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EURO 50 GROUP

A framework for a successor to the Stability and Growth Pact

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The issue of the rules of the European fiscal framework has been put on hold because of Covid.

This subject is far from simple. The rules of the Stability and Growth Pact have become difficult to interpret let alone implement.

Behind this difficulty, it must be understood that the subject is complex, not least because of the heterogeneity of the economic and financial situations of the Member States which has been increased by the Covid crisis[1] .

Why do we need fiscal discipline in a Monetary Union?

Fiscal coordination is needed in a monetary union The reason stems from the fact that the Union European is not a state and that negative externalities - stemming from questionable national policies - should be taken into account and avoided. The European Monetary Union has a single monetary policy but no common fiscal and economic policy. Therefore, the need for fiscal coordination.

Must we abolish the numerical rules of the Stability and Growth Pact? The deficit (3% of GDP) is a hard-to-challenge safeguard in "Normal" periods". On the other hand, the limit of 60% of GDP for public debt seems both outdated and of questionable logic. This ratio varies greatly from one Member State to another and should be "personalised" on a case-by-case basis, depending on available margins and debt sustainability.

[1]According to the EU Commission (May 2021), seven EU Member States would have their public debt exceeding 110% of GDP in 2021: Greece (208,8%), Italy (156,6%), Portugal (127,2% of GDP), Spain (116,9%), France (116,4%), Belgium (115,3%) and Cyprus (112,2%). By contrast, sixteen EU countries will keep their ratio at or below 75% of GDP in 2021. Among them, Germany, the Netherlands, and Finland will see their public debt compared to GDP hovering respectively at 72,1% of GDP, 56,8% and 71% in 2021.

In the spirit of the recent proposal by the French Economic Analysis Council, we believe that a common framework should be maintained at European level.

Some may think that fiscal discipline is no more indispensable because of low interest rates. This is a profound misconception: interest rates will not stay at zero level for ever and the markets are already showing this. And to base a fiscal framework on the assumption of indefinite low interest rates and monetization of public debt is not consistent with the functioning of our monetary union.

The objectives of the fiscal framework

First, it is important to be clear about the aim of fiscal surveillance, framework or governance, because there are many good reasons to have it. There are several objectives that one tries to reach. One is debt sustainability, but also many want to use fiscal policy to promote growth or the green economy. Some want to prevent or correct divergences in the monetary union, and some want to create space for cyclical stabilisation. These are all serious objectives, and it is difficult to disagree with all of them.

At the same time, it is not feasible to reach five objectives with one rule, so the discussion must be broadened, remembering that other instruments exist, like the EU budget notably for the small countries. The EU budget provides permanent transfers from richer to poorer countries and can be used to prevent divergences among countries and to promote convergence. It can also be used to promote greening of the economy. The annual country-specific recommendations could also be used. There are many instruments – not only the Stability and Growth Pact – to reach several objectives linked to budgetary and fiscal policies.

A rule adapted to certain circumstances may not make sense in another context. Over the years, attempts to pre-program all possible contingencies have led to excessive complexity while Member States have not wished to give the Commission effective powers to adapt the rules to specific situations.

Distinguish between legitimate and abnormal fiscal heterogeneity

To work on this complexity, first it is critical to understand what could be called the "legitimate heterogeneity". If Greece is on one side and Germany the other, the structures, histories and capabilities are different. Homogeneity will not be attained because of a 3% rule or a 60% rule. It is thus important to distinguish between legitimate heterogeneity, which is, in many cases, the product of history, and "abnormal" heterogeneity, which is the incremental heterogeneity that has been created by public action or inaction. This has to be analysed carefully. If abnormal heterogeneity is detected, it can be worked on, not necessarily to erase it in a couple of years but to start working gradually on that element.

Better internalize the European framework in domestic systems

The framework seems more important than the precise rules, if 'rules' means a set of numbers. A set of numbers is not going to solve the credibility problem for the framework. What will be helpful is finding ways for countries to better internalise the framework in their domestic systems.

An adapted framework for a common discipline

As Tuomas Saarenheimo, President of the EU's Economic and Financial Committee, pointed out during an exchange of views at a Eurofi Seminar in April 2021, it would not make much sense to go back to a disciplinary system based on sanctions. The purpose should be to introduce into the European mechanisms an intelligent view of the priorities to be implemented on a State-by-State basis. That is the real challenge.

