

## THE REFORM OF THE STABILITY AND GROWTH PACT

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In November 2002, the European Commission send a Communication to the Council and the European Parliament titled "Strengthening the coordination of budgetary policies" (ECFIN/581/02-rev.3) in which it made a very reasonable proposals of how to reform and improve the content and implementation of the Stability and Growth Pact (SGP) that, in my opinion, should be the basic framework to make the SGP a necessary and workable instrument of budgetary stability and coordination among Member States.

Unfortunately, in the ECOFIN Council of March 2003, only a small part of the November proposals by the Commission was approved (7208/03, UEM 68) with the negative consequences, which followed after the breach of the SGP by two large members and the decision by the Commission to propose legal action before the European Court of Justice. The problem of going into a legal action is somehow risky. If the Commission loses the governments will have very little incentive to reform the SGP and only if the Commission wins there is a chance of reforming it. Therefore, it is preferable to achieve a consensus, before any decision is taken by the Court of Justice, about a reasonable and more extensive reform of the SGP. Nevertheless, it seems to me very clear that any new reform of the SGP should be based on the said communication and should include the totality of its proposals.

The original design of the SGP was heavily criticized, from the start, by most European academics and economists because it contained an excess of political wishful thinking and a lack of economic rationality, introducing a large uncertainty about the actual possibility of its implementation, as it has finally resulted. Nobody doubted about the need of having some rules of fiscal discipline to induce the member countries of the European Monetary Union (EMU) to comply with the Maastricht criteria and to achieve a successful single currency and a single monetary policy by the ECB. This is the reason why the SGP introduced, as a first rule, the "deficit ceiling of the 3% of GDP reference value" and, consequently, the "excessive deficits" procedure. Later, it was also the reason to introduce a second rule: the "close to balance or in surplus" budget rule, so that the "automatic stabilizers" could operate within the confines of that deficit ceiling, given that the historical experience of the EU Member States, previous to Monetary Union, was marked by maintaining large deficits in the expansion phases of the business cycle, so that those stabilizers could not operate fully in the recession phases.

The experience with the two rules or requirements could not be more disappointing. The budget stability rule has been breached several times and it had to be postponed every time because it was ill conceived, since it had to be met at a certain date, without taking into consideration the different phase in the cycle of every Member State, and the excessive deficit rule has been breached recently by two large countries, as soon as the Euro Area economy started a fast deceleration for the first time since the SGP was implemented, showing in full the rigidity and lack of rationality of both rules. Not only that, moreover, there have been reporting anomalies detected in some Member States leading to upward revisions of

their budgetary balances; discrepancies between deficits accrued basis and debt issuance in cash terms have been detected; ex-post revisions to budgetary data keep becoming larger and the early warning mechanism has not proved to be effective in dealing with significant slippages from budget targets.

The Commission proposals made to the Council, in November 2002, were most welcome by most European economists, analysts, and fiscal and monetary experts, because, for the first time, they tried to solve most of the basic economic theory weaknesses of the SGP. In sum, they were the following:

First, Member States should reaffirm their political commitment to the SGP in a resolution called “to reinforce the coordination of budgetary policies” according to the proposals of the Commission and to be endorsed by the European Council.

Second, the present use of “nominal budget balances”, as a way of measuring the “stability rule”, should be replaced by “underlying budget balances”, which take into account the effect of the economic cycle in the budget position. Therefore, the compliance of the “close to balance or in surplus” rule, should be understood to be “over the cycle” and the method of calculating the budget situations should be in terms of “cyclically-adjusted” budget balances, that is, net of transitory effects of cyclical fluctuations on budgets. The principle tool for assessing underlying budget positions will be the common methodology of “cyclically adjusted budget balances (CAB) agreed both by the Commission and the Member States, based on a production function approach to estimating output-gaps, already calculated by the OECD, proposed by the Economic Policy Committee (ECFIN/EPC/670/01) and endorsed by the Council in July 2002. To achieve the “close to balance or in surplus” goal of the SGP, the size of budgetary consolidation efforts require of Member States should also take account of economic conditions through “underlying deficits” and the general principle for Member States with underlying deficits should be a reduction of 0,5% of GDP each year until they comply with the rule, being larger if they have very high deficits or debt levels.

Third, in order to avoid a pro-cyclical loosening of fiscal policies in good times, the automatic stabilizers should operate symmetrically over the cycle. This implies running nominal surpluses when conditions are favourable. Expansionary fiscal policy for stabilization purposes should be confined to Member States that have already created enough budgetary room to do so. On the other side, a small and temporary deterioration of the underlying budget balances could be envisaged only if the Member State has already made substantial progress towards the “close to balance or in surplus” requirement and if its debt to GDP ratio is below the 60% reference value.

