Finanzgruppe
Deutscher Sparkassen-
und Giroverband

STANDPUNKTE
DER CHEFVOLKSWIRTE

Fiscal policy in challenging times

The European Commission's amendment proposal for the Stability and Growth Pact (SGP) seems a little like old wine in new bottles. For it fails to address the central problem: the lack of political will to implement the Pact's provisions. It is true that Europe is somewhat better off than other major currency areas with regard to the levels of overall public debt. Unfortunately, however, there has been no discernible trend toward improvement since the creation of the European Monetary Union. In the view of the Chief Economists of the Savings Banks Finance Group, there is a threat of the new attempt at reform fizzling out as well:

- In practice, the SGP has not helped to limit the inexorable rise in government debt. Instead of converging, the state of public finances across the euro zone is tending to diverge more sharply today than in previous years. The European Commission's intention is to make the SGP more fully functional.
- True, some of the Commission's proposals aim in the right direction. For example, metrics such as the output gap or the structural deficit are to be dropped in future. We welcome this.
- However, the Commission proposal does not sufficiently tackle the fundamental implementation problem currently hobbling the SGP. Governance of the SGP should be improved by greater involvement of - and greater independence for - institutions such as the Fiscal Council.
- In addition, political incentives to impose sanctions could be strengthened in a carefully focused manner, for example by converting penalties into non-repayable contributions to the EU budget.

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The SGP backstory

The Stability and Growth Pact was established in order to ensure that all member states of the European Economic and Monetary Union (EEMU) feel committed to delivering sustainable public finances. Macrostability within the context of this monetary union is a public good - all those on board should contribute to this goal, and free-riding has to be prevented.

When the fiscal framework for the European Union was sketched out on the drawing board in the 1990s, the main concern was to guarantee the smooth functioning of the new single currency, the euro. The design was focused on insulating a centralised monetary policy from the possible consequences of unsustainable national fiscal policies. In other words, it was primarily a matter of risk reduction. This is why those guardrails of 3 percent and 60 percent of gross national product were created as upper limits for general government deficits and public debt. These were legally anchored in the Maastricht Treaty. If implemented consistently, the idea was that there would be a gradual convergence over time between what were initially widely divergent public-debt ratios across the various member states. The SGP describes in detail the processes and competences for ensuring fiscal stability.

The purpose of the fiscal framework was to reduce risk

Since the financial crisis and especially the sovereign debt crisis, new instruments have been added, such as the European Stability Mechanism (ESM), but also various instruments devised by the ECB. These new tools were aimed at providing financial assistance to member states in danger of losing access to the capital markets, or which had already lost it, due to some emergency. In order to comply with the much-discussed no-bail-out clause, the use of these instruments was linked to economic-policy conditionality and thus to encroachments on national sovereignty.

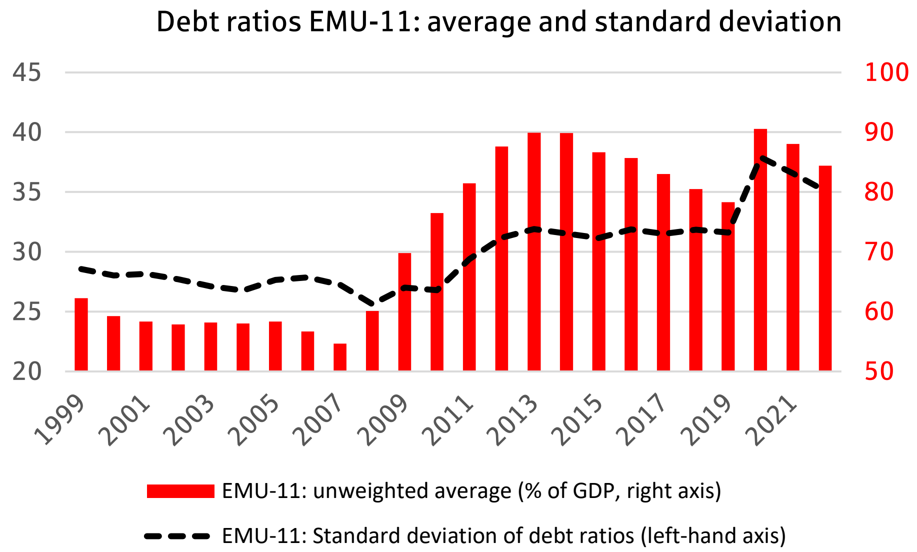
Already by 2021, the European Commission had collected proposals on how the SGP could be further reformed, with the Chief Economists of the Savings Banks Finance Group participating in this consultation process. The proposal now presented by the European Commission threatens not to adequately address the existential problem facing the European Union, namely the divergence between, and insufficient soundness of, the trends in public finances across the various member states. A look at what has happened on the ground since the introduction of the common European currency clearly reveals how urgently a substantial reform is required.

