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The EU should harness domestic politics, not fines, to bring deficits into line

John Bruton

28 October 2010

France and Germany have agreed in Deauville to propose, inter alia, that the EU treaties be amended to provide for the sanction of countries whose government budgets exceed EU deficit or debt limits by withdrawing their voting rights in the EU. I believe there is a better, less cumbersome way of getting the same result.

It is not clear what voting rights Germany and France propose to take away. Would it only be votes in the Finance Ministers Council? Or would they take away voting rights in all Councils of Ministers formations and in the European Parliament as well? Any disqualification of voting rights would radically change the democratic nature of the European Union and would thus require an amendment of the European treaties and probably also referenda in a number of countries because of their nature.

In return, under the Franco-German proposals, a system for giving conditional financial aid to countries in the eurozone that are unable to get out of financial difficulties on their own accord and cannot borrow from the bond markets, would be introduced as a permanent feature into the European treaties. This would, in effect, make the European Monetary Fund, which now exists temporarily and whose mandate will expire just before the next German Federal elections are due, a permanent feature. It would also satisfy the German Constitutional Court, which is careful about extensions of EU competence without explicit authorisation. It is understandable that Germany would want some assurances before it could agree to this treaty revision, but one must ask whether a withdrawal of voting rights is the best card to play.

A system that would allow countries to renegotiate or reschedule their debts with their creditors in an orderly and EU-compliant fashion is also being entertained. This would have considerable merit. It would make the markets more wary of lending money to countries whose finances were unsound because it would create the possibility that careless lenders to governments might not be repaid in full.

There are also proposals on the table to impose fines on countries whose borrowing and debts are seriously above EU limits. Some argue that such fines should be automatic. Others say that there should be a margin for political judgement as to whether to impose a fine in a particular case.

A number of questions have to be asked about these various proposals:

1) Do they address the real problem? It is true that many European countries now have big government finance problems. But, with the exception of Greece, the origin of the present problems is not with the government's own finances as such, but rather with a private sector credit bubble. In the

John Bruton is a member of the CEPS Board of Directors. He served as Taoiseach (prime minister) of Ireland from 1994 to 1997 and as the Ambassador of the European Union to the United States from 2004–09. He is also a former Vice-President of the European People's Party (EPP).

case of Ireland, for example, the problem was an explosion in private-sector credit, which first overwhelmed the banking system and then later dragged the government's finances down too. A disciplinary system that focuses on the government's finances alone, as this proposal does, is likely to miss the target, because it will be activated too late. Private-sector credit developments and losses in competitiveness need to be subject to discipline. The European Commission has attempted to deal with this by its excessive imbalances procedure, which addresses wider imbalances in a member state's economy. But this will involve making fine judgments about what constitutes an 'imbalance', which may not easily serve as an adequate legal basis for fines or voting right sanctions.

2) Will the proposal by France and Germany to withdraw voting rights ever be accepted and brought into force? All 27 countries will have to ratify it, if it is to become part of the EU treaties. It is easy to see where objections might come from. A country that was still bound by EU decisions and required to contribute to the EU budget but which had no vote in those decisions would be in the position of being a sort of EU colony. I do not think there is much chance that all 27 countries, particularly smaller ones, will be easily persuaded to accept that possibility. Using up political capital on a proposal that has only a small chance of being accepted in the end would be politically unwise.

3) What sort of assumptions would be used in making these decisions? The ratio of a government's deficit to its country's GDP is a relationship between three variables – revenue, expenditure and GDP – all of which are highly unpredictable and uncertain. Making assumptions about the future growth of GDP, and even about the present size of GDP, is a hazardous exercise. The size of GDP in a given year often has to be revised a few years later when more information is acquired. The French President himself has pioneered studies to devise a more accurate measure of welfare than GDP. Basing a decision to remove voting rights from a sovereign state on the basis of this ratio between three uncertain variables would be a very messy legal process. So also is imposing fines on that basis.

4) Will the proposal on fines make the problem worse? Imposing a fine on a country that is already in a precarious position could drive it over the brink. That would be counterproductive and would increase the final cost of the exercise. One does not have to be a European historian to know that imposing collective 'reparations' or fines on 'guilty' nations sometimes lead to tragic events.

If a convincing answer cannot be given to these four questions, it may be good to look for other approaches.

I believe one such approach would be to harness the power of the bond markets and of domestic opposition parties to discipline governments when they are beginning to go in the wrong direction on debts, deficits, private sector credit or competitiveness.

This could become effective at a much earlier stage than most of the proposals now being considered. It could also be done without amending the treaties, and could build on proposals already tabled by the Commission. Using domestic political leverage, rather than external pressure, is also more likely to elicit a constructive response. People often react adversely to outside pressure, even when it is entirely justified.

I suggest that errant governments could be brought into line by involving, as of right now, the opposition parties in all national Parliaments in the European Commission's formal process of invigilating the national economic policy of all member states. Every consultation with the government could in future be accompanied by a detailed formal briefing of the opposition. Given that oppositions like to expose failings of governments, such briefings would serve as the lever that the Commission would use to pressure governments to adopt responsible policies.

Such a process would also have an impact on the bond markets. Bond markets may have been slow to identify sovereign debt vulnerabilities in the recent past, but they are very much on the alert now and are likely to remain so for many years to come.

Unfavourable public commentary by the Commission on a government's fiscal policies, either directly or through opposition parties, would make it more expensive for that government to borrow.

That would be a much quicker and more effective financial penalty on errant governments than would the cumbersome system of fines that is now being proposed, and, unlike the proposed fines, it would come into effect before it was too late.