A fiscal-stabilisation facility should be added to this new framework so that, in exceptional circumstances – when, for instance, the Commission declares that a country is in exceptional circumstances and there is a reason to activate the escape clause – additional fiscal space from the European side is made available to the country. These are all elements where it will not be easy to find a consensus in the Eurogroup.

The gist of a common framework

This revised common framework should, if it is to be useful and realistic, define, on a State-by-State basis and in a medium-term perspective, the budgetary guidelines which best reflect the particular national and Community interests.

Each state would have to explain its orientation by focusing on its own priorities. The European authorities (European Commission, ESM) should regularly monitor the implementation of what would reflect the common understanding on these issues.

It should be suggested, for example, that countries with excessive government spending compared with average of the euro area, will need to focus on significantly reducing this particularity (with a well-established and monitored nominal spending standard).
Other countries will have to focus more on reducing their public debt if such reduction appears to be useful in addressing the sustainability problems of the countries concerned (debt target and primary surplus). This is important because the markets are guided more by dynamics than by absolute numbers in determining country spreads. If we accept that monetary policy will not always be there to buy all the new sovereign issues, it will be imperative to reassure the markets by gradual fiscal normalization policy. From this point of view, the updated fiscal rules should include special monitoring of the primary balance by prohibiting primary deficits.

More generally, the quality of public spending must be given more importance than its quantity. We have to recognize that the shift towards more productive investment will require substantial political effort because presently public investment only accounts for some 4% of GDP while current – nonproductive expenditure – represent almost all public expenditure.

In this respect, a country like France, which holds all records of public spending relative to GDP, devotes only a small amount of resources to productive public investment. Absorbing 55% of GDP to finance the “end of the month” is much more serious in itself than if much of it were spent on public investment. The new European mechanism will have to take this into account. In this perspective, putting in place early warning mechanisms to prevent unsustainable public finance trajectories would be also required. Indeed, a country whose share of public expenditure reaches record levels in relation to the European average should be suject to special discipline. It is more serious to reach 55% of public expenditure on GDP (before Covid) when the European average is 8 to 10 percentage points lower, than to have public debt above 60%.

As Commissioner Gentiloni pointed out: “Fiscal policy should ensure a composition of public finances that is both growth-friendly and sustainable. A special treatment for growth-enhancing expenditure would be helpful…. Or to put it another way, our fiscal rules should be adapted to improve the composition of public finances and make sure that any new debt is good debt”.

The idea would be to achieve a mechanism that is sufficiently adapted to the problems – by definition different – of each of the Member States, by establishing common standards under European supervision.

The proposals to entrust an independent European Budget Committee with responsibility for defining the concept of sustainability as well as the debt target and growth assumptions seem excellent.

Transitional aspects

The general escape clause in the current year will also apply in the next. In 2023, when it will probably no longer apply, there will not be many countries with a deficit below 3%. Several will have deficits close to 10% and will need and should have a number of years, for economic reasons, to reduce them. A recent proposal from Jean Pisani-Ferry and his colleagues is to look at plans country by country for how to manage public finances in the future.

For the framework it is preferable to have a new set of rules, but they cannot apply immediately, because the situation in 2022-23 will make that impossible. A transition period could be envisaged, where something like Jean Pisani-Ferry's recommendations is used: country-specific adjustment or consolidation plans proposed by the Commission, discussed in the Eurogroup and agreed in the Council, in order to bridge the time until a new common framework is reached, perhaps after three or four years.

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As long as it is not sufficiently understood, notably in indebted countries (France, Italy, Spain etc), that excessive debt is a source of under competitiveness, the economic situation in these countries will continue to deteriorate. Only domestic structural reforms can resolve structural issues and increase productivity and growth. It is an illusion to try to solve the structural problems of our economies by prolonged increases in public or private debt or by using money creation. Yet this is what has been too often tried by pursuing lax fiscal, monetary and political policies that inevitably pose systemic risks to financial stability and therefore to future growth.

Experience has shown that many States had not complied with the Pact. The following lessons must be learned:

- Rules are needed.
- They must be "personalized" (country by country).
- The methodology used must be indisputable.

Of course, all of the above could be completely unimplemented, as was the case with the old rules of Stability and Growth Pact. The sanctions originally provided for were never implemented. If this drift were to continue, we would end up making the virtuous countries pay for the slippage. This is the definition of a non-cooperative game where most players try to avoid their obligations by shifting the cost to those who observe them.

If this were the case, the logical result would be an inevitable, major, new crisis of the euro zone.

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