitted. Each programme will contain information about the paths of the ratios of budget deficit to GDP and national debt to GDP. The Council (ECOFIN) examine the stability reports and deliver an opinion on a recommendation by the Commission (within two months of the reports submission). If the stability programme reveals that a country is significantly diverging from its medium-term budgetary objective, then the council will recommend that the stability programme is 'strengthened'--that is cuts in public expenditure and increases in taxation imposed. If the situation persists then the member state will have been judged to have breached the reference values. The Pact details 'escape' clauses which allows a member state that has an excessive deficit to avoid sanction.

If a country is found to have breached the reference values, then it has four months to introduce the corrective measures suggested by the Council. If the country follows the Council's recommendations, then the 'excessive' deficit can continue, but the budget deficit must be corrected within a year following its identification. A country which chooses not to introduce corrective measures will be subject to a range of sanctions (Article 104c(11)), at least one or more must be imposed, of which one must be in the form of a non-interest bearing deposit lodged by the national government. In this instance, it will fall upon EMU members, excluding the member country under consideration, to reach a decision on sanctions. The non-interest bearing deposit consists of a fixed component (0.2 per cent of GDP), and a variable component (one tenth of the difference between the deficit ratio and the 3 per cent reference value). If the budget deficit is not corrected within two years, the deposit is forfeited and becomes a fine, whereas if the deficit is corrected within two years the deposit is returned and the penalty becomes the foregone interest. The penalty clause would add to the deficit it is meant to cure, and as such it could generate national opposition. This restriction on the workings of automatic stabilisers could lead to weaker fiscal stabilisation and greater output volatility.

At first glance, it may appear that the terms of the SGP are rather similar to those of the Maastricht convergence criteria quoted above in that the same 3 per cent figure is used for the deficit to GDP ratio requirement (and the same 60 per cent figure in respect of the debt to GDP ratio requirement). However, there is though a major difference. The 3 per cent figure for the budget deficit in the Maastricht Treaty was to be achieved at a particular point in time (March 1998 as it transpired for the now eurozone countries), though considerable efforts had to be made for a number of countries in terms of cutting public expenditure to meet that 3 per cent figure (see Arestis, Brown, and Sawyer 2001). In contrast, the 3 per cent figure in the Stability and Growth Pact is the maximum budget deficit which can reached at any time in the course of the business cycle. Over the course of the business cycle, the budget deficit tends to vary with the cycle, rising when output slows down and falling when output is rising. As income and employment rise, tax revenues tend to rise, and some expenditure on social security fall, leading to a falling deficit. As income and employment fall, the reverse occurs and deficit tends to widen. The 'swing' in the size of the budget deficit may be of the order of 6 to 8 per cent of national income. With such swings, a maximum deficit of 3 per cent of national income would mean a 3 to 5 per cent surplus at other times, and an average budget position close to balance.

One (perhaps) minor side effect is that there appears to be no route for any expansion of base money: on average the budget is to be balanced or in surplus, and anyway any deficit (even a temporary one) cannot be directly monetised. The banking system (expanding at around 4.5 per cent per annum if the money supply reference level is achieved) would be operating with diminishing reserve ratios unless the ECB is generally engaging in open market operations which have the effect of buying in the debt of national governments.

The rationale for the 'no bail out' rule and the limits on budget deficits would appear to be some combination of seeking 'credibility' in the financial markets and dealing with possible externalities whereby one government's borrowing (in euros) would have negative effects on the ability of other eurozone governments to borrow. It was thought that 'credibility' (of the euro and the institutions of the eurozone particularly the ECB) would be gained through adherence to particular rules for economic policy as well as granting 'independence' to central banks etc.. Whatever the intention, the decline in the value of the euro by around 25 per cent in its first three years of existence does not suggest much success in gaining 'credibility' (see Arestis et al., 2002, for full details).

The externality effects would arise if high levels of borrowing of euros by one government put upward pressure on the interest rate on bonds paid by that government which in turn could edge up interest rate on bonds issued by other eurozone governments. But this would be based on some combination of the argument that there are limited funds for borrowing and that the risk premium attached to one eurozone country affects the risk premium of other eurozone countries.

