Reforming the Stability and Growth Pact

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European fiscal rules, as enshrined in the Stability and Growth Pact, are currently suspended to allow governments to fight the economic fallout from the pandemic. Under current plans, these fiscal rules will be enacted again in 2024 and the EU Commission should put forward its SGP reform proposals this fall.

This subject is far from simple. The rules of the Stability and Growth Pact have become difficult to interpret let alone implement.

Behind this difficulty, it must be understood that the subject is complex, not least because of the heterogeneity of the economic and financial situations of the Member States which has been increased by the Covid crisis.

The purpose of this note is to propose principles for the revision of the Stability and Growth Pact and in particular more individualized rules for each Member State, less dependent on abstract figures and at the same time more rigorous so that the new EU fiscal framework becomes more effective

1. An EU and adapted framework for a common discipline

1.1 Why do we need fiscal discipline in a Monetary Union?

Fiscal coordination is needed in a monetary union The reason stems from the fact that the Union European is not a state and that negative externalities – stemming from questionable national policies – should be taken into account and avoided. The European Monetary Union has a single monetary policy but no common fiscal and economic policy. Therefore, the need for fiscal coordination.

The purpose of EU fiscal rules should be to reduce the risk of debt crisis related spillovers across Member States, by making sure that each country's debt remains sustainable. In the event of a crisis, no responsible state should ever accept financing current public deficits generated by other members of the Union that do not follow the rules of the Union. If all countries ensure the sustainability of public debt, national debt crises that threaten the existence of the euro would be avoided and confidence among Member States would be boosted.

In addition, sound public finances are essential for growing out of debt. They represent an important safeguard to the single monetary policy and keep away monetary policy makers from being under pressure to guarantee government solvency.

Some may think that fiscal discipline is no more indispensable because of low interest rates. This is a profound misconception: interest rates will not stay at zero level for ever and the markets are already showing this. And to base a fiscal framework on the assumption of indefinite low interest rates and monetization of public debt is not consistent with the functioning of our monetary union.

1.2 The increased heterogeneity of the economic and financial situations of the Member States

In the euro area, between 2007 and 2019, the aggregate government debt-to-GDP ratio rose from 66 % to 83.8% – one-third more debt compared to the pre-crisis level. In France, the public debt ratio compared to GDP has increased even more from 64.5% to 97.4% of GDP between 2007 and 2019. In Italy the public debt ratio has grown from 103.9% to 134.1% and in Spain from 35.8% to 98.3%. However, by contrast, in Germany public debt has decreased from 64.2% in 2007 to 58.9% in 2019.
Except for few countries, the fiscal rules of the SGP have not been obeyed particularly for large countries (*e.g.*, Italy, France...).

The economic consequences of the current Covid-19 crisis are worsening the situation. They are increasing the heterogeneity of fiscal performance across euro area member states. The aggregate government debt-to-GDP ratio rose by around 12 percentage points between 2019 and 2021, reaching respectively 88.1% and 95.6% in the EU/EA in 2021, according to Eurostat.

Between 2019 and 2021, fiscal divergences rose further in terms of public debt-to-GDP. In average, the public debt of each EU Member State deviated by 37.3 percentage points from the EU aggregate public debt level in 2021, up from 35.2 percentage points in 2019. Indeed, five EU Member States still saw their public debt exceeding 110% of GDP in 2021: Greece (193.3%), Italy (150.8%), Portugal (127.4%), Spain (118.4%) and France (112.9%). By contrast, seventeen EU countries kept their ratio below 75% of GDP in 2021. Among them, Germany, the Netherlands, and Finland had their public debt compared to GDP hovering respectively at 69.3% of GDP, 52.1% and 65.8% in 2021.

After the Covid-19 crisis, the public debt-to-GDP ratio is projected to stabilize at elevated levels in EU Member States. For 2022, the ratio would fall marginally in France from 112.9% of GDP in 2021 to 111.2%. It would drop by 3.3 pp in Spain (from 118.4% to 115.1%) and by 2.9 pp in Italy (from 150.8% to 147.9%), according to the EU Commission[1].

In such a context, it would be rational to propose that each member country should outline a specific path for reducing

1. Forecast released in May 2022

its public debt which would take account of specific local parameters (level of savings, economic potential…) and debt sustainability but it should be up to EU Institutions to discuss and formally validate these plans notably to avoid any asymmetry of treatment between small and large countries.

