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# A dynamic rule applied to the threshold imposed on the European budgetary deficits

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**Abstract**

Up until now, European fiscal discipline has been essentially assessed on the basis of the deficit rather than on the debt situations of EU countries. However, the sustainability of the public debt depends on the discrepancy between the interest rate and the growth rate of any given country. As these future economic variables are difficult to anticipate, however, the present paper proposes a more applicable rule for the deficits. Unlike what is stated in the Stability and Growth Pact, the budgetary deficits in the European Union may therefore be kept at higher levels as a country maintains a high inflation or real growth rate, and a low level of public indebtedness.
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## 1. Introduction

Up until now, European fiscal discipline has been essentially assessed and enforced on the basis of the deficit rather than on the debt situations of EU countries. Indeed, the Stability and Growth Pact (SGP) was designed to better specify the implementation of the Maastricht Treaty with regard to budgetary multilateral surveillance and coordination. In fact, it represents a kind of departure from the Treaty since it focuses mainly on deficits, while the Treaty focuses on both public debts and deficits. So, the Pact focuses exceedingly on short-term fiscal behaviours, without taking properly into account debt sustainability nor the impact of ageing populations on public finances. However, the European Union should probably benefit from increasing the importance

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of the viability of public finances in the medium or even the long run, for the multilateral surveillance of the member countries and for the definition of the deficits which can be described as "excessive".

In this framework, the issue of sustainability of the public debt is assessed essentially from an econometrical viewpoint [e.g.: Papadopoulos & Sidiropoulos, 1999; Uctum & Wickens, 1997]. Nevertheless, beyond the problem of diverging results, those tests also wrongly assume that the current fiscal regime will continue forever. Unlike those studies, the present paper relies on a simple macro-economic framework, in order to contribute to the current discussion on the more appropriate threshold to be imposed upon budgetary deficits, particularly for the European Union countries. To that effect, Section 2 covers the general conditions of sustainability of the public debt from a theoretical point of view. Then, Section 3 analyses the possibility of ensuring the solvability of the State with a constraint on the budgetary deficit. Nevertheless, there are drawbacks with a uniform budgetary rule, as in the SGP, addressed in Section 4. In order to ensure the sustainability of the public debt, Section 5 then proposes a new dynamic rule taking into account the growth rates and the indebtedness of the member states in the European Union. Sections 6 and 7 respectively examine the empirical and policy implications of such a rule for the European countries. Finally, we will conclude our analysis in Section 8.

## 2. The sustainability of the public debt

Let us first go back to the Maastricht Treaty and to its conception of a healthy budgetary situation. The Treaty contains two fiscal criteria: a threshold to the global budgetary deficit, and a threshold to the level of the public debt as long-run solvency criterion. Nevertheless, even this last indebtedness criterion appears as insufficient and vague to evaluate the future sustainability of the budgetary situations. Indeed, the Treaty only mentions that the ratio of government debt to GDP must not exceed the reference value of 60%, "*unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace*" (article 104C). It does not really consider, however, the dynamic path of evolution for this debt, as the current public debt is an historical ratio essentially inherited from the past. It would then be more relevant to consider whether a budgetary trajectory is sustainable or not and whether the public debt for any given State is solvable in the long-term, in other words, whether it respects the condition for an inter-temporal budgetary equilibrium. According to Aglietta and Uctum (1996, p. 58), it is therefore "the anticipated level of the discounted debt, included in the convergence programs presented by the countries, that must decrease" to respect the sustainability of the public indebtedness.

This sustainability of the public debt means long-term solvability of the public finances, ensuring that the debt would not increase dramatically and preventing the State from allowing its refund. That definition therefore allows the possibility of important disequilibria in budgetary balances, provided that they are not permanent but compensated by sufficient future surpluses. In this framework, a good expression of the solvency of a State is the one given by Henin (1997, p. 373):

- the current debt is equal to the discounted value of the anticipated future primary surpluses;
- the limit for a horizon tending towards the infinite of the anticipation of the discounted value of the debt in $(t+s)$ is null.

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