HOW TO SAVE THE STABILITY AND GROWTH PACT

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SUMMARY

The European Commission's proposal to reform the Stability and Growth Pact (SGP) is old wine in new bottles. It fails to address the central problem that has contributed to the SGP's failure from the onset – the lack of political will to implement the Pact's provisions. Blatant conflicts of interest need to be tackled head on.

A long time ago, elected politicians realised that they cannot be trusted with providing stable monetary policy. Consequently, they have delegated the task to independent central banks. More than two decades of trying have provided ample evidence that, similar to the case of monetary policy, elected officials also cannot be entrusted with activating financial sanctions when rules are being broken.

Give this role to an independent fiscal council. Fiscal policies are still determined by democratically-elected governments. But the judgement on whether those policies conform with the agreed legal framework cannot be credibly performed by the same set of people that have broken the rules in the first place.

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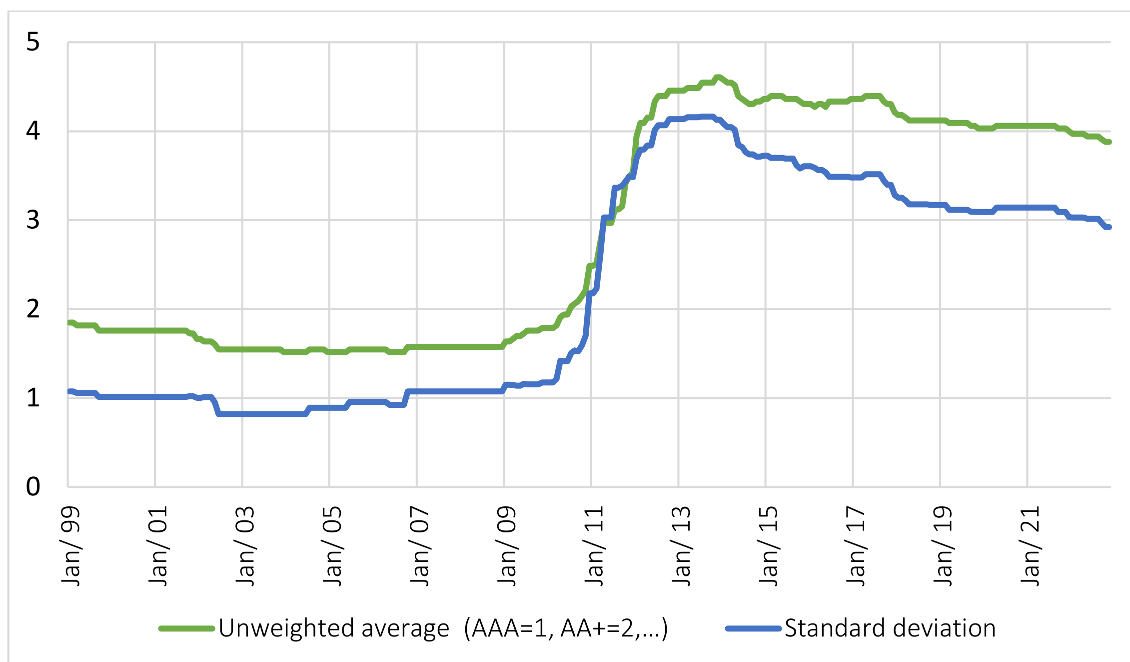
Despite the best efforts of European policymakers through various versions of the Stability and Growth Pact (SGP), there has been no discernible trend towards fiscal improvement since the introduction of the common currency.

In fact, both the level and the dispersion of national debt ratios has risen sharply. The same deterioration can be observed for Member States' creditworthiness, as expressed in average sovereign ratings (Figure 1). Instead of convergence in the euro area, we got divergence. Clearly, the SGP has not been fit for purpose. It needs to be improved.