1.3 Structural problems need to be addressed by structural reforms; a qualitative change in budget expenditure is also required: from unproductive to productive goals.

A proactive fiscal policy to "substitute" for a dwindling monetary policy would be a great mistake. Fiscal or monetary stimulus will not necessarily enhance potential growth. Indeed, the huge monetary and fiscal stances of the last decades have not led to investment or higher growth. There is no automatic substitution effect: less monetary expansion offset by more fiscal deficits.

Fiscal deficits – if they are increased above their huge present levels – will only be possible if monetary policy and interest rates remain accommodative. One of the most concerning consequences of accommodative and low rates for long policies has been precisely the marked reduction in real terms of global productive investment over the last 15 years: lasting low interest rates do not foster, by themselves, more productive investment[2]. What they do – notably in the EU – is to encourage savers to keep their financial assets in liquid instruments and not to channel them in securities geared to long term investments[3].

What we need is more long-term investment to cope with the challenges of reduced labour and ecology. This will not be achieved though more distribution through budgets or more money creation. It will only be possible if structural – supply side oriented – reforms as well as a normal remuneration of risky investments are made possible. This combination requires a reining in of excessive current public expenditure (*i.e.* fiscal normalization), alongside a qualitative shift towards reasonable public investment.

If we continue to live on the illusion that fiscal stimulus can "replace" monetary stimulus, we will have two negative results:

- Fiscal dominance because fiscal stimulus cannot co-exist with high rates
- A financial crisis because excessive leverage always leads to it.

1.4 Distinguish between legitimate and abnormal fiscal heterogeneity

A rule adapted to certain circumstances may not make sense in another context. Over the years, attempts to pre-program all possible contingencies have led to excessive complexity while Member States have not wished to give the Commission effective powers to adapt the rules to specific situations.

To work on this complexity, first it is critical to understand what could be called the "legitimate heterogeneity". If Greece is on one side and Germany the other, the structures, histories and capabilities are different. Homogeneity will not be attained because of a 3% rule or a 60% rule. It is thus important to distinguish between legitimate heterogeneity, which is, in many cases, the product of history, and "abnormal" heterogeneity, which is the incremental heterogeneity that has been created by public action or inaction. This has to be analysed carefully. If abnormal heterogeneity is detected, it can be worked on, not necessarily to erase it in a couple of years but to start working gradually on that element.

1.5 Better internalize the European framework in domestic systems

We need to recognize that the present system of sanctions has not been observed because the figures and norms were considered as externally imposed. As Tuomas Saarenheimo, President of the EU's Economic and Financial Committee, pointed out during an exchange of views at a Eurofi Seminar in April 2021, it would not make much sense to go back to a disciplinary system based on sanctions. The purpose should be to introduce into the European mechanisms an intelligent view of the priorities to be implemented on a State-by-State basis. That is the real challenge.

The framework seems more important than the precise rules, if 'rules' means a set of numbers. A set of numbers in itself is not going to solve the credibility problem for the framework. What will be helpful is finding ways for countries to better internalise the framework in their domestic systems. This by definition would be better than pretending to apply sanctions.

Promoting transparent discussions on fiscal issues between an independent EU fiscal authority and each Member State is a right approach. Having a dialogue like the one at the IMF for article IV would certainly be a progress. Socratic discussion leads to a quantum of realism and is a better approach than having a few arithmetical rules that will never be applied.

A fiscal-stabilisation facility should also be added to this new EU fiscal framework so that, in exceptional circumstances – when, for instance, the Commission declares that a country is in exceptional circumstances and there is a reason to activate the escape clause – additional fiscal space from the European side is made available to the country. These are all elements where it will not be easy to find a consensus in the Eurogroup.

2. The gist of a common framework

The approach would be to achieve a mechanism that is sufficiently adapted to the problems – by definition different – of each of the Member States, by establishing common standards under European supervision in order to achieve credible and realistic debt-reduction trajectories and build fiscal buffers to face new unexpected challenges.

2. See Eurofi Economic and Monetary Scoreboards, February 2022
3. Long-term investments do not produce returns consistent with the risks involved in such projects. So, savers act rationally and prefer to keep liquid banking accounts that are easily mobilizable. This is the "liquidity trap" feared by Keynes which is particularly severe in European countries that do not have the risk appetite for equity that characterizes US markets

2.1 A case-by-case framework

Macroeconomic circumstances and the debt dynamics are different for every country. Sustainability of public finance very much depends on country specific factors (level of potential growth of savings and taxes, type of government...) and equal treatment of EU Member States does not necessarily mean "one-size-fits-all" rules.