Missed targets: the SGP has not proved effective

Fiscal stability has not been achieved

Hopes that common budget rules would lead to fiscal stability have been disappointed. Up until the financial crisis, there was admittedly some initial convergence between public-debt ratios. Fig. 1 shows that the standard deviation of public-debt ratios was on a marginally downward trend. Member countries with high public-debt ratios benefited from a declining interest burden after acceding to the euro area.

Figure 1:



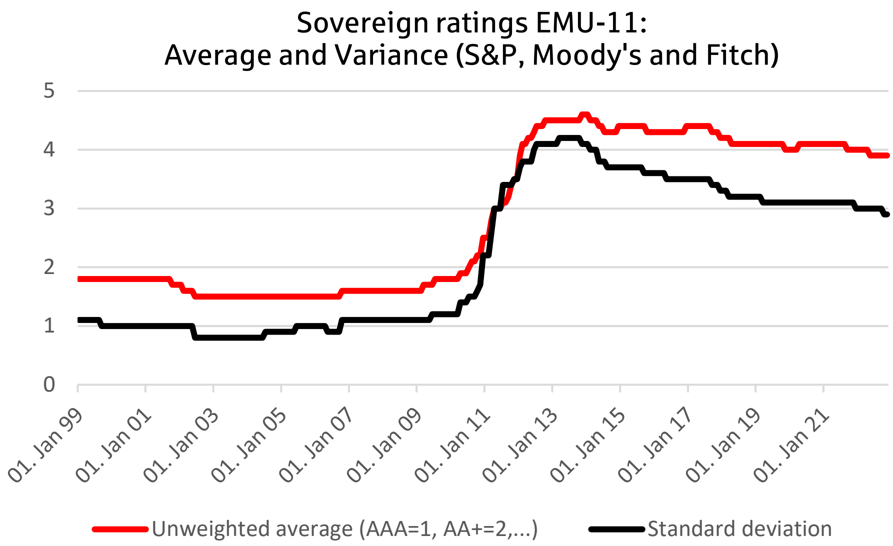
Source: European Commission, DSGV

In some cases, this "accession dividend" was used for debt consolidation. Yet this process came to an abrupt end with the onset of the sovereign debt crisis. As early as in 2011, the degree of divergence between national public-debt ratios was higher than at the time that the single currency was first introduced. This negative trend gathered pace through to the end of the sovereign debt crisis. Thereafter, a sideways trend ensued until the coronavirus crisis led to another massive widening in debt inequality. The inescapable conclusion is that the SGP has not been successful in stemming upward debt momentum. But what is even more serious: instead of convergence, there has actually been further divergence between debt ratios despite the existence of the SGP.

Widening debt inequality

The same trend can be observed in the case of sovereign ratings (Fig. 2). The average rating awarded by the three leading rating agencies is now AA-minus, more than two notches below the average sovereign credit rating during the euro's first decade of life. Divergence has also increased sharply in the case of this performance metric: the euro area´s member states are drifting further and further apart. And this is the case despite the fact that the rating agencies have exercised conspicuous restraint since the outbreak of the pandemic, avoiding further downgrades.