The EU budget is small (around 1.25 per cent of GDP), required to be always in balance and dominated by the Common Agricultural Policy (CAP). There is clearly little role for fiscal transfers from relatively rich countries to relatively poor countries, nor is there any possibility of the EU budget operating as a stabiliser. About half of the transfers which do occur will be set by the requirements of the CAP, although much of the remainder (in the form of regional policy) do involve transfers from rich to poor areas. There is currently no mechanism for the operation of an EU level fiscal policy which could have stabilising effects (as an automatic stabiliser) over time nor which has any significant redistributive element across economic regions.

Although there is an absence of any significant EU-level fiscal policy, there is, of course, the national fiscal policies. These policies could be said to be coordinated through the Stability and Growth Pact and the meetings of ECOFIN (the EU Council of Economic and Finance ministers), but the term subordinated might be more appropriate since national fiscal policy has to conform to the requirement of the budget deficit being in balance or small surplus on average. But the coordination of fiscal policies from that Pact is not of the form of coordinated reflation or deflation to deal with EU-wide issues of unemployment or inflation, nor is it a coordination which seeks to achieve an overall average high level of aggregate demand. Indeed, the fiscal policy imposed by the SGP is close to a 'one size fits all' approach (which is also a feature of the monetary policy in the eurozone where the interest rate set by the European Central Bank applies across the eurozone). The 'one size' is that over the course of the business cycle the government budget should be in balance or slight surplus. The budget position can vary over the course of the business cycle, provided that it is deemed consistent with the overall average of balance or slight surplus. National governments are not able to set the general stance of fiscal policy to meet their own needs and requirements, but rather have to conform to that which is laid down by the SGP.

The operation of the SGP over the past couple of years has provided a number of illustrations of its general thrust. A brief review of these particular cases serves to indicate the ways in which the SGP bears down on public expenditure with a general deflationary bias. The first concerned the criticism of Irish budgetary policy adopted by the ECOFIN on 12 February, 2001 (based on recommendations from the European Commission). The Irish government proposed some tax reduction measures following an agreement with the trade unions to contain wage increases. At the time these proposals were made, the Irish budget was in significant surplus, unemployment was low but inflation was over 5 per cent per annum. The Irish proposals were viewed as stimulating the economy which was already buoyant.

The Council of the European Union concluded that 'The macroeconomic scenario underlying these projections assumes a gentle decline in real GDP growth and in inflation over the period. The positive output gap, after an estimated 4.5 per cent of trend GDP in 2000, is expected to peak in 2001 at 5.4 per cent and to gradually decline thereafter. In this context, the Council considers that the stimulatory nature of the budget for 2001 poses a considerable risk to the benign outlook in terms of growth and inflation portrayed in the 2000 update. The Council considers that this budget - the main measures of which are indirect and direct tax cuts and substantial increases in current and capital expenditure is pro-cyclical. The Council finds that it will give a boost to demand of at least 0.5 per cent of GDP and that its possible supply effects are likely to be small in the short term, thereby aggravating overheating and inflationary pressures and widening the positive output gap. ... Further, while indirect tax cuts have a once-and-for-all effect on the price level, they probably have no lasting effects on the rate of inflation but clearly further stimulate demand. Given that the monetary policy is now set for the euro area as a whole and no longer available as an instrument at national level, other policies, including budgetary policies, must be used more actively. Against this background, the Council finds that the planned contribution of fiscal policy to the macroeconomic policy mix in Ireland is inappropriate. The Council recalls that it has repeatedly urged the Irish authorities, most recently in its 2000 broad guidelines of the economic policies, to ensure economic stability by means of fiscal policy. The Council regrets that this advice was not reflected in the budget for 2001, despite developments in the course of 2000 indicating an increasing extent of overheating. The Council considers that Irish fiscal policy in 2001 is not consistent with the broad guidelines of the economic policies as regards budgetary policy. The Council has therefore decided, together with this Opinion, to make a recommendation under Article 99(4) of the Treaty establishing the European Community with a view to ending this inconsistency'.

