BRIEFING PAPER

# Opinions on the Reform of the SGP


by

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## Executive Summary

In March the European Council made a proposal on an improved implementation of the Stability and Growth Pact (SGP). The reason why the Council had to change existing rules is that the SGP simply did not work as expected. The most important advantage of the Councils decision to reform the SGP is that it implies a more flexible assessment of the 3 % threshold. However the reform does not correct a major constructional failure already part of the SGP. While there still are fairly strict and precise rules on what to do when at economically bad times the deficit becomes excessive, there are no restrictions for good times. Hence the asymmetry of SGP rules prevails. The only difference to the previous situation is that the mechanical interpretation of margins has been removed and replaced by more economic considerations. It would have been preferable if the reform would have been more systematic.

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## 1. The Proposal of the Council

On March 20 the European Council made a proposal on an improved implementation of the Stability and Growth Pact (SGP). The reason why the Council had to change existing rules is that the SGP simply did not work as expected. All major member countries like France, Germany and supposedly Italy of the Euro area showed excessive deficits according to the prevailing rules and were unable to reduce them below the reference value. Hence the council had to make up his mind either applying the fines as defined by the SGP in case of non compliance or change the rules.

While the former suggestion was seen by many scholars as recommendable to preserve the credibility of SGP, others advocated strongly for the latter in order to make the SGP really working. The Council has decided to follow the latter option that shall be outlined in this section.

The main intention of the Council is to enrich the "common framework with a stronger emphasis on economic rationale of its rules." (European Council (2005), p.3). Thereby credibility and ownership of the SGP should be improved. One of the most important parts of the suggestion is that a deviation from the Medium Term Objective (MTO), i.e . a budget close to balance or in surplus and a debt burden below 60% of GDP, or a trespassing of the reference value of 3 % should be interpreted against the backdrop of other economic variables. Among them special attention should be paid to pension reforms that introduce a multi pillar system including a mandatory fully funded pillar. This kind of measure is expected to reduce the implicit debt burden originating from demographic changes straining the financial means of pay as you go social security systems. As far as the introduction of such a pillar creates costs, short term deviations from the adjustment path to MTO or the MTO itself will be accepted. Furthermore it should be taken into consideration whether the deficit exceeds government investment expenditure. As long as the deficit does not do so, the future revenues of today's investment may finance the deficit, such that no long term indebt ness is involved. It also should be considered whether the excessive deficit is the result of wrong forecasts rather than wrong policy. In the former case the government cannot be hold responsible and should not be punished. Another reason for deviations to be considered when assessing excessive deficits by the Council is that the debt burden is still below the reference value of 60%. Then a temporary rise of the deficit does not destroy the sustainability of public finances. In a further step the deficit criterion is connected to the Lisbon strategy. All costs caused by measures in the framework of the Lisbon strategy are allowed to raise the deficit temporarily. The argument is basically the same as in the case of investment. By raising potential growth future revenues can cover present deficits. Finally, the Council accepts that a deficit reduction strategy starts one year after the excessive deficit has been detected, usually almost two years after its occurrence. That gives enough time to the government to set up a proper consolidation strategy. Furthermore it is expected that any economic weakness that may have caused the high deficits has been overcome until such a consolidation strategy becomes effective.

## 2. The Pros of the Councils Decision

The most important advantage of the Councils decision is that it implies a more flexible assessment of the 3 % threshold. It was stupid indeed to fix such a margin without almost any qualifications. That has been changed now and a number of considerations are now necessary before declaring a deficit value above 3 % as excessive. Before 1992 when the Maastricht treaty was sealed there was no economic theory that said deficits should always be lower than 3 % or the debt burden should always be below 60 %. In fact these conditions were set as a self commitment based on average figures on the debt ratio in potential member countries of the currency union at that time. The 3 % threshold was derived from the 60 % margin by assuming a 5 % average nominal GDP growth in the Euro area. Then a 3 % deficit reflects a 60 % debt ratio in the long run and any trespassing of the 3 % would raise the long term debt ratio. In the meantime this relationship has broken down since nominal growth in the Euro area was on average below 5 %. Consequently either the deficit margin would have been lowered or the allowed debt ratio to be increased in order to regain consistency between both values. Another way out, gone by the Council, is to interpret these criteria more flexible. On the one hand then the self commitment is not kept and this may hamper the credibility of the consolidation process. On the other hand the past has shown that the commitment could not be kept without severe damage to the respective economies and it therefore simply had to be changed in order to be credibly applied.