Figure 1. Sovereign ratings EMU-11: Average and Variance (S&P, Moody's and Fitch)



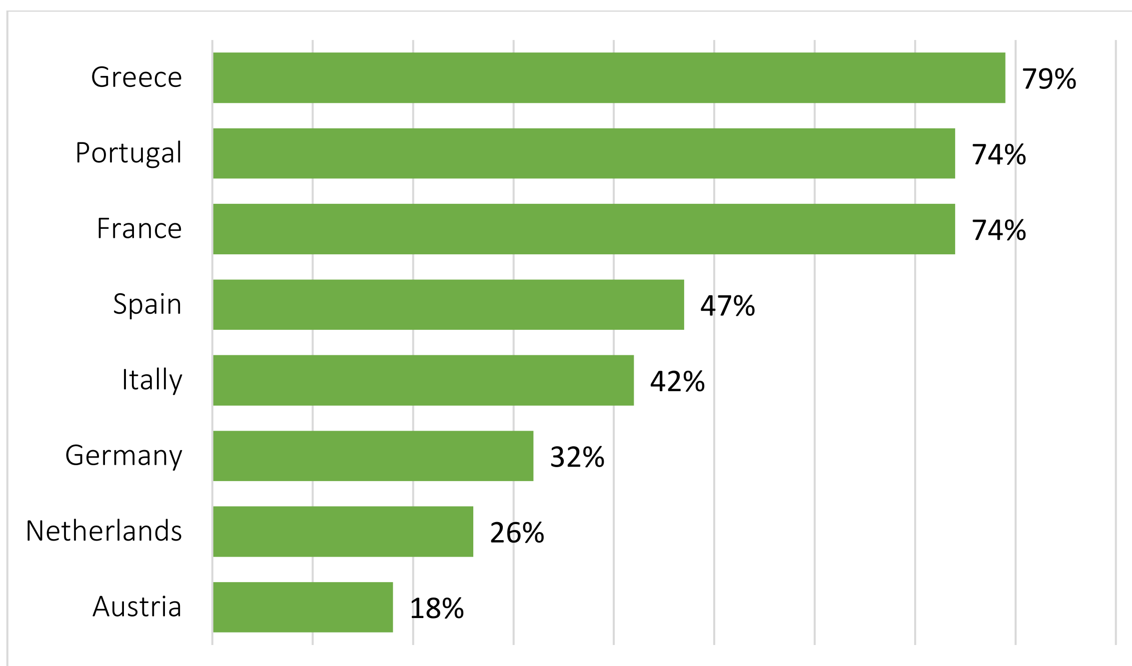
Source: CountryRisk.io

WHOLSEALE FAILURE – THE NEED FOR REFORM IS IRREFUTABLE

Since the introduction of the euro, the European Commission has launched no fewer than 38 excessive deficit procedures (EDPs). Nevertheless, in not a single case has the Council imposed a sanction on a member country. It should not be forgotten either that the sanction provided for by the SGP is, in any case, only very mild, almost symbolic. At most, interest-free deposits of a maximum of 0.5 % of national GDP can be demanded, which may be converted into non-repayable penalties if a country drags its heels on deficit reduction for a further two years.

Especially in times of low interest rates, a penalty involving 'interest-free deposits' was not likely to have much of a deterrent effect, even if it had been imposed. Accordingly, breaking the rules has become a bit of a habit for many euro area sovereigns (see Figure 2).

Figure 2. Proportion of years in which Member States had deficits of more than 3 % of GDP (2001-2019, in %)



Source: European Commission, DSGV.

Actually, it is not strictly correct to assert that sanctions have never ever been imposed. In 2016, even when applying utmost leniency, the European Commission could not avoid proposing sanctions against Spain and Portugal. Their target misses were simply too glaring to turn a blind eye to.

However, to avoid a politically conflict-laden discussion about encroachments on national sovereignty by a non-democratically-elected supranational institution, the size of the fine was set at precisely – you guessed it – zero euros.

In essence, the Commission was ready to bark, i.e. put countries into the EDP, but unwilling to bite, i.e. demand that sanctions actually be activated. In that same year, then-Commission President Jean-Claude Juncker, when asked why no sanctions had ever been imposed on France, replied laconically: 'Because it is France!'

Politicians made a mockery of the agreed fiscal rules. The sanction mechanism envisaged in the SGP was publicly reduced to absurdity.

The Commission's reform proposal – beating around the bush

The Commission's proposal to reform the SGP presented last October contains several welcome initiatives. It moves away from amorphous macroeconomic variables such as the output gaps or the structural budget balance. In the past, estimates of those unobservable variables have proved unreliable.

