EPC Issue Paper No. 12

A "Good Quality Finance Rule"

By Pier Carlo Padoan and Maria João Rodrigues[1]

6.2.2004

The Stability and Growth Pact and the Lisbon Strategy need each other – and Europe needs both.

1. **The SGP is a fundamental pillar of the European construction. Yet it needs to be strengthened**. The SGP is a fundamental pillar of the European construction and has delivered great benefits to the EU economy. Just to mention a few, it has maintained interest rates at low levels, even for high debt countries; it has, if only indirectly, encouraged the adoption of major reforms, in labour markets and in pension systems in several euro area countries. If only for these reasons the SGP needs to be strengthened and made more effective.

Recent events have shaken the credibility of the SGP and this could have severe repercussions for the future construction of Europe. As it stands, the SGP is flexible enough to accommodate critical situations, however its performance so far has suffered from two main shortcomings: a) its pro-cyclical bias which is especially reflected in the failure in most countries to undertake fiscal adjustment during the upswing; b) the limited, if not very weak, contribution to medium and long term growth. In what follows we concentrate on this latter point, thus neglecting the other, just as relevant, issues of the credible application of the rules and the ways to deal with the pro-cyclical bias in the SGP.

[1] The contents of this paper only engage the authors on a personal basis

2. The relationship between fiscal discipline and growth is bidirectional and mutually reinforcing. EU growth remains to a large extent dependent on external developments. But without strong autonomous growth the sustainability of the EU economic and social model will be increasingly difficult to maintain.

The relationship between fiscal discipline and growth is bidirectional and mutually reinforcing. High and sustained growth would make the respect of the SGP commitments easier, it would strengthen debt sustainability and debt reduction and, even more importantly, it would speed up the reform process by providing more room for fiscal adjustment. In turn, a stronger and credible SGP increases confidence and enhances growth. Strengthening the SGP and strengthening the sources of growth should be the two main, and mutually reinforcing pillars of the European economic strategy. However more needs to be done to set up such a virtuous interaction.

3. **Public finances can provide a significant contribution to growth.** Public finances can provide a significant contribution to growth in at least three ways[2]: through the provision of a stable macroeconomic environment, through factor accumulation, and by providing the appropriate incentives. So far the SGP has provided a contribution to European growth mostly through the first channel. It is imperative that the contribution to growth through the other two sources be dramatically strengthened. The Broad Economic Policy Guidelines have already been modified to strengthen the connection between the macroeconomic and the structural sources of growth. However more needs to be done (for instance towards the definition of a Europe Wide Stability Program that could provide a common framework to those elaborated by Member States. Such a document would represent an initial step towards an ex ante coordination of national budget programmes. It would exploit the benefits of a better allocation of resources, especially in those areas where significant externalities are present). But, beyond this, the SGP must be linked to long term growth strategy of the EU, the Lisbon Strategy (LS).

4. The Lisbon Strategy defines the long term growth strategy of the EU[3]. The LS defines the long term growth strategy of the EU which calls for Europe to

[2] See COM (2000) 846, The Contribution of Public Finances to Growth and Employment: Improving Quality and Sustainability

[3] European Commission, *Communication from the Commission: Realising the European Union's potential: consolidating and extending the Lisbon Strategy*, COM (2001) 79 final, 08.02.01; European Commission, *Contribution to the Spring European Council in Barcelona: The Lisbon Strategy - Making Change happen*, COM (2002) 14 final, 15.01.2002; European Commission, *Choosing to grow: Knowledge, Innovation and Jobs in a cohesive society – Report to the Spring European Council, 21 March 2003*, COM (2003) 5 final, 14.01.2003; Rodrigues, Maria João, *The New Knowledge Economy in Europe – A Strategy for International Competitiveness and Social*

(continued)

become the most dynamic and competitive knowledge based economy by 2010. High and sustained growth requires Europe to fully exploit the opportunities of the new technologies while significantly raising the employment rate. Fully implementing the LS would decrease the dependence of European growth from external developments while allowing Europe to provide a strong contribution to growth of the international economy and the absorption of global imbalances.

The Lisbon strategy is based on a wide range of policies, converging to four main priorities:

- The policies for information society, research and development, innovation and education are being mobilized to build a stronger knowledge base;
- The policies for enterprise and single market are focusing key economic reforms in the enlarged European market;
- The policies for employment, social protection, and social inclusion aim at reforming the European social model to safeguard its sustainability;
- The policies for transport, energy, and health are being redirected by the concern for sustainable development.