This episode illustrates three points. First, the Stability and Growth Pact is seen to involve the notion that government budgets should be, on average, in balance or surplus in order to comply with the reference value of 3 per cent of GDP for the budget deficit. Second, the Stability and Growth Pact is interpreted to say that budgets must be tightened rather than loosened when there is evidence of 'overheating', without regard to the budget position and without regard to the prospects for inflation. Third, there are some fundamental differences between governments on economic policy and the workings of the economy. In this instance the European Commission and a number of member governments seem to be saying that inflation is necessarily demand-push to be met by fiscal demand deflation (even though monetary policy is supposed to be the policy instrument for the control of inflation), whereas the Irish government appears to be arguing that wage agreements can moderate inflation.

The second case that illustrates the general thrust of SGP operation, involves the recommendation in April 2001 to the British government (who are not formally governed by the Stability and Growth Pact, although prescribed by it as mentioned earlier) that in the event of a downturn in 2002, public expenditure should be reduced (below planned levels) to maintain the public expenditure to GDP ratio. 'However, the Council notes that a persistent deficit of 1 per cent of GDP emerges in the latter years of the plan. This would not be in line with the prescription of "close to balance or surplus" contained in the Stability and Growth Pact. ... While the specific recommendations to the UK in the BEPG [Broad Economic Policy Guidelines] advised the UK to pursue a policy of substantially raising the ratio of government fixed investment to GDP, it also recommended to do so within the context of firm control of government expenditure, thereby keeping the underlying position of government finances broadly unchanged. Therefore, the Council encourages the government to be alive to any deterioration in the public finances that would take them away from the terms of the Stability and Growth Pact and, if necessary, to take remedial action'. In other words, increased expenditure on health service may well have to be matched by cuts in public expenditure elsewhere.

The third comes from the response of the ECB president Duisenberg at a press conference on 6 December, 2001, after the ECB's policy-making council, to an Italian request to delay target dates for budget balance in view of the projected downturn in economic activity. He argued that 'it is of the greatest importance to enhance confidence with both consumers and investors if governments stick to their medium-term strategy, whatever happens'. This significance of this type of remark is that the not only does the ECB push to deflationary budget measures but is likely to respond to any increase in budget deficits by raising interest rates.

The fourth comes from recent European Commission predictions for the year 2002 relating to budget deficits under the terms of the SGP, which prompted the possibility of the 'early warning' mechanism in the cases of Germany and Portugal Their deficits for 2001 were creeping close to the SGP 3 per cent ceiling (it stood at 2.7 per cent of GDP in the case of Germany and 2.2 per cent in the case of Portugal).

The Commission had recommended to the Council [of Ministers] for an 'early warning' to be issued to Germany 'in order to prevent the occurrence of an excessive deficit'. In the event, a compromise was reached whereby the German government gave a range of commitments. These were that it

> 'confirms its endeavour to ensure that the 3 per cent of GDP reference value for the general government deficit will not be breached; to this end, the government intends to closely monitor budgetary developments at all levels of government in 2002, including the States (Lander) and the social security system:
>
> will implement budgetary plans for this year carefully, avoiding to take discretionary measures that could aggravate the budgetary position and using any budgetary room for manoeuvre to reduce the deficit:
>
> confirms that a close to balance position will be reached by 2004, in accordance with previous commitments; this may require, once the economic recovery is established, discretionary measures in addition to those included in the 2001 updated stability programme:
>
> will, through agreements with the regional authorities, make every effort to ensure that the above commitments are met' (Minutes of 2407th Council meeting : ECOFIN 12th February 2002)

'In light of these commitments by the German government, the Council [in a unanimous decision] considers that it has effectively responded to the concerns expressed in the Commission recommendation ...'

A similar set of conclusions and recommendations were reached in the case of Portugal. This outcome was interpreted by some as severely undermining the Stability and Growth Pact. For example :

'The news that EU finance ministers had opted not to punish Germany and Portugal for budgetary sloppiness has reinforced the notion that Europe will always put political expediency ahead to economic good sense. Two weeks ago, the European Commission voted to issue a formal warning to the two countries, whose budget deficits were wobbling close to eurozone limits. The fact that ministers stitched up a face-saving compromise has risked controversy'

'The Stability and Growth Pact is now in effect a dead letter. The rules, stipulating a warning when a state approaches its budget deficit ceiling, are clear and unambiguous. On this, their first public test, they have been brutally streamrolled. This is certainly embarrassing, for several reasons.

