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Europe's tough fiscal rules are likely to be broken

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SO Europe is to get new fiscal rules, imposing tighter constraints on debt and deficits. But Australians don't need to leave home to understand why markets are sceptical as to their effectiveness.

After all, in the 2009-10 budget, Wayne Swan announced real growth in spending would be held "to 2 per cent per annum to expedite the return to surplus once economic growth returns to above-trend levels." But merely a few months later, that "no ifs, no buts" rule had been watered down by more excuses than a shamefaced teenager. Spending growth would be cut, but only "on average", only "once the budget returns to surplus", and only "until surpluses are 1 per cent of GDP".

And the circumstances the Europeans face are far more challenging than Swan's. There is, to begin with, some unpleasant arithmetic. Start, like Italy, with debt equal to 120 per cent of GDP and a real interest rate on that debt of more than 4 per cent. Then simply paying the interest will take more than 5 per cent of national income annually. And with GDP actually falling, that share, and the pain it inflicts, are all the greater, as the payments need to be extracted from a smaller base. So with a high initial debt-to-GDP ratio and growth rates well below real interest rates, merely standing still is difficult; paying off the principal, and hence bringing debt levels down, requires budget surpluses so large and persistent as to seem completely beyond reach.

Previously, it was inflation that squared that circle, at least temporarily, as printing money eroded the value of outstanding obligations. Moreover, bouts of inflation were combined with devaluations, that, again at least temporarily,

increased competitiveness, boosting growth and hence increasing government revenues. And inflation also shifted taxpayers into higher tax brackets, further raising revenues, while cutting real public sector wages and transfers, such as pensions, that were only indexed with a lag.

But those options are no longer available to the heavily indebted European countries, as it is the European Central Bank, not national governments, that controls the printing presses. As a result, meeting the targets, which are likely to require halving the debt to GDP ratio of the heavily indebted countries, would seem to entail drastic cuts in living standards, as current consumption is curtailed to fund budget surpluses that can pay off debts.

Is that achievable? History shows durable fiscal consolidation involves significant reductions in public expenditure, rather than mere increases in taxation (which tend to get dissipated in wasteful public spending).

And yes, there are instances where such reductions have occurred. For example, between 1995 and 2006, general government expenditures as a share of GDP declined by 10.8 percentage points in Sweden, 8 percentage points in Denmark and 12.7 percentage points in Finland (albeit in each case from a very high base). But carrying through with fiscal consolidation requires two interrelated conditions.

First, the political system must manage the terrible asymmetry that exists between fiscal expansions and contractions. Expansions provide concentrated and immediate benefits in exchange for diffuse, postponed, costs; contractions typically impose concentrated, immediate costs in exchange for benefits that seem remote and uncertain. That is difficult to do unless the pain is seen to be widely and equitably spread.

Second, the macroeconomic consequences of fiscal consolidation depend crucially on whether it allows reductions in real wages, which can increase private sector employment, thus cushioning the effects of reduced public spending. For that to occur, labour market insiders must be brought to accept real wage falls either by agreement or by weakening their bargaining position. And even then, falls in real wages are likely to allow a return to growth only if they are accompanied by structural reforms that support higher productivity, as happened in Australia in the late 1980s and early 90s.

Set against those conditions, the current situation in the eurozone is hardly promising. In Italy, the package announced last week by the new Prime Minister, Mario Monti, primarily involves increases in personal income taxes, which mainly hit wage and salary earners, with relatively little being done to seriously reduce tax evasion or to prevent a further shift to the black economy. While there are some cuts in public pensions, they make little progress in tackling the looming burdens on Italy's pension system. And nothing at all has been done to advance desperately needed labour market reforms, which Monti has deferred for 18 months, jeopardising their prospects.

The result is a package that is both insufficient and inequitable. True, Monti is constrained by the fact that he lacks an electoral mandate, and depends on the same parliament that previously supported Berlusconi. Substantial progress therefore seems far less likely in Italy than in Spain, where the new centre-right government's substantial parliamentary majority should allow it to implement its ambitious reform plans. But even there, the scale of the problems is such that progress will be slow and painful. And so too in France, where President Nicolas Sarkozy has been far more adept at the rhetoric of fiscal consolidation than at its reality.

It is therefore all very well for German Chancellor Angela Merkel to announce new disciplines intended to restore low debts and eliminate persistent budget deficits. But for more than 30 years, political forces in the eurozone have pushed in the opposite direction. It remains to be seen what powers Brussels could be given that would both be politically acceptable and sufficient to force reluctant governments to over-ride perceived electoral imperatives.

As a result, the smart money is on a repeat of last decade's performance, when France and Germany, faced with domestic political pressures to incur substantial deficits, led the charge in dramatically weakening the fiscal constraints imposed by the Stability and Growth Pact. The consequences of those changes, implemented in 2005, were predictable: they encouraged unchecked debt accumulation.

If those consequences are undeniable, there is no sign European leaders have learned the lesson: that fiscal constraints are unlikely to be effective unless electorates endorse them and can be counted on to punish violations. Securing that endorsement requires a willingness to engage with electorates that Europe's

leaders largely lack. So in its absence, rules will be made to be broken. Just ask Wayne Swan.

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