As presented in Table 1, the implementation of these various policies implies combining the traditional European legislative instruments with the more recently adopted open method of coordination which is based on common guidelines or objectives adopted at European level, translated into the national level by the Member States taking into account their specificities and leading to a regular process of exchange of best practices, monitoring and evaluation.

5. The implementation of the LS has already produced significant results but its effectiveness could be significantly reinforced. The implementation of the Lisbon Agenda has already produced significant results. The first phase is now completed by specifying the Lisbon Summit commitments into European instruments, by introducing some institutional mechanisms for implementation such as the Spring European Council, the coordination of policies and the tools of the open method of coordination in each policy. The implementation at national level, which is still very unequal across policies and Member States, should now become the main focus of the second phase through a stronger involvement of governments, national parliaments and civil society. In the meantime, many concrete measures were launched in various policy fields, such as those mentioned in Table 1. This is all the more remarkable if we take into account that, contrary to

---

Cohesion (coord.) with the collabouration of Robert Boyer, Manuel Castells, Gøsta Esping-Andersen, Robert Lindley, Bengt-Åke Lundvall, Luc Soete, Mario Telò and Mark Tomlinson, London, Edward Elgar, 2002; and Rodrigues, Maria João, *European Policies for a Knowledge Economy,* London, Edward Elgar, 2003.

the SGP, the LS lacks a system of strong incentives, based on punishments and rewards. A more effective incentive set would boost the growth potential of the LS.

6. The SGP and the LS face symmetrical incentive problems The two main pillars of the economic strategy of the EU (in addition to monetary union), the SGP and the LS, face symmetrical problems. The SGP is based on a clearly defined incentive set, itself underpinned by behavioural rules which, however, produce only a limited boost to growth. Conversely, the LS would significantly boost growth if it could rely on stronger incentives. As a consequence, the overall EU strategy is now very weakly oriented to growth, if at all. Eliminating or limiting such a bias is imperative for the future of Europe. To do so the SGP and the LS, while clearly representing two separate pillars of the EU model, should be much better connected by allowing the other two channels through which public finances influence growth –factor accumulation and provision of the right incentives- to operate fully.

7. Exploiting fully the contribution of public finances to growth, by changing its composition. To move in this direction one should start by considering that the individual items in the government budget, be they expenditure or taxes, have different impacts on growth[4]. Spending on education and research by increasing factor accumulation, providing fiscal incentives to innovation increase growth potential. Indeed some of the LS targets such as devoting 3% of GDP for R&D have a direct impact on budget allocation measures. On the other hand, ageing related spending lowers sustainable growth, one-off measures, such as tax amnesties, depress growth by decreasing long run tax certainty and depressing the propensity to invest, generating the wrong incentives for the private sector. In sum, for given size of the budget and of the deficit, its composition will have a different impact on sustainable growth.

8. A Good Quality Finance Rule. Taking this aspect into account it would be possible to use the discipline element of the SGP, its incentive structure, in order to redirect resources towards more sustained growth and reinforce the implementation of the LS. Both these aspects would put more emphasis on the longer term aspects of the EU model: the need to increase potential output growth and strengthen its sustainability by putting more emphasis on the intertemporal dimension of financial equilibrium. To this purpose we propose to introduce a Good Quality Finance Rule (GQFR) to complement the rules already underpinning the SGP. The GQFR should be based on two pillars: a budget pillar, and a debt pillar.

[4] See COM (2000) cit.

The budget pillar. While maintaining the 3% deficit limit and the commitment to reach a budget position in surplus or close to balance the budget items would count differently towards the respect of the SGP requirements. Factor accumulation measures, should be excluded, totally or partially, towards the computation of the SGP deficit definition. (For example the increase in the deficit resulting from expenditure for research or education, tax incentives to innovation, would be excluded or counted only partially towards the SGP requirements). Conversely, measures that depress long run growth, such as tax amnesties whose revenue reduces the deficit, would not be admitted towards meeting the SGP requirements. Both sets of measures would enhance growth through, respectively their support to factor accumulation, and the suppression of negative incentives. This, of course, requires a careful identification of those budget items that should be considered as supporting factor accumulation, i.e. physical, human, and knowledge capital. The transparency of the process is to be guaranteed through an accurate and independent assessment of the specific budget items by Eurostat and by strengthened surveillance by the Commission. Table 2 provides a preliminary illustration of some of the concrete measures included in the Lisbon strategy which would enhance the growth potential and might have budgetary implications.

The debt pillar. Long term growth must be sustainable and sustainability requires a decline of debt to GDP ratio which should be as rapid as possible, especially for high debt countries. Reinforcing the role of public finances to support growth should not go to the detriment of debt sustainability. To this purpose the measures suggested above under the budget pillar should be implemented subject to the conditions of a sufficiently rapid decline of the debt to GDP ratio (for countries whose debt/GDP is above 60%) or, in any case, that debt should not go above 60% (for countries whose debt/GDP is below 60%).