First, it was the Germans who insisted on tough eurozone budgetary rules ... in the first place. Five years ago, Germany was concerned that potential budget renegades, such as Italy, needed shackling, if faith in the single currency were to be maintained. Now Germany, along with Portugal, has become the first country to break its own rules.

Second, any form of political interference in economic issues looks desperately bad in the eyes of the money market markets, which have ruthlessly driven down the euro since its introduction three years ago.

Significantly, the UK was one of the countries lobbying for leniency, fearing perhaps that it would need similarly understanding treatment if it joined the eurozone.' ('Analysis: Europe's budget 'stictch-up" by James Arnold (BBC online 12th February 2002).

Although Portugal escaped censure at that time, subsequently the pressures of the SGP appear (at the time of writing) to be leading to reductions in public expenditure and increases in taxation. The following was reported in the *Financial Times* (9th May 2002). 'Portugal risks becoming the first eurozone country to have development aid blocked if it fails to implement emergency measures to cut its soaring budget deficit, Minister Ferreira Leite, finance minister in the country's new centre-right government, has warned. "We have seven months to bring a deficit heading inevitably towards 4.5 per cent of GDP to below 3 per cent," she said in an interview. "If we fail, Portugal will be automatically barred from applying for new development funds. The effect on the economy would be devastating."

Being denied further aid from the Cohesion Fund for the European Union's four poorest countries is the sanction Portugal fears most for failing to comply with the eurozone growth and stability pact, said Ms Ferreira Leite ...

Austerity measures were inescapable, even though they would slow economic growth, increase unemployment and possibly cause social tension. "Our economy is like a drowning man," she said. "It's not a question of deliberating over what medicine to administer. We have to act now to save it."'

Measures include raising VAT from 17 per cent to 19 per cent, civil service recruitment frozen, municipalities prohibited from incurring more debt and more than 70 state institutions closed or merged.

'Before its defeat in a general election in March, the socialist government had budgeted for a 2002 deficit of 1.8 per cent of gross domestic product, committing Portugal to this target under the eurozone pact. But Ms Ferreira Leite said this was a gross overestimate of tax revenue and underestimate of public spending. "If we did nothing, the deficit would be well above 4 per cent by the end of the year." The latest European Commission forecast is 2.6 per cent.'

Ms. Leite estimates that her measures would cut deficit to 2.8 per cent. 'Pedro Solbes, European Commissioner for economic and monetary affairs, welcomed her commitment to tough action but warned that the revised target left Portugal perilously close to the 3 per cent limit with little room for manoeuvre.'

The thrust of economic policy within the European Union is set out each year in the Broad Economic Policy Guidelines. We quote from the guidelines of 2001 to give a flavour of the EU's approach to economic policy.

'*In general, Member States should:*

i. meet, as a rule, and in keeping with last year's commitment, budgetary positions of close to balance or in surplus in 2001 so as to achieve a sufficient margin to cope with the impact of adverse cyclical fluctuations; ensure a rigorous execution of their budgets so as to prevent slippage from the stability programme targets;

ii. prepare budgets for 2002 in keeping with the need to achieve or preserve budgetary positions close to balance or in surplus and to avoid pro-cyclical fiscal policies; where appropriate, further strengthen public finances, especially with a view to securing their long-term sustainability; and

iii. be ready, in those Member States where overheating and inflationary pressures prevail to tighten budgetary policy, to pursue wage moderation and to advance further structural reforms aiming at reducing inflation and contributing to an appropriate macroeconomic policy mix at national level.' (9326/01, p.15)

The overall conclusion to be drawn from this section is that the Stability and Growth Pact has been designed to punish any national government which might attempt to reflate its economy when the monetary policy of the ECB dictates otherwise. It may also serve to punish any national government whose regional or local governments increase their budget deficits. This was the intention of the German proposals which led to the Stability Pact (later the Stability and Growth Pact) but even this intention has been 'fudged' as the recent experience of Germany and Portugal have indicated. This conclusion leads us to clarify ECB monetary policy in the next section. We conclude that the Stability and Growth Pact places downward pressure on budget deficit and thereby onto public expenditure. In a subsequent section we provide some estimates of the extent of this downward pressure on public expenditure.

