Stability and Growth Pact II? Let's Move On to SGP III: "*À la carte*"

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Stability and Growth Pact II? Let's Move On to SGP III: "*À la carte*"

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Abstract

After the fuzziness in Europe that surrounded the implementation of the excessive deficit procedure foreseen by the Stability and Growth Pact (SGP), the European Union had to restore the credibility of the weakened fiscal rule. On March 2005, the 25 members amended the SGP. The constraint was to keep alive the Treaty of Amsterdam, which instituted the SGP. Indeed, an attempt to make major changes to the SGP would have necessitated a new Treaty, and hence a ratification by the 25 countries. This could have meant no more Europe-wide fiscal rule. But are minor changes enough? This paper addresses this question by deciphering the amended version of the SGP, and finds that, in the case countries still breach the SGP, another minor change is possible: an "à la carte" version of the SGP.

Keywords: *Europe, Fiscal rule, Stability and Growth Pact*

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1. Introduction

On March 20, 2005, Europe amended the Stability and Growth Pact (SGP). The Stability and Growth Pact is the concrete EU answer to concerns on the continuation of budgetary discipline in the Economic and Monetary Union (EMU). Adopted in 1997, the SGP strengthened the Treaty provisions on fiscal discipline in EMU foreseen by articles 99 and 104, with the full provisions taking effect when the Euro was launched on 1 January 1999.

Under these circumstances, the big constraint was to adapt the rule without renegotiating the treaty of Amsterdam. Indeed, this would have required every country among the 25 members to agree upon the new rule. This practical constraint rendered impossible a change in the 3% of GDP deficit limit and 60% of GDP debt limit. How can we reform a rule in order to keep what is good in the SGP, incorporate criticisms from the economic literature, and introduce flexibility while the main two criteria cannot be changed? In the spring of 2005, this is the contortion European policymakers tried to make. The conclusion of this paper is that the curse of the first design of the SGP is still there. The author proposes a rule that is still in the spirit of the Treaty of Amsterdam, while conforming to the prerogatives laid out by the economic literature. To ease reading, SGP I is employed to describe the original version of the Pact, SGP II is related to the 2005 amended version (Warin, 2005), and SGP III is a potential rule based upon the provocative bet that countries will not abide by the SGP II; hence the European Union will have to find a new reading of the Treaty of Amsterdam if the EU does not want to revoke it.

2. Economic rationales of the SGP

Several articles appeared in the immediate aftermath of the implementation of the SGP. Authors such as Eichengreen and Wyplosz (1998), Beetsma and Uhlig (1999), Bolt (1999), or Buti and van den Noord (2003, 2004) analyzed different elements of the Pact including pros and cons of its implementation, and its effects on discretionary fiscal policy and elections.

The question of fiscal sustainability

Eichengreen and Wyplosz (1998) find that the most compelling rationale for the SGP rests in the need to strengthen the no-bail-out rule and the budgetary surveillance guidelines. The SGP is important since it can prevent debt accumulation from becoming unsustainable. By implementing the SGP, member countries would receive early warning signals of an economic downturn before such a situation appears. However, the authors conclude that in most other situations the enforcement of the pact will be relatively loose. They hypothesize that both EU officials and member states will be reluctant to levy deposits, and to impose fines. In 2005, the European Union decided not to fine Germany and France although they breached the deficit ceiling for three years in a row. Eichengreen and Wyplosz (1998) conclude that the SGP is a “minor nuisance” if countries have balanced or surplus budgets. However, if a country has a 3% deficit from the start, the SGP becomes an issue, because abiding by the 3% level depends heavily on external factors that can positively affect the GDP growth rate.

Beetsma and Bovenberg (1995) study how national fiscal policies relate with a common monetary policy. They suggest a model of a monetary union where the price level is uniform across the union, labor is immobile internationally, and there is a single commodity which is perfectly substitutable and perfectly tradable. Under these assumptions, the authors test the effects of decentralized policymaking when facing asymmetric shocks. They conclude that because the monetary policy is less likely to be used, fiscal policy is the only remaining device to ease the economic burden. However, they extrapolate that if a country always resorts to using fiscal policies, their situation could become unsustainable and other countries might be forced to take informal action to bail out an insolvent national government. As a result, this literature finds a clear need to strengthen the no-bail-out policy outlined by the Treaty of Maastricht. Beetsma and Uhlig (1999) took another perspective on the importance and consequences of the SGP.