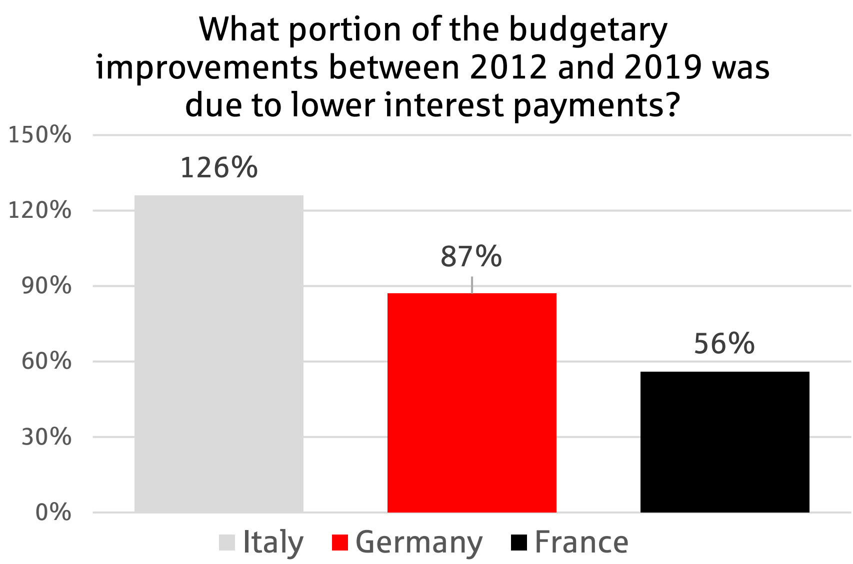
Figure 2:



Source: CountryRisk.io

At most, the period between the end of the euro crisis and the outbreak of the pandemic could (if looked at benevolently) be considered a success. But even this phase of stability between 2013 and 2019 was not, in fact, due to determinedly resolute budgetary measures adopted by the member states. It was rather that the ECB's aggressive low-interest-rate policy permitted budget consolidation almost for free. Taxes and primary spending did not have to be touched at all; government budgets and public-debt levels stabilised nonetheless. In Germany, for example, over 80 percent of the consolidation accomplished between 2012 and 2019 was attributable to lower interest rates (Fig. 3). In Italy, the Figure was even higher than 100 percent: in the boot-shaped peninsular, no discretionary consolidation whatsoever took place.

Figure 3:



Source: European Commission, DSGV

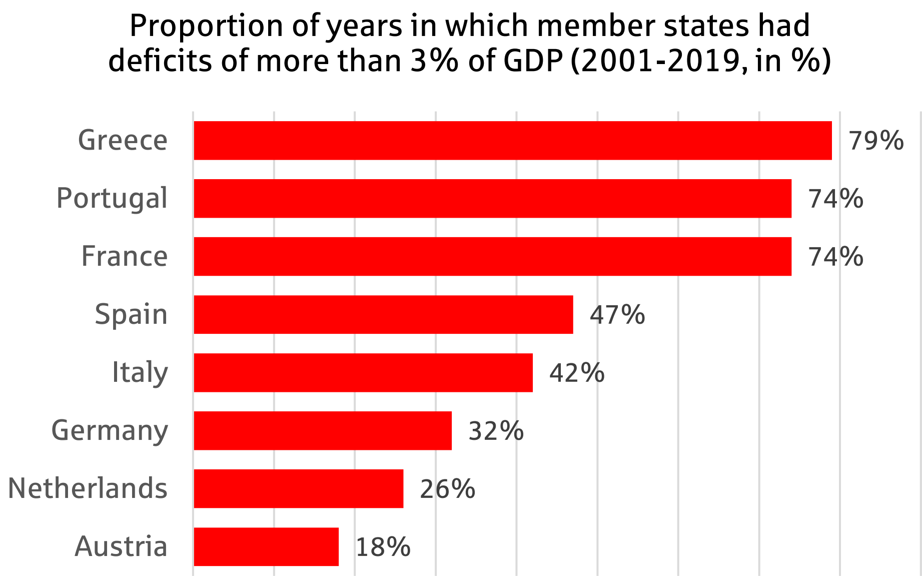
The budgetary improvements were therefore secured primarily in Frankfurt, not in Berlin, Rome or Paris. Yet the helpful tailwind from falling interest rates has now turned and is blowing in the face of public finances. This is going to make consolidation endeavours all the more challenging in the future - and will make a resilient stability architecture in the eurozone all the more urgent.