EUROPEAN CENTRAL BANK

The institutional policy framework, within which the euro operates, has three key elements which relate directly to monetary and financial policy. First, the ECB is the only effective federal economic institution. The ECB has the one policy instrument of the rate of interest (the 'repo' rate) to pursue the main objective of low inflation. The Governing Council of the ECB agreed on the main features of their stability?oriented policy strategy. The single monetary policy has a euro area?wide perspective. A quantitative definition of price stability has been adopted (by the ECB itself; not by the elected body of the European Parliament) in the form of, in effect, a 0-2 per cent target for the annual increase in the Harmonised Index of Consumer Prices (HICP) for the euro area. The ECB has adopted a 'two-pillar' monetary strategy to achieve this target through the policy instrument of interest rate. The 'first pillar' is a commitment to analyse monetary developments for the information they contain about future price developments. This is the quantitative reference value for monetary growth, where a target of 4.5 per cent of M3 has been imposed. Being a reference level, there is no mechanistic commitment to correct deviations in the short term, although it is stated that deviations from the reference value would, under normal circumstances, 'signal risks to price stability'. It has also been agreed that a broadly?based assessment of future price developments will be undertaken, but not publicly announced. The 'second pillar' is a broadly based assessment of the outlook of price developments and the risks to price stability. This broad range of indicators includes: the euro exchange rate; labour market indicators, such as wages and unit labour costs; fiscal policy indicators (essentially the budget deficit to GDP ratio and the public debt to GDP ratio); financial market indicators, such as asset prices.

Second, the ECB and the national central banks are linked into the European System of Central Banks (ESCB) with a division of responsibility between them. The ECB has the responsibility for setting interest rates in pursuit of the inflation objective and the national central banks the responsibility for regulatory matters.

Third, the ECB is intended to be independent of the EU Council and Parliament and of its member governments. Thus, there is a complete separation between the monetary authorities, in the form of the ESCB, and the fiscal authorities, in the shape of the national governments comprising the European Monetary Union. It follows that there can be little co?ordination of monetary and fiscal policy. Indeed, any attempt at co-ordination would be extremely difficult to implement. For apart from the separation of the monetary and fiscal authorities, there is also the requirement that national governments (and hence fiscal authorities) should not exert any influence on the ECB (and hence monetary authorities). For example, 'neither the ECB, nor a national central bank, nor any member of their decision making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member States or from any other body' (Article 7 of The Statute of the European System of Central Banks and of the European Central Bank). Any strict interpretation of that edict would rule out any attempt at co?ordination of monetary and fiscal policies.

The ECB at present stands as the only body which can implement economic policy at a European Union (EU) level. The ways in which the ECB operates is crucial for the economic health of the EU, but it suffers from three major shortcomings, namely its undemocratic and unrepresentative nature, the confusing nature of its operations, and the objective that it has been set. The operation of the ECB should be changed in two significant ways: the membership of the board of directors should be broadened and the directors made directly answerable to the European Parliament, and the objectives set for it reformulated to include growth and employment, not merely price stability. A further change would be an increase in the transparency of the operations of the ECB, for example, the publication of the minutes of the meetings of the ECB Governing Body to determine interest rate policy (at present the intention is to publish the minutes 16 years after the event).

The eurozone is perhaps unique in having a 'high level' monetary authority (the ECB) and in effect no 'high level' fiscal authority with fiscal policy residing at the national level (albeit constrained by the Stability and Growth Pact). There cannot be any substantive co-ordination of monetary and fiscal policies in these circumstances, and there is a sense in which the monetary authority has the last word in that interest rates are set frequently and can be adjusted to seek to offset any fiscal policy. It is also the case that the independence of the ECB and the national central banks places heavy constraints on any coordination of fiscal and monetary policy.

LEVELS OF PUBLIC EXPENDITURE

There would seem to be very little, if anything, within the legislation governing the European Union or in its operations which would directly serve to limit the level or composition of public expenditure. In section 3 above the ways in which the Stability and Growth Pact bear down on fiscal policy and on the difference between public expenditure and tax revenue was set out. In the next section we will indicate the effects which these constraints on the budget deficit would have on public expenditure in the UK. The formation of the single market and the adoption of the single currency may also be seen to generate pressures in the direction of lower taxes. There will be the temptation for countries to engage in 'tax competition': lowering tax rates to encourage inward investment, for example. Any significant degree of 'tax competition' would inevitably lead to downward pressure on public expenditure.

