Inventaire avant sortie de crise !

Muriel Bouchet – Julie Boyer – Christel Chatelain – Louis Chauvel
Narimène Dahmani – Vincent Hein – Georges Heinrich
Sylvain Hoffmann – François Koulischer – Jean-Paul Olinger
Antoine Paccoud – Sidonie Paris – Pauline Perray
André Prüm – Michel-Edouard Ruben – Céline Schall
Alain Steichen – Thi Thu Huyen Tran

Juin 2021

idea
Fondation

Stability and Growth Pact: Dropping the anchor to gain stability

Georges Heinrich

The Covid-19 pandemic has killed millions of people around the globe. It has destroyed lives, disrupted our habits and our beliefs – not just short-term, but potentially also long-term.

After the banking and subsequent sovereign debt crisis of 2008-2015, the pandemic is the second black swan to hit Europe in a little over ten years. These two low-probability but very high-impact events have left some gaping holes in public finances: although the EU's Stability and Growth Pact fixes the upper limit for the debt-to-GDP ratio at 60%, 14 out of 19 euro area Member states currently exceed that ceiling and half of those exhibit debt levels above 100% of GDP.

However, unlike 10 years ago, when concerns about public debt sustainability almost led to the implosion of the euro area, this has been much less of an issue in the context of the Covid-19 crisis.

In fact, governments have stepped up public spending and deficits have ballooned in order to alleviate the most acute economic and social consequences of the fight against Covid-19 and the ensuing serial lockdowns.

However, the very significant conventional and non-conventional policies deployed by central banks in order to overcome the euro area sovereign debt crisis have been very successful in allaying fears of loss of market access and have brought down interest rates to such low (or even negative) levels that almost any level of public debt has become sustainable.

So, are we about to witness a major paradigm shift in European public finances? Should we prepare for fiscal policy to venture into non-conventional territory, get ready for helicopter money and debt cancellations? And are we soon going to witness the final demise of the much-despised Stability and Growth Pact (SGP)?

The SGP is the cornerstone of the fiscal policy framework of the European Economic and Monetary Union (EMU). For much of its existence since 1997, it has also been the focal point of major political controversies and tensions between Member states.

Broadly speaking, the SGP calls for countries to exhibit fiscal positions close to balance over the cycle. Deficits higher than 3% of GDP are deemed excessive - and so are debt levels above 60% of GDP. There are some escape clauses or exceptional circumstances which Member states can invoke to obtain some respite. But a quick look at current deficit and debt levels makes clear that those escape clauses are not nearly flexible enough to cope with the consequences of the pandemic crisis.

As a result, the SGP is currently suspended as enforcing its rules in the current context, by asking governments to tighten their fiscal policy stance and threaten them with sanctions if they don’t, does not make very much sense.

However, the SGP is not a mere political agreement: it is enshrined in the EU treaties and regulations. Furthermore, since the ratification of the Fiscal Compact of 2013, some key features of the SGP have been integrated into national fiscal frameworks in order to enhance national appropriation of those rules - or at least that was the idea.

Thus, sooner or later, the SGP will have to come out of the freezer and EU institutions and Member states will need to come to an agreement on its future. In fact, the debate has already started, and some are already suggesting that the SGP might need another revamp. This would then be the third major reform – following those of 2005 and 2011.

Given the circumstances and frequency of changes to the rules, one might be tempted to ask: is a rule that changes whenever it is put to the test really a rule? In fact, the SGP bears more resemblance to a thermometer for fever than an actual body of rules: it takes the temperature of the political debate on fiscal policy in Europe – and we see that currently, this temperature is rising again. However, as is the case with a real fever, treating the symptom will not actually help to diagnose the actual illness or make it go away…

The temperature is rising because the prospect of a reactivation of the SGP rules rekindles the eternal conflict between 'stability proponents' and 'growth proponents' in the euro area. This conflict is as old as the SGP – in fact, it is even older than the SGP, as it led to the creation of the SGP; however, as at the time the issue was fudged rather than resolved, it regularly reappears at the top of the list of political emergencies.

So, what is the underlying issue? The German language has a word that captures it quite well: *Etikettenschwindel*. That is, what it says on the label, and what is really inside is not quite the same thing... In the run-up to the EMU, in order to be 'fit for the euro', candidate countries did undergo extraordinary deficit and debt reduction efforts. But how to ensure that fiscal discipline would be sustained beyond the 'eurozone entry test' and how to prevent reckless fiscal policies by one or a few countries from jeopardising the whole project? The answer to this conundrum gave us the Stability and Growth Pact (SGP): a political contract between countries with the aim of fostering trust between fiscally more conservative and fiscally more profligate countries.