The question of policy-mix

Beetsma and Uhlig (1999) build a model of “centralized monetary policymaking and decentralized fiscal policymaking by governments which are myopic because they can be voted out of office.” Using this approach, the authors investigate several different scenarios with and without the presence of the SGP. They find that a monetary union combined with an appropriately designed fiscal rule will be strictly preferred to fiscal autonomy.

In his paper, Bolt (1999) focuses on the role of debt and the effects of fiscal spillovers on a union-wide inflation. The author simulates different scenarios of fiscal and monetary policy mixes, and concludes that inflationary pressures increase as the impact of fiscal spillovers on the interest rates become greater. In this situation, the presence of the fiscal restraints would be beneficial.

The political budget cycle approach

Another important piece of the SGP literature focuses on the effects of elections on fiscal policy. Buti and van den Noord (2003) examine the fragile mechanisms in place to prevent politically motivated fiscal policies. They explain that the SGP “does not tackle a typical failure of fiscal policy behavior in Europe, namely the tendency to run expansionary pro-cyclical policies in good times.” Donahue and Warin (2006) confirm that the SGP is not a good device to prevent national elections from interfering with the European fiscal rule.

3. “Debt and deficit”, or “debt or deficit”? Alternative rules to the SGP

In the early twenty-first century, the two major proponents of the SGP breached the SGP. Germany and France were not fined and this led to the collapse of the credibility of the SGP. The economic literature had an opportunity to propose several alternatives. According to Buti, et al. (2003), these alternative proposals can be divided into four main categories: first, reform of the national institutions and budgetary procedures; second, factor in the “quality” of public finances; third, focus on debt and sustainability; and fourth, fiscal policy coordination at the Euro area level.

The reform of national institutions

Two distinct reform packages have been suggested: first, procedural reforms; and second, institutional reforms. The former focuses on changing budgetary procedures through the implementation of different rules for the presentation, adoption, and execution of the government budgets. The latter focuses on retrenching existing institutions or creating independent Fiscal Policy Committees (FPC) within each country.

Authors such as Wyplosz (2005), Beetsma and Debrun (2005), Annet, et al. (2005), and Marinheiro (2005) argue for the strong version of institutional reform, the creation of an independent FPC, and a reconfiguring of the debt targets so that they are established country by country on a basis of the starting position.

The "quality" of pubic finances

There are two distinctive reform choices discussed in the literature about the quality of public finances: first, an expenditure target; and second, the golden rule of deficit financing. The first choice focuses on how expenditure rules can link the annual budgetary process to a multi-annual policy framework (Buti, et al., 2003). Brunila (2002) argue for expenditure targets for central governments, and balanced budget requirements for local governments. In contrast, the golden rule allows for the spreading of capital projects over several different generations of taxpayers. This golden rule provides an answer to the criticisms of maintaining close to balance or surplus budget positions, because capital expenditures would not necessarily have to come out of the current revenues (Buti, et al., 2003; Fatas, 2005).

Debt and sustainability

For historical reasons, the SGP focuses mainly on deficits. Indeed, the Treaty of Amsterdam passed in 1997 is an extension of the fiscal criteria of the Treaty of Maastricht implemented in 1993. In

1998, some countries failed to qualify the debt criterion. Since then, the debt has been interpreted in trend and not in level. Proposals provide an opportunity to overcome the homogeneity of the pact by providing more emphasis on public debt (Buti, et al., 2003). A reform could be to make the deficit ceiling dependent on the stock of debt. De Grauwe (2003) argues that countries should be able to choose their own debt targets, and as a consequence would have different deficit targets. Another method to make debt an important part of the SGP would consist of a choice for countries to opt-out of the Excessive Deficit Procedure based on the deficit to abide by a the debt criterion only (Pisani-Ferry, 2002) or a Debt-Sensitive Stability Pact (DSSP) (Saraceno and Montperrus-Veroni, 2004).

Fiscal policy coordination

In this branch of the literature, proposals are twofold: first, to define an aggregate budget balance target; and second, to implement a tradable deficit permit mechanism. The rationale of the first proposal is that the 3% GDP criterion would apply only to the average deficit in the Euro area and not to individual members (Muscatelli, et al., 2003). That means certain member states could overshoot the targets as long as other states have deficits below that value. The second proposal is supported by Casella, et al. (1999), who suggest that there should be market mechanisms to allocate deficit permits.