Fourth, the long-term sustainability of public finances should become a core policy objective. To this aim, greater weight must be attached to government debt ratios in the budgetary surveillance process, and Member States with debt levels above 60% of GDP should approach the reference value at a “satisfactory pace” and have a detailed strategy to reduce them below the reference value. The sustainability of public finances should take into account the challenge posed by ageing populations, and should be running primary budget surpluses in the coming years.

Fifth, the quality and timeliness of government finance statistics should be improved as they are the foundation on which budgetary surveillance is built and that a Code of “best practices” on the reporting of budgetary data should be endorsed by the ECOFIN Council to upgrade the quality, transparency and reliability of budgetary statistics. That a greater reliance on underlying budget positions in the EU surveillance process be accompanied with an

improvement in the analysis of the Member States budget positions, because, in contrast to the actual budget balance, the underlying budget position is not directly observable. In many Member States Convergence Programs the nominal deficit targets were sometimes based on optimistic growth assumptions and with adjustment efforts back-loaded towards the end on their time horizons. The Commission wants to make sure that those targets really meet the requirements of the SGP and, therefore, it is going to use its own forecasts to assess the realism of the macroeconomic assumptions on which the budget targets are based. This step will need that the Code of Conduct on the content and presentation of the Stability and Convergence Programs be updated also, to require Member States to provide information on important one-off budget operations. The reinforcement of the surveillance of the Member States economies should concentrate on countries which have difficulties in meeting the requirements of the SGP, organizing frequent and comprehensive missions and in-depth country studies, to be made public.

Sixth, the criteria that the Commission will use when deciding whether to activate the “early warning” mechanism in the event of significant divergence from budgetary targets, should be clearly specified, which in turn would be used by the Council in deciding whether to endorse the Commission recommendation. Three basic factors should be taken into account, namely, the size of the budgetary slippage from the established target in the program, whether the divergence from the target is explained by cyclical or discretionary factors and thirdly, the possibility of deficits raising and approaching the 3% of GDP reference value. Moreover, the inappropriate pro-cyclical loosening of the budget in good times should be viewed as a violation of the budgetary requirements and should lead to an adequate and timely response through the use of the instruments provided by the Treaty.

Unfortunately, the agreement achieved by the ECOFIN Council, in March 2003, over the Commission proposals was quite vague and only accepted the idea of the cyclically-adjusted budget balances for the “close to balance or in surplus” rule, but not for the 3% reference value, which should be interpreted as nominal, the idea that the automatic stabilizers should operate symmetrically over the cycle, the need to pay attention to the long-term sustainability of public finances, to the need of sufficient safety margins at all times, including an allowance for automatic stabilizers to operate fully without breaching the 3% reference value and the coherence between the evolution and quality of the public finances in the Stability and Convergence Programs and the close to balance or in surplus requirement.

To these reasonable proposals made by the Commission, I would add another three. The first one is that in order to make the procedure of “early warnings” more effective I think that the Commission should be the only European Institution involved. Today, the Commission “early warning” proposals need to be approved by the ECOFIN Council, that is, by the “warned” countries themselves, which is completely inconsistent. The experience shows that when the Member States “warned” are the larger ones the ECOFIN is not able to endorse the “early warning” issued by the Commission. The solution to this problem is either give full powers to the Commission to carry out the warnings or to create a new independent body to do it. The first alternative is much easier and effective.

The second one relates to the deficit ceiling reference value of 3% of GDP, which contrary to the “close to balance or in surplus” rule is understood to be a nominal and not “cyclically-adjusted” reference value, although the protocol of the Treaty does not say in which of the two terms should be interpreted. It is understood that to change this reference value, when it has been approved in the Treaty, would need an amendment, which it needs to be ratified by Member States. Nevertheless, there is no need to amend it. All is required is a

clarification of what is meant by “exceptional”, by “temporary” and by “close” to 3%, when the Treaty allows for a breach of such reference value. At present, an “exceptional” event is when GDP declines by “at least” 0.75% in any year. This definition could be redefined by saying instead “when GDP falls at least 2% below trend”. The term “temporary” should be maintained and the term “close to 3%” could be modified to say “and the cyclically adjusted deficit remains close to 3%”.

Finally, in order to create the right incentives, the SGP should have not only a system of penalties for those Member States, which do not comply, but also a system of premiums for those that do comply with the SGP requirements, by giving them more flexibility to meet those requirements when they have achieved a sound fiscal situation. One possibility to achieve this aim, given the large heterogeneity of fiscal and growth trend situations of Member States, could be to apply the SGP in a less general and more country specific way, that is, to implement the SGP individually to every country according to its specific situation in relation to the compliance of the requirements.