Both pillars would have to be put in an appropriate time frame, taking into account the inter-temporal dimension and avoiding pro-cyclical effects. This can be developed in a number of ways and a several useful proposals have already been put forward. We mention, for example, setting aside resources for “rainy days” and the adoption of indicators to assess long term debt sustainability, including the implications of implicit liabilities related to pension systems, as well as the adoption of an explicit minimum debt reduction requirement.

9. The GQFR would be complemented by increased effectiveness of public finances, use and reallocation of resources in the Financial Perspectives, and the implementation of the “European Growth Initiative.” Achieving the LS targets will require more than the redirection of financial resources in national budgets towards factor accumulation and the generation of positive incentives also taking into account that a number of public expenditures components, most notably on research, innovation, higher education, and infrastructure, are likely to produce positive externalities at the supranational level. Ways to internalise such externalities should be explored, for example through the adoption of a Europe

Wide Stability Program as mentioned in paragraph 3. In addition, the impact of the GQFR will be strengthened by enhancing the effectiveness and not only the amount of resources directed at the LS goals, identifying other resources in support of the LS, both through the "European Growth Initiative" and the Financial Perspectives.

10. Increasing the effectiveness of public finances towards the LS goals. The application of the GQFR should generate strong incentives towards the redirection of public finances towards the achievement of the LS goals. However this would represent only one step towards the fulfilment of the LS. A major contribution in this respect would come from increased efficiency in the provision of public services. Several initiatives can be thought of in this respect, including enhanced transparency and more effective public-private-partnerships.

11. Possible Criticism. Drawing on the current wide debate on the future of the SGP it is possible to anticipate some (certainly not all) of the criticism to the GQFR.

Not just an extended "golden rule." One likely criticism to our proposal is that it resembles closely a "golden rule" extended to items that include, but are also additional to, public investment. In such a case the GQFR would be subject to the criticism that is applied to the "golden rule," i.e. that it is highly questionable that public investment does indeed support growth. A reply would be twofold. First, as the UK case shows, a golden rule can be very effective, if coupled with a debt rule, in enhancing the supply of public infrastructure and services, and, if these are well managed, enhancing welfare and growth. Second, our proposal would include items that would be not counted as public investments yet providing a significant contribution to factor accumulation and growth. Indeed there is ample evidence that, for example, spending on education and R&D does support long term growth. This would also counter the criticism that the SGP carries a bias against public investment and for current spending.

An incentive for "creative accounting"? Given the difficulty to identify in practice the items in the budget related to factor accumulation the scope for creative accounting as a way to bypass the SGP rules would be increased. Identifying correctly the items in the budget is a difficult but not impossible task. The risk of less than fully transparent identification of budget items is common to other proposals, including the one advanced by the Commission to allow for deviation of the budget rule for expenditures related to the implementation of structural reforms. Such a risk can be countered by an accurate and independent assessment of the specific budget items by Eurostat and by strengthened surveillance by the Commission of the implementation of the GQFR.

Why change the SGP to implement the LS? There is no need to modify the SGP to achieve the LS targets. As it stands the SGP already allows for redirecting resources towards LS targets provided the deficit limits are respected. This is true but, as experience shows, fiscal consolidation very often comes at the cost of cutting factor accumulation spending, not only public investment but also R&D and education. Hence the SGP does not provide the right incentives to redirect spending toward growth enhancing measures. Our proposal would strengthen the incentives to revert these trends.

The recent modifications to the SGP provide enough room for a stimulus to long term growth. The recent modifications to the SGP, stressing the role of structural budget adjustment and the possibility to deviate from the zero balance to accommodate for short term cost of structural reforms, go in the right direction and should be maintained and the terms of implementation further clarified. As mentioned however the latter of the modifications lends itself to a number of similar criticisms as it involves an amount of ambiguity and uncertainty as to which measures could be classified as structural. Nonetheless such measures would certainly provide a welcome stimulus to structural adjustment and growth

Redirecting public finances is not enough. True. As we stated above redirecting public finances through the GQFR should be seen as a necessary but not sufficient condition for meeting the LS goals. Additional and just as important measures include enhancing transparency in management of public services, extending PPP, as well as promoting all the other measures included in LS as discussed above.