4. The institutional design

The loss of the exchange rate instrument in the EMU was said to imply a greater role for automatic fiscal stabilizers to help economies adjust to asymmetric shocks, and make it “necessary to ensure that national budgetary policies support stability oriented monetary policies.” This is the rationale behind the SGP, *i.e.* to set the “ [medium-term] objective of budgetary positions close to balance or in surplus…” which “[will] allow all Member States to deal with normal cyclical fluctuations while keeping the government deficit within the reference value of 3% of GDP.” (Regulation 1466/97).

The SGP I

Formally, the SGP I consisted of three elements defined as follows:

- a political commitment by all parties involved in the SGP (Commission, Member States, Council) to the full and timely implementation of the budget surveillance process. These are contained in a resolution agreed upon by the Amsterdam European Council of 17 June 1997. This political commitment ensures that effective peer pressure is exerted on a Member State failing to live up to its commitments;

- preventive elements which, through regular surveillance, aim at preventing budget deficits going above the 3% reference value. To this end, Council Regulation 1466/97 reinforces the multilateral surveillance of budget positions and the co-ordination of economic policies. The regulation foresees the possibility of triggering the early warning mechanism in the event a significant slippage in the budgetary position of a Member State is identified. Part of this preventive component is the definition of the medium-term objective and its distinction from the reference value. The medium-term objective of budgetary positions should be close to balance or in surplus in order to allow Member States to deal with normal cyclical fluctuations while keeping the government deficit within the 3 % of GDP reference value;

- dissuasive elements, which in the event of the 3% reference value being breached, require Member States to take immediate corrective action and, if necessary, allow for the imposition of sanctions. These elements are contained in Council Regulation 1467/97 on the speeding up and clarifying of the implementation of the excessive deficit procedure.

The SGP II

The SGP II does not exist formally, it is just an amended version of the SGP I. Changes are twofold and concern both the preventive and dissuasive arms of the Pact. First, it is about the new definition of the medium-term objective (preventive arm). Second, it is about exceptional circumstances (dissuasive arm).

First, the medium-term objective definition is refined: prior to the change, Member States had to adhere to the medium-term objective for their budgetary positions of ‘close to balance or in surplus,’ In light of the economic and budgetary heterogeneity in the Union, the medium-term budgetary objective is now country-specific and its level should leave enough room for the country to adjust to any normal cyclical fluctuations while keeping the government below the 3% of GDP reference value. The rationale of this change was to take into account the diversity of economic and budgetary positions and developments, as well as fiscal risks to the sustainability of public finances in the face of prospective demographic changes.

This amendment may have interesting results. Indeed, the medium-term objective in the SGP I was ignored by the countries, which considered only the 3% of GDP reference value. Its new definition based on country specificities is now at the core of the assessment of countries’ fiscal policies. In other words, it seems that for national policies, what matters is no longer 3%, but their specific medium-term objective, by definition lower than 3%. In this regard, the new preventive arm seems to be tighter than the original SGP. However, the European Union relaxed the pressure a bit. Indeed, if countries do not abide by the medium-term objective, this is acceptable as long as they do not go over the reference value of 3%: regulation 1466/97 explains “[in] order to enhance the growth-oriented nature of the Pact, major structural reforms which have direct long-term cost-saving effects, including by raising potential growth, and therefore a verifiable impact on the long-term sustainability of public finances, should be taken into account when defining the adjustment path to the medium-term budgetary objective for countries that have not yet reached this objective and in allowing a temporary deviation from this objective for countries that have already reached it.” This excerpt from the amended regulation is sometimes misunderstood as a way to relax the reference value, when in fact it is a way to relax the constraint imposed by the medium-term objective. The amendment adds: “in order not to hamper structural reforms that unequivocally improve the long-term sustainability of public finances, special attention should be paid to pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar, because these reforms entail a short-term deterioration of public finances during the implementation period."