The SGP's central ambition has been thwarted

In retrospect, it was an illusion that the SGP would succeed in welding all member states together into a Community of Stability. The SGP has instead failed in its central ambition. Incidentally, this failure was already apparent even before Greece and Cyprus plunged traumatically into de facto insolvency. For the SGP was revealed to be a mere toothless tiger early on in its history. November 25th 2003 was the day when the fall from grace occurred. On this date, which has since become known in Brussels as "Black Tuesday," the European Council overrode the European Commission's recommendation to subject Germany and France to the next stage of the excessive deficit procedure. And the Council did so despite the fact that both governments had incontrovertibly and repeatedly run deficits that were too high. As a result, the credibility of the Pact's institutional integrity was quickly torn to shreds.

From that point in time onwards, budgetary discipline went steadily downhill. Admittedly, the European Commission continued to work valiantly on the fiscal plans submitted by the member states. The only problem is that such labours bore no positive consequences: between 2001 and 2019, fovernment budget deficits in France and Portugal were above the 3 percent of GDP ceiling in three quarters of all years, not to mention Greece (see Fig. 4).

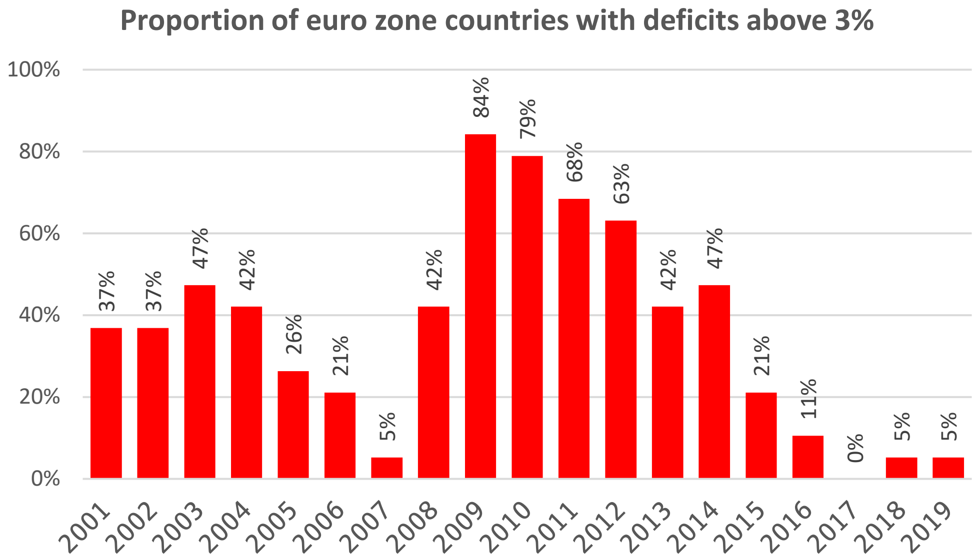
Figure 4:



Source: European Commission, DSGV

Eight EMU members recorded an average annual budget deficit in excess of 3 percent between 2001 and 2019, including the heavyweights France, Italy and Spain. In total, the deficit rule anchored in the Maastricht Treaty was violated no less than 130 times during this period (see Fig. 5). Only at the apex of the credit bubble (2007) and after half a decade of Draghi's interest-rate tonic (2016-2019) was the letter of the Pact respected. On both these occasions, an avalanche of deficits followed hard on the heels of that phase.