However, some countries feared that in the absence of a supplementary growth orientation applied to the Pact, its purely stability-oriented prescriptions might be perceived as too strict in the 'court of public opinion' and grant too little leeway to countries wanting to implement discretionary fiscal policy. Thus, as a concession to the more growth conscious countries, the Stability Pact was called Stability *and Growth* Pact. But, to be honest, it never really was about growth *per se*. It was about stability. It was about fostering trust and credibility. And it was about the necessity to consider national fiscal policy as a matter of common interest and thus coordinate accordingly.

So how could the SGP be fixed in order to resolve the inherent conflict between stability and growth?

Well, fixing it in such a way is probably an impossible task. In fact, under the circumstances, it is highly unlikely that a meaningful reform of the current framework can be achieved. Hence, rather than trying to make the impossible possible through the art of political compromise, it may be more sensible to consign the SGP to the annals of history and replace it with a new framework respecting the Tinbergen Rule, i.e. avoiding the pursuit of multiple policy objectives with a single policy instrument.

Stability and fiscal rectitude remain of paramount importance in the context of the euro area. Interest rates are currently very low or even negative, implying that the mounting debt levels do not entail a sharp increase in debt servicing. There is also nothing that suggests that the European Central Bank (ECB) is likely to rapidly terminate its sovereign bond purchases. In the current context, debt sustainability is safeguarded – even for the most highly indebted euro area countries. However, do we really believe that this is the ‘new normal’ of public finances? That euro area members will continue to be able to finance themselves at next-to-no cost going forward for the next 10 or even 20 years? And that the ECB will eternally continue to bankroll governments without any collateral damage to its credibility and its mandate? It is, of course, possible that it will be the ‘new normal’. But it is just as likely that new events will intrude and take us in a different direction...

The new fiscal framework should therefore be able to deal with such uncertainty, and it should also be able to cope with the heterogeneity of fiscal shocks that may occur.

Thus, rather than relying on an indicator-based system with added scope for political judgement, fiscal surveillance should be embedded in a genuine risk management framework and be based on a 'fiscal heatmap' providing a comprehensive analysis of fiscal risks, probabilities of occurrence and scenarios.

In fact, there is nothing sacrosanct about a deficit of 3% of GDP or a debt level of 60% of GDP. Depending on country-specific circumstances, these benchmarks may be too low, too high – or just about right... In order to be able to carry out an informed judgement of the fiscal risks associated with a specific deficit or debt level, it is necessary to carry out a more granular analysis. It is, for instance, important to take into account a country's conditions of market access; to understand whether a deficit is financed by debt or out of reserves; appreciate the size of the public debt in light of assets held – or implicit liabilities incurred (e.g., unfunded pension liabilities, state guarantees); to analyse the sensitivity of public expenditures and revenues to the business cycle; to assess how much of the public expenditures are allocated to categories that enhance the growth potential of the economy (which, incidentally, is not the same as gross capital formation according to the European System of Accounts – ESA); or to evaluate the reliability of the public finance statistics and forecasts produced by the authorities...

A ‘fiscal heatmap’ will also serve as a more reliable early warning system than the current SGP, allowing for the early identification and possible correction of adverse trends before they show up in headline deficit or debt figures – which can sometimes occur with a significant lag. The early warning capability of the SGP was particularly weak and time lags between the occurrence of a departure from the rules and the prescription of corrective measures were too long. Unfortunately, such procrastination usually only makes the cost of the necessary adjustment go up – both economically and politically… Hence, early action is of the essence!

Make no mistake: this is not a manifesto for unfettered growth of public deficits and debt. Current deficit and debt levels – although unavoidable – pose a very significant risk to the sustainability of public finances in the euro area and the euro area needs a robust fiscal framework to address this risk in a structured way. Benign neglect of an increasing balance of risks and lack of credible sanctions has already forced the euro area to balance on the knife edge once, and a repeat performance should be avoided. The proposed fiscal framework will allow EU institutions and Member states to better identify the risks, to more precisely target the necessary adjustment measures and to tailor them to the needs and specificities of individual countries. However, absence of effective action will need to be reprimanded. The SGP relied on pecuniary sanctions, which turned out to be nothing more than a theoretical instrument. Based on that experience, it is obvious that a credible sanctions mechanism cannot be enforced by Member states. The ECB on the other hand, via its sovereign bond purchasing programmes, has at its disposal an extremely powerful tool to elicit fiscal discipline. It is true that the ECB's primary objective is price stability, and not enforcement of the euro area's fiscal rules. Conversely, its determined actions during the recent crises confirm its overarching role in managing systemic risks and safeguarding the stability of the euro.

Thus, by monitoring fiscal risks in a dynamic framework rather than targeting ex post fiscal outcomes and by granting enforcement powers to an institution less prone to forming collusive alliances, the proposed framework corrects the main shortcomings of the SGP and in this way, is more likely to help combat the underlying illness rather than merely treating the symptoms...

