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A simple and flexible alternative to Stability and Growth Pact deficit ceilings. Is it at hand?

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We model a monetary union where fiscal discretion generates excessive debt accumulation in steady state and inefficiently delayed debt adjustment following shocks. By setting a debt target and raising the political cost of deviating from the optimal pace of debt reversal, institutional design induces fiscal policymakers to implement unbiased responses to shocks. This is partly achieved by increasing the transparency of the decision-making process. We therefore call for more focused supervision tasks for the European Commission and for parliamentary discussion whenever a disagreement arises between the Commission and a national government.

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1. Introduction

The Maastricht Treaty and the Stability and Growth Pact (SGP) provide the institutional framework that regulates fiscal policies within the European Monetary Union. Adopted in 1997, the SGP stipulates that countries should aim for public budgets close to balance or in surplus, and set a ceiling to national deficits as a proportion of GDP (3%), making exception only for large adverse shocks. Shortly after its adoption, the SGP architecture was put under severe strain. Between 2001 and 2004 several countries breached the 3% deficit ceiling and in March 2005 the Pact was reformed.

A widely recognized weakness of the original SGP was that it did not take into account structural differences across countries, such as different stocks of outstanding debt or the asymmetric effects of national fiscal policies. Under the new Pact, each member state is required to announce a medium-term budgetary objective (MTO). The MTO is expected to vary according to a country's own initial debt-to-GDP ratio and growth potential. Countries with high debt and low growth potential should aim at budgetary positions that are balanced or in surplus, while countries with low debt and high growth potential are allowed MTOs of up to −1% of GDP (European Commission, 2005). The adjustment path towards the MTO is measured on a cyclically adjusted basis, taking into account major structural reforms and subject to a benchmark adjustment of 0.5% per year on average over the

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cycle. Thus, the new Pact recognizes the importance of structural differences across countries and allows for differentiated budgetary objectives. Nevertheless, it reverts to a "one-size-fits-all" policy when recommending a uniform minimum pace of deficit reversal, irrespective of accumulated debt-to-GDP ratios.

The old SGP has been criticized for imposing unduly restrictive deficit ceilings in bad times. The new regulations maintain a deficit ceiling at 3% of GDP but broaden the circumstances when a breach of the 3% ceiling does not trigger an Excessive Deficit Procedure. In essence "exceptional circumstances" can be invoked in all recessions and when growth is low relative to trend, not just in cases of severe recession.[1] Several contributions indicated that the old Pact could not discipline procyclical fiscal policies in good times (Bean, 1998; CESifo, 2002; Canzoneri and Diba, 2001). Under the new Pact, the Commission is allowed to bring to the attention of the Council not only countries at risk of breaching the 3% ceiling but also countries failing to comply with the preventive rules of the new Pact. However, as in the old Pact, there are no costs for government non-compliance with SGP rules.

EMU fiscal policies have been criticized for being too timid (IMF, 2009) even though in the aftermath of the 2008 financial crisis the new SGP allowed for budget deficits well beyond the 3% deficit ceiling. Unfortunately, the crisis unveiled another weakness of the EMU institutional framework. In fact, it transpired that official figures for Greek deficits had been systematically manipulated before and after the country joined EMU in 2001 (Almunia, 2004). In 2009 the actual budget deficit was 15.4% of GDP, more than double the 2008 government forecasts. This triggered fears that a Greek default could destabilize the Euro area.

In this paper, we review the working of the SGP and advocate further reform. The empirical evidence presented in the paper shows that, despite its apparent flexibility, the new Pact is associated with procyclical policies that reduced debt when business cycle conditions were deteriorating. This could be justified as the hard price to pay after the profligacy of the early EMU years. However, despite new emphasis on debt control, observed rates of change in national debt levels are uncorrelated with debt-to-GDP ratios accumulated in 2004. Nor do we find any evidence for a reduction in the dispersion of national debt ratios after 2005. In addition, the Greek debt build-up highlights a dramatic failure of the surveillance framework (Rehn, 2010). These apparent shortcomings suggest that further amendments should be introduced in the Pact.

Our analysis is based on a simple theoretical model of a monetary union where myopic discretionary fiscal policies generate excessive debt accumulation in steady state and inefficiently delayed debt adjustment following a shock. Borrowing from the literature on monetary policy games (Svensson, 1997), we advocate the adoption of a *flexible debt-targeting approach*. We show that, by setting a long-term debt target and raising the political cost associated to deviations from the optimal pace of debt reversal following a shock, institutional design induces fiscal policymakers to implement unbiased discretionary responses to shocks. Even when left with full discretion to decide the initial policy action, policymakers never choose an "excessive" deficit if it will then be necessary to reverse it at optimal speed.

Our results call for the *de facto* demise of deficit ceilings that cause inefficient stabilization in the face of adverse shocks, but in normal times allow countries to satisfy the ceiling even if policies are relatively undisciplined. The numerical rule requiring a uniform pace of deficits reversal should also be dismissed, as it enforces stronger discipline on those who need it less, i.e. low-debt countries. Can these arrangements be replaced by more efficient ones? It should be made clear we are not proposing to simply adopt a different numerical rule for the pace of debt reversal. In fact, such numerical rules are inevitably bound to introduce excessive rigidity in an uncertain macroeconomic environment. In our view, since fiscal policy decisions lie at the heart of the electoral competition in modern democracies, the power to discipline policymakers ultimately rests in the hands of national voters. Institutional design should therefore raise the political cost of implementing inefficient policies. This can be achieved by increasing the transparency of the decision-making process, making it easier for national voters to understand the long-term consequences of fiscal policies. In practice, we call for a substantial strengthening of the Pact pre-emptive arm, relying on clearer and more focused supervision tasks for the European Commission and for a more active role for national Parliaments whenever a disagreement arises between the Commission and a national government. Had these proposed changes been introduced in the 2005 reform, Greek policies would have been more tightly disciplined at the right time during the fast-growth period that preceded the 2008 crisis. By contrast, we are skeptical of proposals that rely on a stronger corrective arm, such as negating the right to vote within the European Council.[2] In fact, the curse of the SGP is that sanctions have been unable to discipline governments in good times and have often been renegotiated or become irrelevant ex-post.

In a nutshell, the key aspects of our proposal are summarized as follows. The Commission should evaluate fiscal policies, irrespective of the current deficit size, taking into account both the short-term impact on the economy and the long-term consequences for debt accumulation. In case of disagreement with the government, the latter would be required to report to the national Parliament, publicly motivating its decisions. This simple, transparency-enhancing proposal would raise the political cost of disregarding the Commission's advice. The European Commission would act as the "sound fiscal conscience" for national governments, and public debates in national Parliaments would trigger media coverage sufficient to provide adequate information to voters. Just as our modeling approach is akin to the theoretical analysis of flexible inflation-targeting schemes, our proposal is inspired by the behavior of central banks that adopted inflation targets and carefully designed their communication strategies as a device to strengthen their reputation and protect their independence (Mishkin and Posen, 1997; Mishkin, 2001).

The remainder of the paper is organized as follows: Section 2 introduces new empirical evidence on the working of the (old and new) SGP. Section 3 presents the model and illustrates the design of a deficit-reversal rule that overcomes the inefficiencies generated by discretionary fiscal policy. Section 4 explains how the rule could operate in practice and discusses the implications for EMU institutional design. Section 5 concludes.

[1] See Artis and Onorante (2006) for a critical analysis.
[2] See the proposal advanced by the German chancellor, Angela Merkel (FT, 1st of May 2010).

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