Figure 5:



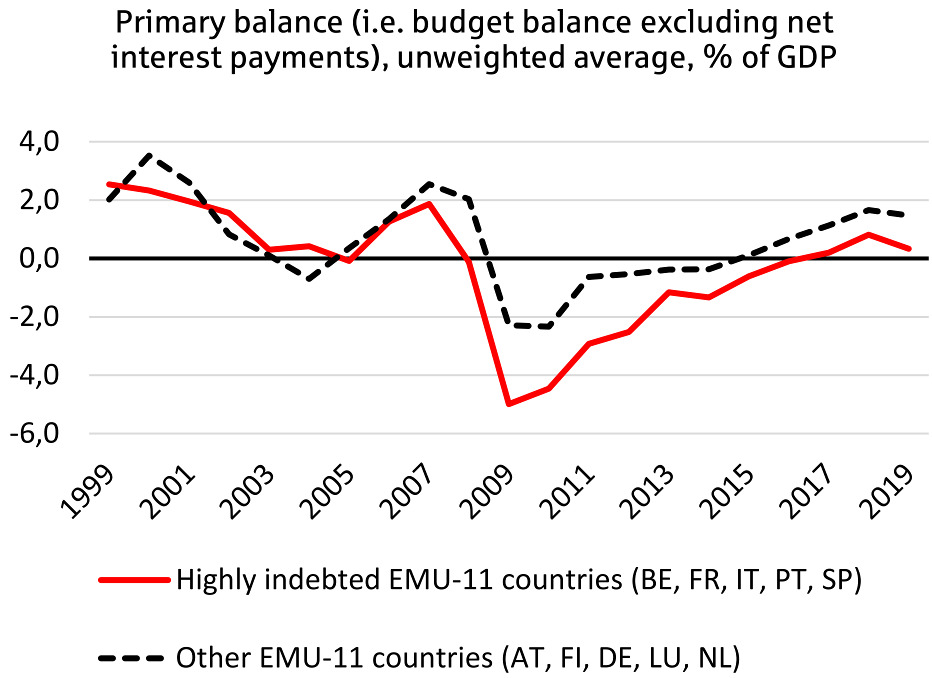
Source: European Commission, DSGV

The goals of the SGP have been missed - even despite the fact that the SGP has been readjusted several times during its lifespan in a bid to render it "smarter." The bitter truth is that the SGP has only become more and more complicated in the process, with its application ever more dependent on political whims.

Free-riding has only been insufficiently curbed

The skeptics' fears have come true: the danger of free-riding has only been insufficiently curbed by the pan-European fiscal rules. Member states burdened with high public debt loads have been unwilling, or unable, to achieve primary surpluses (i.e. a budget surplus excluding net interest payments on outstanding government debt) high enough to enable fiscal convergence. In fact, between 2000 and 2019, the highly indebted members of the EMU actually ran primary deficits on average. Member states with more moderate debt levels, on the other hand, were able to post primary surpluses on average (cf. Fig. 6). Over time, the respective sets of national public finances have drifted further and further apart across the euro area. To make matters worse, the fiscal drag from the pandemic has now further accentuated this growing discrepancy.

Figure 6:



Depiction without Greece

Source: European Commission, DSGV

If this process is not stopped, such growing heterogeneity may entail existential risks for the currency area. The Stability and Growth Pact has been put on hold until the end of 2023; the European Commission is aware that a fresh start will have to be made thereafter. To start over using the old, failed model would be a venture doomed to failure. Accordingly, on November 9th 2022, the Commission presented a draft designed to serve as a basis for discussion and as a blueprint for a reformed Stability and Growth Pact. Rapid political agreement is called for. The reformed Pact is expected to be operational in time for fiscal year 2024. In the following, the Commission's proposed measures will be presented and critically elucidated.