For example, in its autumn forecasts, the Commission has since 2000 projected a negative output gap for the euro area in the following year almost 90 % of the time[1]. The optimistic bias of overestimating the growth potential of Member States has been systemic. This renders any meaningful policy guidance of an output gap calculation impossible. In some cases, a 'structural' deficit of below 3 % of GDP has given Member State governments a deceptive sense of security. It contributed to a complacent 'wait-and-see' approach to economic and fiscal policy.

It has also led to overly optimistic forecasts in Member States' stability and convergence programmes. Ditching those concepts is real progress. The proposal to reduce or freeze EU structural funds in the case of non-compliance with SGP rules could also generate a positive effect should it be applied consistently.

On balance, however, the European Commission's plan is ill-suited to overcome the problems which have hounded the existing SGP. The central weakness of the SGP during the first twenty years of its existence was not its operational or parametric design.

To be sure, there were some imperfections on these fronts as well. **But the fundamental weakness of the SGP is to be found elsewhere – in its governance and institutional design**. Under the current system, governments, through the European Council, ultimately have to impose sanctions on their own colleagues. Unsuprisingly, they regularly shy away from this.

This unwillingness to follow through has been observable even in cases of repeated and flagrant failures to achieve the agreed goals, as lenient as they may have been formulated in the first place. Instead, discretionary leeway has invariably been used to avoid imposing penalties. After all, you never know when you'll need the vote of the colleague you just slapped a hefty financial penalty on. Predictably, a '*I scratch your back, you scratch mine*'-mentality took hold.

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[1] Analysis by the authors of all DG ECFIN autumn forecasts from 2000 to 2022. The only exceptions of output gaps indicating economic activity above potential were the autumn forecasts of 2017, 2018 and 2019. On average over the 23-year period the European Commission estimated that the euro area was below potential by 1.2 %. Such a persistent one-directional output gap is clearly nonsensical. See for more detail S&P Global Ratings (2016): 'Ultralow Interest Mask Sovereigns' Underlying Fiscal Imbalances', RatingsDirect (paywall).

At its summit in March, the European Council was able to take up most of the European Commission's proposals but, on Germany's initiative, no final decisions have yet been taken. **Finalising the reform is becoming urgent**. The general Covid-induced exception from the SGP's stipulations will only last to the end of 2023. The budget processes for 2024 are already getting underway. Germany, among others, still seems concerned that the basic stability concept could be undermined.

We tend to partially agree. The current endeavour to reform the SGP risks becoming just as unsuccessful as past attempts. Even the most perfect rules will have next to no effect if they are not complemented by a credible enforcement mechanism.

Unfortunately, the Commission's proposal largely misdiagnoses the problems that have hobbled the SGP's effectiveness. It doesn't address the fundamental governance problem of serial rule-bending in any discernible way. The Commission proposal allows policymakers' conflicts of interest to continue to fester unimpeded.

CREATING A NEW INDEPENDENT FISCAL INSTITUTION

Changing the strictly operational parameters resembles a little like painting the deck of a ship that is tossed back and forth in a storm. **Instead, if we want to stabilise the fiscal ship in the euro area, the SGP's governance must be strengthened**. **Obvious conflicts of interest need to be tackled head on. This could be achieved through the greater involvement of – and greater independence for – institutions such as the European Fiscal Board**.

Elected politicians realised many years ago that they cannot be trusted with providing stable monetary policy. Consequently, they have delegated the task to independent central banks, which conduct monetary policy at arm's length. Like Ulysses, politicians have wisely had themselves tied to the mast to resist the sirens' song of loose monetary policies. Now they should apply this wisdom once more to fiscal policy as well.

More than two decades of experience have provided ample evidence that, like the case of monetary policy, elected officials also cannot be entrusted with activating financial sanctions when rules are being broken.

Better to give this role to a technocratic institution, such as a pan-European Independent Fiscal Council (IFC). This institution could – but does not have to be – an institutional enhancement of the existing European Fiscal Board.

Obviously fiscal policy will have to remain a core competency of the Member States. Fiscal policies would still be determined by democratically-elected governments. **But the judgement on whether those policies conform with the agreed rules cannot be credibly performed by the same set of people that have broken the rules in the first place**.