Nevertheless, the most effective way to achieve long term sustainability of public finances in the proposed fiscal framework is to implement policies that foster economic growth. Yet, the proposal has not mentioned growth in any way. How can that be?

The purpose of fiscal framework is to deliver stability. One objective. One policy instrument. Just like the Tinbergen Rule says.

Fiscal policy should of course support a growth agenda. But maybe it is also time to debunk some myths about fiscal policy, the SGP and its link to economic growth.

Frankly speaking, the suggestion that the SGP has prevented governments from implementing growth-friendly policies is simply absurd. In most countries, public expenditure and public revenue account for 45-55% of GDP. So how credible is it to claim that a restriction that prevents a government from spending 3% more of GDP than it collects in revenues is the reason why it is not implementing growth-friendly policies? What about the remaining 50% of GDP both on the expenditure and on the revenue side? Is there really no scope for growth-enhancing policies in there?

Euro area finance ministers and Heads of State and Government should talk more about the link between fiscal policy and growth and discuss how they can fine-tune their expenditure and tax policies in order to deliver more robust growth. However, such discussions should take place within the fiscal framework – and not in the context of the fiscal framework. A subtle but very important nuance...

Furthermore, for the sake of this discussion, it would probably be helpful to distinguish more clearly the macroeconomic and microeconomic aspects of fiscal policy. Or rather, to talk more about the quality than about the quantity...

As mentioned above, public expenditure and revenues account for about 50% of GDP in most euro area countries. It is therefore undeniable and rather arithmetic that changes to public expenditures or revenues are prone to have a sizeable impact on macroeconomic aggregates, including GDP. However, impacting GDP at any point in time is rather different from generating an economic impulse that will foster sustainable growth. One is accounting, the other is engineering – with no disrespect meant to accountants, of course...

The point is: merely juggling with large numbers and not paying enough attention to 'details' like timeliness, incentive structures, moral hazard, adverse selection or distributional impacts undermine the growth impact of public finances.

Take for instance the so-called 'Juncker Plan' and the more recent 'Recovery plan for Europe'. Although not directly in the realm of Member states' public finances, these frameworks provide a good illustration for the above-mentioned point. Both programmes have aimed big in terms of headline spending numbers. Both sets had or have identified spending targets that support long term growth. Yet, the 'time to market' is disappointing: protracted political discussions at EU and national levels and complicated disbursement procedures imply long time lags between the impact of the crisis and the actual support measures reaching the real economy. Worse: the pledged amounts may not even be disbursed completely, or they may fall prey of adverse selection – which is not a problem in an 'accounting mindset' but carries an opportunity cost in an 'engineering mindset'.

The accounting issue also pertains to other categories of public spending, e.g., public investment. The political litmus test of the quality of any budget is the share of resources allocated to public investment. Surely that's a good thing as, by definition, an investment yields future returns greater than its initial cost. The problem with 'public investment' is that from an SGP perspective, an investment is an expenditure that according to ESA accounting principles counts towards 'gross fixed capital formation'. So, spending public monies on health, transport, IT or energy infrastructures counts as investment. So far, so good. Building a new school is also an investment yielding long-term benefits. But what about the adjacent swimming pool? Or the refurbishment of the gymnasium? There is probably still an investment part in there, but clearly there are decreasing returns to many types of investment expenditures. However, by bunching all these expenditures together in the same category without assessing whether there is a genuine added impact on future growth is economically questionable.

The revenue-side of budgets is also linked to economic growth. Let's take a brief look, for instance, at the current discussion on governments taxing their way out of the Covid-19 budget deficits. Should so-called 'Covid winners' be taxed? In a static, macroeconomic framework, such a proposal could indeed make sense. However, the 'Covid winners' are a more than a heterogeneous bunch. Some were just lucky, a case of 'in the right place at the right time'. Likewise, many entrepreneurs adapted their business model to a changing environment, innovated, took risks – and succeeded. So, what is the message to them? Solidarity, yes. But what will be the second-round impact on risk-taking and the drive for innovation? Tough call... In any case, there is a lot of empirical evidence to suggest that tax reforms that incentivise positive actions have a greater positive impact on long-term growth than more punitive tax measures. This is not to say that contributive capacity should not play a role in the design of tax policies. However, for efficiency and equity reasons, it may be warranted to identify more precisely the reasons underlying contributive capacities, notably where they stem from economic rents related to some sort of market-failure. In that respect, some but not all 'Covid winners' may have accumulated economic rent, but so have many real estate investors…

There are plenty of genuine fiscal policy issues to be discussed in Brussels and capitals around Europe without venturing into the minefield of SGP reform, late-night drama at the Eurogroup and eleventh-hour European Councils to save the day. Europe and its citizens deserve better. They deserve stability and growth.