Second, the dissuasive arm is now looser than it was. The European Commission is asked to prepare a report in case of a breach of the deficit reference value. In case the breach is not justified by an economic downturn (a recession of at least 2% of GDP), or an exceptional external event, countries have to make deposits to the European Commission that will be transformed into fines the third year, if a country could not abide by the reference value for three years in a row. The amended regulation loosens the constraint by introducing the notion of relevant factors: "[the] Commission, when preparing a report… shall take into account all relevant factors…." Moreover, before asking for deposits when a country breaches the deficit reference value for the first or second time, the Commission should look first at medium term economic position of a country, second at relevant factors, and third at the overall quality of public finances. First, the medium term economic position of a country should be scrutinized and "[in] particular potential growth, prevailing cyclical conditions, the implementation of policies in the context of the Lisbon agenda and policies to foster research and development and innovation." Second, the amended version lists the relevant factors: budgetary efforts towards increasing, or maintaining at a high level, financial contributions to foster international solidarity and achieve European policy goals. A goal of note is the unification of Europe, which may have a detrimental effect on the growth and fiscal burden of a Member State. Third, qualitative factors should be considered, such as fiscal consolidation efforts in "good times," and a high overall quality of public finances: debt sustainability (meaning below 60%), and a big share of the deficit going to public investment (a reference to the golden rule).

This loosening of the dissuasive arm is intended to prevent countries from having to make a deposit the year they breach the deficit reference value, and thus, keep them away from the "three years in a row" rule. It is likely that no country will have to pay fines, since it is very difficult to be three years in a row over the reference value without being excused. This is not a real worry. First if a country is excused, it seems to be for good reasons. Second, through the preventive arm of the SGP, the Commission will put more pressure than under the SGP I. However, the interesting question will be whether the preventive arm – tighter than under the SGP I – will outweigh the loosening of the dissuasive arm? The answer is in the hands of national governments.

The SGP III: “À la carte”

Can we trust national governments? The evidence from the SGP I is “yes” for most of them, but “no” for some others. Ironically the “no” answer is for the two proponents of the SGP, Germany and France. It is, thus, tough to answer the question of whether the preventive arm will be stronger than the dissuasive arm. In case countries breach the SGP and again erode its credibility, there are still many ways to slightly change the interpretation of the Treaty of Amsterdam without having to ratifying a new Treaty with a new fiscal rule.

Saraceno and Montperrus-Veroni (2004) propose the DSSP, and Pisani-Ferry (2002) a debt based criterion. Let us go a little farther:

pick your own menu. This is, in a way, what was proposed by the economic literature calling for more flexibility: one size does not fit all when it comes to the fiscal policy, especially when an economic zone already has a common monetary policy. More precisely, as long as a country has a public debt lower than 60% of GDP, it would be allowed to run any level of public deficit. It is one way to reward countries with a sustainable debt level, as officially defined by the Treaty of Maastricht. Hence, the “well-behaved” country in need of a fiscal answer to a sluggish economy can use fiscal policy. On the other side, if a country is already over the 60% ceiling, then the 3% rule for the deficit should be strictly implemented. The country who had already abused its fiscal policy will have to work on its public finances to make them sustainable. This country would eventually have a debt level below 60%. This would be another reading of the Treaty of Amsterdam. This SGP III is, in a way, already embedded into the SGP II, except the amended version does not go this far: “developments in the medium-term budgetary position [should be considered] (in particular, fiscal consolidation efforts in “good times”, debt sustainability, public investment and the overall quality of public finances).” Here, the European Union asks the Commission, when writing its report on a country who breached the deficit reference value, to consider whether the country has a sound public debt, or has made some efforts in "good times" at lowering the deficit.

5. Conclusion

In retrospect, countries will decide the fate of the SGP II. It is, thus, too early to know whether the new preventive arm—tighter than under SGP I—will outweigh the new dissuasive arm—looser than under the SGP I. In case the SGP II falls into the traps of its predecessor, the European Union could use the "À la carte" approach: the SGP stays the same in terms of reference values, 3% and 60% respectively for the public deficit and the public debt. Instead of only looking at the deficit for practical reasons, the new reading of the SGP would help define easy, and coercive criteria. This interpretation would be more consistent with the idea of sustainability since, now, it would be measured through the lens of the debt instead of the deficit. After all, the emphasis on deficit versus the debt was a natural reaction to the fact that after the signing of the Treaty of Amsterdam, some countries (Italy, Belgium, and Greece) were way over the 60% limit.

With this “À la carte” approach, all the countries would eventually have a debt lower than 60% of GDP, and a deficit lower than 3% of GDP, exactly what was intended in 1993 with the Treaty of Maastricht and in 1997 with the Treaty of Amsterdam.

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