We can learn from the experience of independent central banks when setting up an IFC that is to be the umpire deciding whether fiscal performance is inside or outside the realm of the permitted. **Individual members of the IFC need to be non-political experts with long tenures. They must not be civil servants and their salaries must not be paid by the jurisdictions on whose fiscal behaviour they are expected to opine on. They should furthermore not be official representatives of the country whose passport they carry, but rather impartial guardians of pan-European rules.**

We know from the ECB's experience that this may be easier said than done. Selecting the members will be no easy task. For added purity, nationals of third countries should also be considered for nomination. The IFC must be accountable to the European Parliament, just as the ECB is. National fiscal councils can play an advisory role to the IFC – **but must not have a vote, let alone a veto**.

An obvious alternative could be to empower the Commission to play the IFC's role. But the risk of politicisation is obvious. The inherent principal-agent problem can be more easily managed by a smaller, single-focus institution than the Commission, which depends on national governments' cooperation on a myriad of other policy issues. There is a good reason why a specialist organisation like the ECB was entrusted with the independent conduct of monetary policy and not the Berlaymont.

OF COURSE, WE HAVE A PLAN B

For some, the involvement of a technocratic unelected fiscal council may be a step too far. To this we would say that the role for the fiscal council would only be a small – but critical – step compared to the already huge role played by the equally unelected Commission in the realm of fiscal surveillance and implementing the SGP.

For those sceptics we would offer a 'smaller solution' by enhancing the political incentives to impose sanctions where sanctions are due. **No IFC, but a setting that allows for a more rules-bound European Council. Specifically, automatic penalties in the form of non-repayable contributions to the EU budget could be triggered, whenever a Member State finds itself in the EDP**.

This would remove the need to determine that a Member State is in 'persistent' breach of the Pact's stipulations. The subjectivity of 'persistence' was another concept that allowed policymakers to wiggle out of applying sanctions. If any breach with the Maastricht deficit limit automatically triggers EU budget contributions, there will be no discretionary room for '*pretend and extend*'. To secure the political underpinnings of this procedure, the breach will have to be formally confirmed by the European Council, the elected leaders of the Member States.

This proposal would tilt the incentives of all parties involved towards stability-oriented fiscal policies. Firstly, each Member State would know that driving through the 3 % deficit stop sign would immediately trigger a speeding ticket. It would also imply a political cost in the form of lost prestige, internationally as well as domestically.

Shifting the incentives in such a way might induce Member State governments to treat the Maastricht deficit limit once again for what it had been designed to be – not as a safe target, but an absolute upper limit that must not be breached. Not even in the case of unexpected external shocks.

Secondly, **other Member State governments have a reduced incentive to nix the automated sanctions too easily**, e.g. by vetoing it through on a qualified majority. Letting their peers off the hook would force them to explain to their own taxpayers back home why they were sparing the fiscal perpetrator to the detriment of domestic voters and taxpayers, which will now have to pay proportionately higher contributions to the EU budget. In short, not a vote winner.

The electorate will have sympathy with their own government voting in favour of waiving the penalty if a country is subject to a large idiosyncratic shock, such as a major natural catastrophe. But in the overwhelming majority of cases, breaking the fiscal rules in the past was the direct result of poor fiscal management, a homemade problem.

A generalised shock could push every Member State's deficit across the 3 % line. All of them would then be obliged to make payments to the EU budget. **But since the overall financial envelope of the EU budget would remain unchanged, no government is really 'punished'**. If the breach over the 3 % hurdle is of the same relative size for all Member States, the net contributions to the EU budget would not change at all.

CONCLUSIONS

Whether you opt for the small solution ('Plan B') or the comprehensive institutional reform, the SGP will be unable to live up to its promises unless its fundamental governance problems are addressed.

Adapting the operational details of a regime ruled by faulty incentives will not cure the SGP's ills. If the basic rules of engagement remain unreformed, Europe is setting itself up for another round of disappointment. All the more so as fiscal pressures will predictably rise in many Member States due to rapidly ageing societies, mounting interest outlays and additional spending needs on a range of priorities such as defence, infrastructure and investment towards a net-zero Europe.

When only scratching the surface of the problem with the current proposed reform, we can count on the EU having to have yet another debate on how to reform the SGP before the current decade is out. Mark our words on that.

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