Table 1. The Lisbon Strategy
Policies, European instruments, national instruments and some concrete measures

Policies	European Instruments	National Instruments	Some Concrete Measures
Information Society	eEurope Action Plan Directives on Information Society	National Action Plans for Information Society	- Internet access in schools, public services, companies - e-commerce
Enterprise Policy	Multiannual Programme for Enterprise and Entrepreneurship European Charter for Small Enterprises Technical harmonization Directives	National policy for Enterprise	- Support to start-ups - Cutting red tape
Innovation Policy	Framework of Common Objectives for Innovation	National policy for Innovation	- Developing the national systems of innovation
Research Policy	6th Framework Programme European Research Area Towards 3% of GDP Action Plan for Research	National policy for Research	- Networks of excellence - Integrated projects - European infrastructures
Single Market	Single Market Agenda Harmonization Directives	National implementation of Single Market Agenda	- Telecommunications package - Energy package - Single sky

	Financial Services Action Plan Risk-Capital Action Plan		- Community patent - Gallileo
Education	Common objectives and targets eLearning. Bologna Process for High Level Education. Copenhagen Declaration for lifelong learning Action Plan for skills and mobility Directives on recognition of qualifications	National policy for Education	- New tools for lifelong learning - Convergence of degrees and recognition of qualifications

Policies	**European Instruments**	**National Instruments**	**Some Concrete Measures**
Employment	European Employment Strategy: Joint Employment Report, Employment guidelines and Recommendations for Members States' employment policies Directives on labour standards	National Action Plans for Employment	- Better employment services - Adaptability with security - Equal opportunities - Active ageing
Social Protection	Common objectives for pension provision Integrated approach for safe and sustainable pensions	National strategy to reform Social Protection	- Coping with ageing
Social Inclusion	Common objectives Community Action Programme to combat discrimination Framework strategy on gender equality	National Action Plans for Social Inclusion	- Targeted measures for special groups
Environment	EU strategy for sustainable development 6th Community Action Programme for Environment Community Eco-label working plan	National strategies for Sustainable Development	- Renewable energies - Community Eco-label awards - Environmental inspections

Macroeconomic Policies	Broad Economic Policy Guidelines Stability and Growth Pact	National programmes for stability and growth	- Redirecting public expenditure for growth and employment

Table 2. Implementation of the Lisbon Strategy

Measures enhancing the growth potential and with possible budgetary implications

These concrete examples are included in the common objectives or guidelines adopted by the Member States in the framework of the open method of coordination.

Information Society Policy

- Cheaper and faster Internet access
- Faster Internet for researchers and students
- Participation for all in the knowledge-based economy
- Government online: electronic access to public services
- Health online

Research and Development Policy

- Networking of existing centres of excellence in Europe and the creation of virtual centres through new interactive communication tools
- A common approach to creating and financing large research facilities
- More abundant and more mobile human resources
- Improving Europe's attraction for researchers from the rest of the world
- Enhancing European cohesion in research by fostering the exchange and the transfer of knowledge among regions
- Putting in place fiscal incentives to private investment in research and innovation as well as employment of researchers

Innovation Policy

- Improve the environment for innovative enterprises
- Developing support services including incubators and by spreading educational and training schemes in entrepreneurship and innovation
- Improving the key interfaces in the innovation system, namely by:
    - stimulating regional initiatives for networking the innovation system;
    - developing education and training programmes addressing the skill gaps;
    - encouraging universities to promote the diffusion of knowledge and technologies; and
    - stimulating large public research facilities to improve their partnerships with enterprises.

Education policy

- Improving the education and training for teachers and trainers; providing an adequate supply of qualified entrants in the profession and making it more attractive;
- Ensuring access to ICT for everyone. Widening the range of equipment and educational software so that ICT can be best applied in teaching and training practices;
- Increasing recruitment to scientific and technical studies, in particular research careers and scientific disciplines;
- Developing an open learning environment. Providing education and training so that adults can effectively participate and so that people can combine their participation in learning with other family and professional activities;
- Increasing mobility and exchanges. Ensuring that less privileged establishments and individuals take part in mobility programmes. Certifying the skills acquired through mobility.

Employment Policy

- Implementing active and preventive measures for the unemployed and the inactive
- Fostering entrepreneurship to create more and better jobs
- Promoting active ageing
- Investing in human capital and strategies for lifelong learning
- Promoting gender equality and combining working life and family life
- Supporting integration and combating discrimination in the labour market
- Preventing the risks of social exclusion

Sustainable Development

- Address threats to public health
- Manage natural resources more responsibly

Pier Carlo Padoan, ***Professor of Economics, University of Rome, La Sapienza***
Maria João Rodrigues, ***Professor of Economics in ISCTE, University Institute, Lisbon***