Growing heterogeneity could spawn existential risks for the currency area

The European Commission’s proposal to revitalise the Stability Pact

The European Commission's new proposal is an attempt to square the circle. Not only is the new SGP intended to strengthen incentives for budget consolidation and to achieve a steady reduction in public-debt ratios. It is also intended to strengthen “ownership” on the part of national governments and to promote reforms and investments in energy security, digitisation and the green transformation.

Yet the central benchmarks governing maximum government-deficit and public-debt levels (3 percent and 60 percent of GDP, respectively) have not been altered. That would admittedly be difficult to imagine - after all, both are anchored in the Treaty on European Union (Maastricht Treaty) dating back to 1993. Any amendment on this score would require unanimity and national ratification, in some cases involving referendums. Politically speaking, that cannot be assumed under any plausible scenario.

The new proposal envisions simplifica-tions

One simplification proposed is the elimination of the emphasis on "structural" deficits, i.e. those budget deficits which would persist even if the economy were to grow at its highest sustainable rate, i.e. at the same rate as potential output (the "output gap" is hence adjusted for). This is to have been taken account of under the methodology operated to date: in an economic downturn, the budget deficit automatically increases; however, such fluctuations are beyond the government's control. Therefore, the budget balance has, up to now, been "corrected" so as to edit out this cyclical effect in order to determine the "structural" balance.

Although this approach has theoretical advantages, it has, in practice, proved impossible to arrive at reliable calculations. This is because it is usually only after a time-lag of years that one knows at what point one was in the business cycle at the time a given decision was taken. The output gap is not empirically observable, and it has regularly been the subject of overly optimistic estimates regarding the structural, i.e. cyclically-adjusted, budget position. The authorities now intend to abandon this misguided approach. This is to be welcomed.

The European Commission rightly states too that the 1/20 rule, which has never been applied de facto, is no longer realistic due to the further increase in public-debt ratios in many countries. Pursuant to this rule, public-debt levels of above 60 percent of GDP are obliged to be reduced each year by at least one-twentieth of the proportion above this threshold. For Italy, which is saddled with a public-debt ratio of about 150 percent of GDP, this would mean that the ratio of public debt to GDP would have to decline by more than 4 percent of aggregate economic output each year. That is hard to imagine, especially since the ECB's pivot to rising key rates ("interest-rate turnaround") means that mounting interest expenses are imposing a particularly heavy burden on the balance sheets of highly indebted countries.

The European Commission's proposal focuses on evaluating net primary expenditure. In this context, it is to be welcomed, in principle, that government investment on the green and digital transformation is to be weighted differently than consumption-oriented government spending. In addition, as usual, "net" refers here to the inclusion of interest payments as well as to discretionary revenue-side measures. Unfortunately, there is no further discussion of what is specifically meant by discretionary revenue-side measures. In our view, the European Semester should also keep a closer eye on the government revenue side when it comes to safeguarding fiscal stability. Recent international experiences with drastic changes on the revenue side (e.g. the United Kingdom's recent outsized "Trussonomics" tax cuts) indicate the importance of this.

The focus is on net primary expenditure

To evaluate the effectiveness of reductions in public-debt levels, a medium-term adjustment path is proposed that is judged to be more realistic. Specifically, the following process steps are envisaged:

An adjustment path and process steps are provided for

1. The European Commission is elaborating a fiscal adjustment plan over a period of four years. At the end of this period, the idea is to ensure that the debt path is pointing downwards in a plausible and sustainable manner. In order to determine the degree of plausibility, the Commission will conduct debt-sustainability analyses. The central operational indicator is to be net primary expenditure - a measure capturing aggregate government spending adjusted for interest payments and discretionary revenue-side measures (e.g. tax increases).