How important that is shows the debt burden condition. If the debt ratio to GDP is well below 60% there is no danger financial sustainability according to the criterion of the SGP even the deficit is above 3 %, as long as this is the case only temporarily. Hence the Council just has to check whether the financial strain is really just temporarily and the debt ratio stays below 60 %. Also the delay between the occurrence of a deficit and the beginning of a consolidation strategy could prove stabilising, since it diminishes the risk of a destabilizing pro-cyclical fiscal policy. This correct point is even made explicitly by the Council when stating that governments should "use more effectively periods when economies are growing above trend for budgetary consolidation in order to avoid pro-cyclical policies" (European Council (2005), p.4).

It is also important to stress the role of wrong forecasts. In Germany but also in other countries like Italy forecasts not just by governments but also by professional forecasters tended to be overly optimistic during recent years. As a consequence consolidation plans were based on too optimistic assessments of tax revenues and social spending. In addition to that a lower than expected GDP increases the debt ratio already by definition. A mechanical treatment of the 3 % margin would not take into consideration that the government cannot be hold responsible for wrong forecasts, especially not if these forecasts previously were considered as sound by the Commission.

## 3. The Cons of the Councils Decision

While acknowledging above mentioned advantages of SGP reform there are nevertheless some serious shortcomings. One refers to the treatment of reform costs. In particular an introduction of a fully funded social security system is seen as a reason to deviate from MTO or to trespass the 3 % margin. This is based on the assumption a fully funded system reduces future costs of social security for governments. This is by far not guaranteed. Fully funded systems increase the incentives to save for private households, especially if supported by public subsidies.

Higher private saving by definition means lower consumption and thus money is drawn out of the economic system leading ceteris paribus to lower growth. In turn there is less money to save such that the overall effect on aggregate savings is far from clear. Furthermore if the economy enters a lower growth path, future pensions will be lower if the income distribution between the active and retired population is not changed. Given that, there is no reason to assume that these reforms save future costs.

A more important point refers to the silence of the proposal on what should be done at times when growth is above trend. Apart from the fairly general statement cited above there is still no rule to be observed. Thus the reform does not correct a major constructional failure already part of the SGP. While there were and still are to some extent fairly strict and precise rules on what to do when at economically bad times the deficit becomes excessive, there are no restrictions for good times. Then the deficit may be low, but the debt burden may still be too high to deal with a downturn without trespassing the margins. Hence the asymmetry of SGP rules prevails. But that is exactly time when usually major mistakes are committed with respect to budget consolidations. If there is plenty of money available from high tax revenues, governments tend to spend it rather than to use it for a significant reduction of a debt burden. The only difference to the previous situation is that the mechanical interpretation of margins has been removed and replaced by more economic considerations.

## 4. What should have been done

It would have been preferable if the reform would have been more systematic. One suggestion in that respect is the introduction of expenditure rules to achieve a sustainable budget position. If all non cyclical and non investment expenditures have to follow a predetermined path that given a certain trend growth would lead to consolidation, then there are in particular restrictions for spending at good times. Then governments are forced to use high tax revenues for consolidation. That would have been an appropriate answer to problems created by the previous version of the SGP.

**Reference**

European Council (2005) : Improving the implementation of the Stability and Growth Pact, UEM 97 ECOFIN104,March 2005.