However, any direct constraints on the level of public expenditure would appear to be slight. It can be observed that the levels of public expenditure varies considerable across the eurozone countries, and the UK's level of public expenditure comes rather in the middle of the spectrum. The figures in the second column of Table 1 illustrate this point, varying from a low of under 30 per cent in Ireland to over 50 per cent in France and Greece. With regard to public expenditure on health, the UK's position is again rather in the middle, though the planned increases would over the next few years lift the UK up the rankings.

Hence, we would suggest that the UK's membership of the eurozone would not place direct pressure on public expenditure or on any specific parts of public expenditure. No particular policies have been adopted by the EU in this respect, and the level and pattern of public expenditure in eurozone countries does not suggest that the UK's level of expenditure is out of line. It is rather that the restraints imposed by the SGP will bear down on budget deficits, and thereby indirectly on public expenditure, and it is that point to which we now return.

THE SGP AND PUBLIC EXPENDITURE IN THE UK

The policies on the taxation and publication expenditure which would be imposed by the operation of the Stability and Growth Pact (SGP) can be compared with the policies being currently pursued by the British government. The purpose of making that comparison is to investigate what impact the adoption of the SGP (as a result of sterling joining the euro) could have on the level of public expenditure and taxation in the UK. The outcome of that comparison is found to be that the SGP would involve some combination of significantly lower public expenditure and higher taxation than the policies currently in place.

Fiscal policy adopted by the new Labour government is intended to fulfil two criteria in delivering sound public finances:

'*the golden rule* - on average over the economic cycle, the Government will borrow only to invest and not to fund current spending; and,

- *the sustainable investment rule* - the public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level' (Treasury, *The New Monetary Policy Framework* , 1999, London: HMSO, p.19)

Both these rules seem to involve balancing the current budget between tax revenue and current expenditure. However, these rules are not sufficient to fix precisely the size of the budget deficit since it merely refers to borrowing to finance investment, but without saying what the scale of investment is. It should also be noted that investment in this context refers to expenditure on fixed capital formation, and it does not include most expenditure on education, health, training etc., and hence this view of investment is much narrower than that implied by terms such as the 'social investment' state. In a recent speech, Blair asked 'Who can seriously doubt that Britain has been chronically under-invested in for 20 years or that it harms not just our quality of life but our future prosperity. Every school we invest in helps our children earn more. Every extra nurse we employ in the NHS is a guarantee people won't be forced to go private to be treated when ill. Every penny spend on new track and trains ... is a step towards the transport system that this country ... needs. Yes, it takes time. It takes patience. But it takes, above all, investment. That is the choice we must make' (Speech 22nd November 2000). But in terms of investment as defined for the 'golden rule' building new schools would count as investment (but not be included in the budget figures for investment if they were constructed under the Private Finance Initiative), but the employment of nurses would not.

It is generally recognised that the 3 per cent of GDP limit on budget deficits in the Maastricht convergence criteria was an arbitrary one, and that this figure appears to have been plucked out of the air (some suggest a combination of the average German experience and a figure which corresponded to capital expenditure by many governments). This was based on some notion of a 'golden rule' whereby current government expenditure should on average be covered by taxation but capital expenditure can be financed by borrowing.

The capital expenditure to GDP ratio has been much lower than 3 per cent in the UK in recent years (net capital expenditure to GDP was over 6 per cent in 1970/71 but declined sharply during the 1970s to 1.8 per cent in 1980/81, and was 1.4 per cent in 1990/91 and furtherdeclined to 0.6 per cent in 2000/01. It is estimated to rise to 1.2 per cent in 2001/02 and to 2.1 per cent in 2006/07). The literal reading of the statement from the Treasury given above is that on average (over the course of the business cycle) tax revenues will equal current expenditure, and there will be borrowing to cover capital expenditure. The capital expenditure planned for the middle of this decade would be around 2 per cent of GDP, implying an overall budget deficit (current plus capital account) also of around 2 per cent of GDP.