2. Member states are then to submit a medium-term fiscal plan, as well as reform priorities and national targets for public-sector investment. Member countries can request an extension of the adjustment period by an additional three years (to what would then be a total of seven years). This is to be conditional on a robust set of reforms and investments that are conducive to boosting debt sustainability in the longer term and that take into account the priorities of the European Union as a whole.

3. The European Commission will then monitor each national adjustment plan and will approve it, provided that the public-debt ratio is declining in a credible manner and that budget deficits are not exceeding 3% of GDP in the medium term. The European Council would then give its assent to the national plans deemed fit by the European Commission.

4. At this point, the European Commission's monitoring phase begins. The national governments are obliged to submit annual progress reports to Brussels.

Accompanying reforms

In order to further promote enforcement, the European Commission also proposes the following accompanying reforms:

- A reduction in penalties for rule violations. This is designed help reduce the inhibition threshold for imposing a penalty.

- Freezing EU transfers in the event of rule violations. This is explicitly intended to provide European partners with a further sanctioning instrument. The objective is to create incentives to implement plans in accordance with the rules.

- Tightening the adjustment path in the event of inadequate reforms and investments in the future. If governments implement merely insufficient structural reforms, the European Commission would then have the power to tighten the fiscal adjustment path. It remains unclear how this can be implemented against the will of the government concerned.

The European Commission's proposal, which was preceded by a public consultation in which the Chief Economists of the Savings Banks Finance Group participated at the end of 2021, is now being discussed by the governments of the member states. Agreement is an urgent priority because the budget processes for 2024, which is when the suspension of the current Stability and Growth Pact is scheduled to end, are going to start in the early summer of the present year, at the latest. If no agreement is reached, the existing SGP would come back into force at the end of the suspension period. Given the damaged credibility of the system utilised so far, this would not be desirable.

Evaluation of the Commission's proposal: the core problem is being bypassed

The reform proposal presented by the European Commission contains several welcome initiatives, moving away from a focus on amorphous macroeconomic variables such as the output gaps or the structural budget balance. In the past, the latter have proved unreliable not only *ex post*. In some cases, a structural deficit of "below 3%" has given governments of member states a deceptive sense of security and contributed to a complacent wait-and-see approach to economic and fiscal policy. The intention to bring EU structural funds into play in the future and to reduce and freeze them in the case of non-compliance with the rules could also generate a positive effect if applied consistently.

The proposed plan does not overcome the problems afflicting the current SGP....

On balance, however, the European Commission's plan is not, in our opinion, suited to the task of overcoming, in the long term, the problems which have hounded the existing Stability Pact. Several points of criticism lead to this conclusion.

The central weakness of the Pact during the first twenty years of its existence was not its operational or parametric design. To be sure, there were imperfections on these fronts as well. The fundamental weakness, however, lay in the SGP's institutional design, that is to say, in the governance domain. Under the current system, governments in the European Council ultimately have to impose sanctions on their partners. Yet they regularly shy away from this, even in the case of repeated and flagrant failures to achieve the agreed goals. Instead, discretionary leeway has invariably been used to avoid imposing penalties.

...since the governance problem remains unresolved

In fact, since the introduction of the euro, the European Commission has launched no fewer than 38 excessive deficit procedures (EDPs). The indicator readings delineated in the first part of this issue of "Statement" only allow one compelling conclusion: that, in a large number of cases, the member states have been unwilling, or unable, to reduce excessive deficits as planned.

Nevertheless, in not a single case has the Council imposed a sanction on a member country. It should not be forgotten either that the sanction provided for by the SGP is, in any case, only very mild, almost symbolic: at most, interest-free deposits of a maximum of 0.5 percent of national GDP may be demanded, which may only, at the earliest, be converted into non-repayable penalties if a country drags its heels on deficit reduction for two further years. Especially in times of low interest rates, a penalty involving "interest-free deposits" was not likely to have much of a deterrent effect.