The revised common framework should define, on a State-by-State basis and in a medium-term perspective, the realistic budgetary guidelines which best reflect the particular national and Community interests.

Each state would have to explain its orientation by focusing on its own priorities. The European authorities (European Commission, ESM) should regularly monitor the implementation of what would reflect the common understanding on these issues.

This is important because the markets are guided more by dynamics than by absolute numbers in determining country spreads. Because monetary policy will not always be there to buy all the new sovereign issues, it will be imperative to reassure the markets by gradual fiscal normalization policy.

From this point of view, the updated fiscal rules should include special monitoring of the primary balance by prohibiting primary deficits for over indebtedness countries with lasting excessive fiscal deficits (*see below*).

2.2 A set of rules adapted to each problem (expenditure, primary balances, debt)

Some countries rely too much on public expenditure, which then deteriorates all their fiscal situation. A precise rule on the reduction of public expenditure – and not on the growth of public expenditure – is therefore necessary. Otherwise, the overburdening of taxes and contributions on businesses will continue to penalize those countries because they will remain above the threshold of competitiveness gap.

It should be suggested that countries with excessive government spending compared with average of the euro area, will need to focus on significantly reducing this particularity – and not just increase them in line with potential growth – with a well-established and monitored nominal spending rule. Such a rule could be the following: "Any country that exceeds "the average normal" of public expenditure to GDP in the eurozone would have to eliminate the difference in a period of 5 years or less". This would be a specific constraint to be monitored at the EU level.

It is indeed problematic to reach 55% of public expenditure on GDP (before Covid) when the European average is 8 to 10 percentage points lower. In this respect, a country like France, which holds all records of public spending relative to GDP, devotes only a small amount of resources to productive public investment. Absorbing 55% of GDP to finance the "end of the month" is much more dangerous than if much of it were spent on public investment. Such a situation is incompatible with future growth and requires more active treatment. The new European mechanism will have to take this into account.

A ceiling on public expenditure growth, in such situations, would be inappropriate and contribute to maintain – and even increase – fiscal and competitiveness heterogeneities across Member States.

2.3 Primary fiscal balances

The countries with large fiscal deficits (>3% for instance) and over indebtedness (>100% of GDP for example) should achieve and maintain a primary surplus to be defined and monitored by the EU Commission or the independent EU fiscal authority (*see 2.8*).

2.4 Keeping the 3% of GDP deficit rule – a minimum ratio in normal times – is a reasonable option

The 3% deficit rule is already very tolerant. It is a hard-to-challenge safeguard in "Normal" periods. It is sufficient to stabilize the economy during downturn. It has proven to be a good fiscal anchor and should be kept.

This is a minimum ratio not to be exceeded: in the case of a country's nominal growth of 3% per annum, with a deficit of 3%, the public debt of that country is stabilized.

2.5 The 60% of GDP debt rule: toward a country specific debt adjustment speed

A recent ESM paper[4] states that "Keeping the 60% reference value and assuming a 20-year horizon to achieve it would necessitate unrealistically high fiscal surpluses for several countries. For example, Portugal would need a primary surplus of close to 2.5% of GDP on average for the next 20 years despite a significant decline in debt service costs since the 1990s[5]. The required primary surplus would be even higher for some other countries, which risks causing countries to adopt inappropriately tight and unsustainable policies". This paper also proposes to raise the debt limit to 100%.

As already explained above, the debt ratio compared to GDP varies greatly from one Member State to another. We think that it should be "personalised" on a case-by-case basis, depending on available margins and debt sustainability. Mr P. Gentiloni followed this same logic when he said that the proposed reform of the Stability and Growth Pact by the Commission would set individual debt goals for each country, adding that the Commission should be given more effective instruments to enforce budget rules.

In any event, if the proposed new rule on reducing public expenditure for countries that deviate from the euro area average were adopted and implemented, and if primary surpluses were also respected, the 60% debt-to-GDP rule would become less important.