Compare this with the budgetary rules under the Stability and Growth Pact which indicates on average a balanced budget: that is tax revenue equal current and capital expenditure. In comparison with Brown's 'golden rule', the Stability and Growth Pact implies (on average and year after year) that the budget deficit will be tighter by the equivalent of 2 per cent of GDP. One way would be for tax revenue to be 2 per cent higher relative to GDP, and since tax revenue is around 40 per cent of GDP this would a 5 per cent increase in tax revenue: in money terms this would be an increase of the order of £20 billions. The other way is clearly for public expenditure to be lower by the equivalent of 2 per cent of GDP that is a cut of the order of £20 billions or 5 per cent. For comparison, public expenditure on the NHS education is scheduled to be £68 billions in 2002/03.

The 'golden rule' of public finances is embedded in the Code for Fiscal Stability and there would no doubt be considerable lose of 'political face' if there was a marked divergence from the 'golden rule'. But it also has to be said that it would take a number of years before a divergence could be clearly established: simply it is expected that budget deficits will rise in time of economic downturn, and it would require a few years of continuing deficits before it was clear that the debt to GDP ratio was rising. Further, even if the government did diverge from the 'golden rule', would the opposition seriously campaign for tax increases and expenditure cuts in an economic downturn ?

A constant ratio of debt to national income means that the debt grows at the same rate as national income. The growth of national income of relevance here is the growth of national income in money terms - that is the sum of the growth of real national income plus the rate of inflation. The trend growth rate of the UK economy is around 2 1/2 per cent: combine that with the government's inflation target of 2 1/2 per cent would give a growth of money national income of 5 per cent. With debt to national income ratio around 40 per cent, a 5 per cent rate of growth of the national debt would imply that a budget deficit equivalent to 2 per cent of national income would be consistent with a constant ratio.

Thus whether the Code for Fiscal Stability is interpreted in terms of the 'golden rule' (borrowing to fund public investment) or of a constant debt to national income ratio, an average budget deficit of around 2 per cent of GDP would be permissible within the terms of that Code. The Stability and Growth Pact involves a zero deficit or slight budget surplus. Thus the SGP involves a shift in the average budget position of around 2 per cent of GDP. This would involve some combination of higher taxes or lower public expenditure. Taxation and public expenditure are both around 40 per cent of national income. If all of the tightening is in the form of higher taxes, then taxation would be 5 per cent higher (on average over the business cycle): if in the form of reductions in public expenditure, then that would be 5 per cent lower.

In the figures given with the Budget Report for 2002 the projections for budget deficits over the next five years are for 1.0 per cent of GDP for 2002/03 rising slowly to 1.5 per cent for 2006/07 (calculated in line with EU requirements). By 2006/07 the projected cyclically adjusted budget deficit is 1.5 per cent of GDP, that is compared with a balanced budget or slight surplus required by the Stability and Growth Pact. Thus the current public expenditure plans (which include proposed increases in spending on the NHS) are projected to lead to a budget deficit which is not consistent with the SGP.

The 'golden rule' and Code of Fiscal Stability differ from the rules of the Stability and Growth Pact in two important respects. First, the 'golden rule' does not place any clear upper limit on the size of the deficit during recession, whereas the Stability and Growth Pact does (at 3 per cent). Recall here that the recession of 1991/92 generated a budget deficit of nearly 8 per cent : the SGP would have imposed massive tax increases and expenditure reductions and plunged the British economy into the most almighty recession. The SGP imposes tax increases and expenditure reductions at just the time when they are least required and would be distinctly damaging.

Second, the Stability and Growth Pact has the force of law : it is embedded in the Treaty of Amsterdam and can only be changed through a unanimous vote of the EU member states. The Code for Fiscal Stability does not have the force of law and can be readily varied by Parliament.

PRIVATE FINANCE INITIATIVE

One of the constraints under the Stability and Growth Pact concerns the government gross debt to GDP ratio of 60 per cent. The corresponding element under the convergence criteria of the Maastricht Treaty was widely ignored and three countries (Belgium, Greece and Italy) had debt to GDP ratios well in excess of 60 per cent and closer to 100 per cent (and other countries had debt ratios closer to but exceeding 60 per cent). There is clearly much more attention given to the 3 per cent deficit rule than to the 60 per cent debt rule.