Actually, it is not legally correct to assert that sanctions have never ever been imposed. In 2016, even with all eyes closed, the European Commission could not avoid proposing sanctions against Spain and Portugal. Their target misses were simply too glaring to turn a blind eye to. However, in order to avoid a politically conflict-laden discussion about encroachments on national sovereignty rights by a non-democratically-elected supranational institution, the size of the fine was set at precisely zero euros. In that same year, then-Commission President Jean-Claude Juncker, when asked why no sanctions had ever been imposed on France, replied laconically: "Because it is France!" Thus, long after "Black Tuesday," the sanction mechanism envisaged in the SGP was once again publicly reduced to absurdity.

Conflicts of interest between politicians and the European Commission remain unaddressed

The present Commission proposal does not address this governance problem in any way. It can therefore be conjectured that even the smartest fiscal rules will remain ineffective if no credible sanction mechanism is adopted. And there are no plans for one in the future either. The conflicts of interest between national politicians and the European Commission in Brussels remain unaddressed.

It would have been better to leave the imposition of sanctions to an independent body of experts - as the Chief Economists of the Savings Bank Finance Group already suggested last year. In the case of monetary policy, after all, a conscious decision was taken to place the operational design in independent hands; this was done with the intention of getting a lasting grip on conflicting policy objectives.

An independent panel of experts is necessary

Similarly, the monitoring of adjustment paths and the imposition of sanctions could have been assigned to an institutionally independent European Fiscal Council - in cooperation and, in particular, in advance coordination with the national independent fiscal councils. The existing European Fiscal Council performs valuable conceptual work, but lacks any relevant enforcement authority. To further reduce the suspicion that conflicts of interest prevail, a body composed of experts without a political background would be preferable.

Ideally, the experts in question should possess proven expertise in economics and fiscal policy. Otherwise, there would be a risk that the members of the Fiscal Council would be perceived as the "Italian member" or the "German member," for example. Implicit in such designations is always the suspicion that national interests take precedence over those of the euro area as a whole. Similar observations can be made with regard to the composition of the membership of the ECB's Governing Council.

If the establishment of another non-democratically-legitimised institution was reckoned to be a too radical step, other measures may also be considered which could strengthen the incentives for imposing sanctions. For example, it would be possible to require non-repayable contributions to the EU budget as sanctions. Such contributions would proportionally reduce the payment obligations of all other member states. That could partially correct misincentives. After all, an EMU national government that did not agree to a sanction against another member state would have to publicly explain to its taxpayers why the latter were bearing additional costs simply because their own government had not summoned up the courage to enforce the rules in force. Such a scenario would not be politically attractive, and could well increase the willingness to equip the Pact with teeth.

It is imperative to strengthen incentives for sanctioning

Another potential weakness of the "new SGP" is the continued reliance on debt-sustainability analyses (DSAs). Any economist who has carried out such calculations herself knows how sensitive the results are to the underlying assumptions used. Projected growth rates are a particularly sensitive factor, as are assumptions about future budgetary outcomes. It has been demonstrated, moreover, that forecasts in this field have regularly turned out to have been too optimistic in the past. Optimism has been particularly pronounced in the case of countries contending with high public-debt ratios. Accordingly, the discrepancy between *ex ante* forecasts and and budgetary outcomes observed *ex post* was particularly high for these countries. Such a systematic distortion is likely to have aided and abetted the growing fiscal divergence within the euro area described above.

Strengthening independence: the key to success

To date, European forecasting practice has tended to work against the purpose of containing - and ultimately engineering convergence between - public-debt levels. Unfounded optimism about medium-term economic developments has led to deficit bias, especially in the case of already highly indebted countries. The European Commission has not presented any proposals to remedy this repeated flaw. Here too, it would make manifest sense to place macroeconomic forecasting in the hands of independent institutions, as is already the case in some national economies.

Disclaimer

This position paper by the DSGV Chief Economists does not necessarily reflect the position of all institutions belonging to the Savings Banks Finance Group.

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