4. O. Francová, E. Hitaj, J. Goossen, R. Kraemer, A. Lenarčič, and G. Palaiodimos, "EU fiscal rules: reform considerations", ESM Discussion Paper 17, October 2021
5. "This is an illustrative exercise, and the surplus quoted is different from that implied by the existing debt rule. Debt dynamics could evidently vary over time and for example, require higher consolidation efforts, at the start with higher debt levels. Structural measures of the primary surplus may lead to different outcomes, and possibly showing even higher adjustment needs"

2.6 Public investments should not be excluded from a country's s deficit and debt calculations

There are huge public spending needs, given new investments for the green and digital transitions, education, healthcare[6]. But a special treatment for growth-enhancing expenditure would not be helpful. It comes from the illusion that public financial means are not scarce. Actually, it is a matter of refocusing the priorities. Unproductive public spending needs to be replaced by productive public spending.

It would be a grave mistake to push the extreme fiscal limits in the present situation. Investment-friendly rules – such as a golden rule to protect public investment implying a separate capital account – can lead to excessive borrowing and weaken the link between fiscal targets and debt dynamics, fostering potential risks to debt sustainability. In addition, as stated by the ESM paper, "creative accounting and the reclassification of unproductive expenditures as investments to circumvent rules could challenge monitoring and enforcement, alienate the targets from the numbers and reduce transparency".

We need strong fiscal positions to face the challenge of infrastructure investments and ecological policies. The last thing we need would be to deteriorate current imbalances budgets. The future depends on

- a consolidation of present week fiscal positions (primary surpluses) and
- a shift toward quality of expenditure and investment.

With the amount of liquidity created in the past years, we do not need more redistributive expenses. We must rein them in and allow adequate space for public investment.

2.7 The quality of public spending and composition on public finances must be given more importance than its quantity

Fiscal policy should ensure a composition of public finances that is both growth-friendly and sustainable. We have to recognize that the shift towards more productive investment will require substantial political effort because presently public investment only accounts for some 4% of GDP while current – nonproductive expenditure – represent almost all public expenditure.

In this perspective, putting in place early warning mechanisms to prevent unsustainable public finance trajectories would be required. Indeed, a country whose share of public expenditure reaches record levels in relation to the European average should be subject to special discipline.

The fact that money has been thrown at the problems for years has worked against supply-side policy. In order to reduce the unused margin of the economy ("output gap"), it is necessary to deal not only with the stimulation of demand, the reduction of unemployment but also to increase productive investment and productivity gains, which have been the orphans of this story.

In an extreme case, stimulating demand does not translate into increased production, but leads to a widening of our trade deficit if a country does not have an efficient production system. In this respect, the quality of public spending is becoming an absolute imperative: as much as we need to fight against unproductive spending, we can encourage the financing of infrastructure spending (including research) that can be financed by debt.

2.8 An effective fiscal surveillance and enforcement process

The specific rules that would emanate through each country from the discussion undertaken at the EU level must be internalized in domestic frameworks and these rules should be a condition for the presentation of the national budget to the national parliament.

As mentioned in 1.5, in the absolute, if one wanted an ideal system, promoting transparent discussions on fiscal issues between an independent EU fiscal authority and each Member State is a right approach. Having a dialogue like the one at the IMF for article IV would certainly be a progress. Socratic discussion leads to a quantum of realism and is a better approach than having a few arithmetical rules that will never be applied.

An independent fiscal authority, comprised of economists of good economic and academic backgrounds, would therefore add credibility. The proposals to entrust an independent European Budget Committee with responsibility for defining the concept of sustainability as well as the debt target and growth assumptions seem excellent. It could help each country top fix its personalized standards; it would be free to establish the fundamental macroeconomic assumptions behind the national budgets with the assistance of academics.

In the face of the difficulties of such a system or the opposition that would inevitably arise, one should be able to count on the European Commission to fulfill this role in an independent manner.

In this perspective, each Member State would define a specific path for reducing its public debt and this politically independent EU institution should discuss and validate these plans. A dialogue would be needed between the economists of the Commission and the national authorities. If the country understands that the measures are reasonable, enacting those prescriptions becomes easier. Increased confidence and trust between the economists in charge of this supervision and the national authorities would improve enactment and application of the system.

It would then be appropriate to set up a supervisory body (including economists) that could independently monitor the effective implementation of national budget programs and on which the Commission could rely.

Political difficulties could interfere there: Domestic fiscal choices are domestic and political issues. But, if political factors make comprehensive fiscal action at the level of the Union impossible, the problem is a lack of belief in a true European Union (*see 1.5*).