The debt rule refers to the gross debt of the national governments and is deficient in a number of respects. First, it refers to gross debt, and makes no allowance for the assets of the government. Much government debt has been issued to, in effect, pay for investment in public assets such as roads, schools and hospitals. Thus it focuses on the debit side without any regard to the asset side. Second, it refers only to liabilities of government such as government bonds, Treasury Bills, and does not include obligations of government on future payments. It could, for example, be argued that government has an obligation to make future pension payments, and that obligation is a debt of the government (in a comparable way a pension fund with obligations to make future pension payments has a liability in that respect, which is (hopefully) balanced against assets with which to meet that liability). In particular, this gross debt does not include the liabilities which the government has incurred under the Private Finance Initiaitve. Third, it does not distinguish between debt in the local currency and debt in a foreign currency.

The way in which the private finance initiative is treated in government accounts is particularly relevant here. If the government borrows directly in order to finance the capital construction of a school, then the borrowing (say through sale of bonds) is treated as part of the national debt (and the school does not appear as a capital asset to offset that liability). If the government uses the private finance initiative, then its obligations to make future payments for the leasing of the school do not appear in the calculations of the national debt or of the government's liabilities. A government which was facing the constraint of the 60 per cent debt rule would be encouraged to opt for more private finance initiatives which under the present system would not add to its debts.

The private finance initiative is, of course, piling up future contractual obligations of expenditure. The leases taken out under the PFI involve future commitments to expenditure: at the present time of the order of £4 to £5 billion a year over the next decade, with decrease thereafter. We have estimated (under a 2 1/2 per cent discount rate) that the present capitalised value of those future commitments is now over £76 billion (compared with gross debt of around £380 billion). The commitments can be expected to rise year by year as more PFIs come on stream. These are commitments which cannot be varied depending on economic conditions. The gradual rise of expenditure under the PFI over the next 20 years say will place pressure on all the other expenditure programmes. As the budget deficit is capped under the SGP (to be balanced over the business cycle), either taxation will have to rise or other forms of expenditure cut.

CONCLUSIONS

The convergence criteria under the Maastricht Treaty established the deflationary nature of the euro project. The nature of the Stability and Growth Pact governing the fiscal and monetary policies of the eurozone countries has reinforced that deflationary nature. It has placed considerable power in the hands of the European Commission to determine the appropriate fiscal policies to be pursued by member countries. It has imposed the requirement that government budgets should be, on average, in balance or slight surplus over the course of the business cycle. It thus imposes a condition that has not often been met in the past--in the three decades since 1970/1, general government net borrowing has been negative (that is the government was repaying debt) on just six occasions. It also imposes the condition that the government budget should not be varied in a pro-cylical manner--that is when output is expanding and unemployment relatively low, the budget should not involve expenditure rises or tax decreases - whatever the circumstances of the economy in other respects.

Without in any way endorsing the current policies in Britain on public expenditure and fiscal policy, it is argued here that the application of the Stability and Growth Pact would lead to significant cuts in public expenditure or increases in taxation (as compared with those current policies). The projected increases in public investment would be under considerable threat from the Stability and Growth Pact, and the current projected budget deficits of the order of 1.5 per cent would fall foul of the balanced budget requirements of the Stability and Growth Pact. The estimates made suggest cuts in public expenditure of the order of 5 per cent (or corresponding increases in taxation). This is further evidence of the deflationary nature of the institutions and policies devised for the euro area.

Table 1		
	General government outlays as percent of GDP 2000	Public expenditure on health as percent of GDP 1999
Austria	47.9	5.9
Belgium	46.7	6.3
Finland	43.9	5.1
France	51.0	7.1
Germany	43.3	7.8
Greece	52.3	4.7
Ireland	29.3	4.9
Italy	44.4	6.1
Luxembourg	38.1	5.7
Netherlands	41.6	6.0
Portugal	40.8	5.2
Spain	38.8	5.4
UK	37.0	5.7

Source: OECD *Economic Outlook* December 2001; calculated from European Union, 'The future of health care ...'

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