6. The Commission estimates that the additional private and public needs related to the green and digital transitions will be nearly 650 billion per year until 2030. The green transition alone accounts for €520 billion per year

The Union is based on a cooperative game of all its members. If a country decides to ignore the EU fiscal framework and continue to sink into debt and deficit - which it believes to be its national interest, then it is deliberately out of the game. The sanction is that it can no longer be taken seriously by the Union because it has turned a blind eye to the negative externalities it creates.

In other words, the penalty is the loss of credibility and its ability to participate actively in the Union and its modes of cooperation and of course, a country that embarked on this type of path would be labelled as ***such*** (name and shame).

Transitional aspects

In 2022, there will not be many countries with a deficit below 3%. Several will have deficits close to 5% and will need and should have a number of years, for economic reasons, to reduce them.

A transition period could be envisaged, where something like Jean Pisani-Ferry's recommendations is used[7]: country-specific adjustment or consolidation plans proposed by the Commission, discussed in the Eurogroup and agreed in the Council, in order to bridge the time until a new common framework is reached, perhaps after two years.

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As long as it is not sufficiently understood, notably in highly indebted countries (France, etc.), that excessive debt is a source of under competitiveness, the economic situation in these countries will continue to deteriorate. Only domestic structural reforms can resolve structural issues and increase productivity and growth. It is an illusion to try to solve the structural problems of our economies by prolonged increases in public or private debt or by using money creation. Yet this is what has been too often tried by pursuing lax fiscal, monetary and political policies that inevitably pose systemic risks to financial stability and therefore to future growth.

When the house is burning (when deficits and public debt are increasing in certain countries), we must not postpone the arrival of the fire department (absence of European rules and postponement of the discussion on the economic governance of Europe).

It is important to understand that if fiscal policies were to remain expansionary, central banks would have to tighten monetary policies even further to curb inflation and reduce inflationary expectations exacerbated by this fiscal stimulus.

Moreover, as public debt ratios worsen, the problem of debt sustainability becomes more acute.

Historically, a negative "r-g" ratio (where $r \equiv$ *interest rate*, $g \equiv$ *economic growth rate*) does not eliminate sustainability problems. Indeed, the growth rate and the interest rate are not independent of the level of indebtedness. The higher the level of indebtedness, the higher the market interest rate and the more fragile the economy. Hence the extreme caution that must be attached to the question of risks to debt sustainability in Europe. It must be understood that money creation and the purchase of public securities will not always be able to solve this problem. The Maastricht Treaty contains limits on the monetary financing of the Treasury, and opinions on this issue are far from unified.

Since the pandemic hit in 2020, the general escape clause of the Stability and Growth Pact has been applied and the Commission motivated the Member States to pursue an expansionary fiscal policy. Reacting to the economic consequences of the Russian invasion of Ukraine, the European Commission postponed again the renewed enforcement of its fiscal rules by a year, to 2024. However, the problem of excessive public deficits and indebtedness of some EU Member States constitutes the central explanation for the financial fragmentation within the eurozone.

Without an effectively implemented European fiscal framework, it is not possible to resolve this issue and thus to reduce the growing heterogeneity in terms of budget and debt between the virtuous states (Germany, the Netherlands, Austria, Portugal, etc.) and the others (Italy, France, Spain, etc.).

As we have observed, these fundamental problems have been with us for nearly 20 years and were not created by the war in Ukraine or the Covid crisis. The war in Ukraine exacerbates these problems but is not the cause.

By renewing the suspension of European fiscal rules once again in May 2022, policy makers believe that they will have an easier time later. In reality, postponing solves nothing, exacerbates tensions within the market (due to the lack of reference points) and only complicates the resolution of problems that are likely to become even more acute.

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Experience has shown that many States had not complied with the Pact. The following lessons must be learned:

- Rules are needed.
- They must be "personalized" (country by country).
- The methodology used must be indisputable.

Of course, all of the above could be completely unimplemented, as was the case with the old rules of Stability and Growth Pact. The sanctions originally provided for were never implemented. If this drift were to continue, we would end up making the virtuous countries pay for the slippage. This is the definition of a non-cooperative game where most players try to avoid their obligations by shifting the cost to those who observe them.

If this were the case, the logical result would be an inevitable, major, new crisis of the euro zone.

7. P. Martina, J. Pisani-Ferry and X. Ragot, Reforming the European Fiscal Framework, French Council of Economic Analysis, April 2021.