How could the Stability and Growth Pact be simplified?

Euro Area Scrutiny

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Abstract

The complexity of the SGP, which may have contributed to its limited effectiveness, reflects largely the conflict between the need to make the original SGP rules more stringent and the desire to allow flexibility with respect to various country circumstances. Now that the effects of the largest economic shock since the 1930s are fading away, a major simplification of the system could be achieved by removing some margins of flexibility, while possibly relaxing some of the SGP long-term parameters. The coexistence of the MTO rule and the expenditure benchmark could also be reconsidered. A more radical solution would involve shifting to a single rule in which an “operational target” responds to deviations of public debt from its long-term objective.
How could the SGP be simplified?

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EXECUTIVE SUMMARY

The EU surveillance framework of budgetary policies in the Member States is arguably the most complex system of fiscal rules in the world, and this is partly the outcome of the unique design of the Economic and Monetary Union. As a result, its transparency and perceived legitimacy have been questioned. Furthermore, complexity fosters non-compliance; therefore, the simplification of the Stability and Growth Pact (SGP) appears of great importance.

The original SGP was simple in its formulation, but lacked enforceability and precision. The 3 percent deficit rule was meant to represent a ceiling. However, Member States did not take advantage of good economic times to lower the deficit well below 3 percent, leaving some of them without fiscal buffers when a crisis hit. Moreover, the required pace of debt reduction, in case public debt exceeded 60 percent of GDP, was not specified and the debt rule was simply disregarded.

Various reforms, adding new rules and exception clauses, were implemented over time, through different legislative instruments, making the framework more and more complex:

- In 2005, legislators introduced the concept of Medium Term Objective (MTO) in structural terms (independent of the cycle); but the focus on structural balance required agreement on the methodology applied to estimate potential output, which left room to - still ongoing - debates among Member States;
- In 2011, the Pact was made more stringent through the “Six Pack” legislation, which added, inter alia, a debt reduction rule and an expenditure benchmark; and
- In 2015, the Commission introduced further changes, in order to make adjustment requirements flexible and dependent on the state of the economy with respect to its position in the business cycle, again relying on the measurement of potential output and the output gap.

The complexity of the framework is mainly the result of two apparently conflicting considerations. On the one hand, the pact was modified in order to make it more stringent and precise; on the other hand, the pact was made more flexible, in order to avoid costly or unrealistic adjustments.

Against this background, this paper discusses three types of possible reforms. The type and depth of reforms would depend on the ambition of reformers and on the willingness/opportunity to modify the corresponding legal base.

The first type of proposed reforms, “housekeeping simplification”, would not require extensive changes; an example is the Council (ECOFIN) decision, implemented in 2016, to include the expenditure benchmark also in the corrective arm of the SGP. While easy to adopt and useful, these types of reforms would hardly be perceived as simplification.

The second type of proposed reforms, “simplifying the legal framework”, would require reducing the flexibility clauses, by avoiding the anticipation of any possible contingency, which increases complexity at the expenses of transparency. In the preventive arm of the pact, for example, it could be possible to remove the dependency of the speed of adjustment on the state of the economy, in line with the existing requirement that countries at their MTO are not allowed to use discretionary fiscal measures, but have to rely just on the possibility to activate automatic stabilizers. Another possibility could be requiring that the debt rule only operate on a backward-looking criterion: that would make compliance more stringent and reduce the methodological uncertainties of a forward-looking indicator. Flexibility could be achieved by one single escape rule to the MTO trajectory, entailing a suspension of fiscal adjustments during a decline in GDP. The speed of debt reduction could be slowed, but fixed on a steady path. Another possible reform that would not alter the SGP structure refers to the coexistence of the MTO and the expenditure benchmark: these rules are conceptually equivalent, and therefore
dropping one of the two would help remove one layer of complexity (the choice between the two would be for politicians).

The last class of possible reforms would entail “extensive simplification”, but would alter significantly the SGP architecture and therefore would also be difficult and long to adopt. The most commonly proposed reform, also suggested by the IMF, would imply moving from a “four indicators system” toward a “single formula” that constrains a flow variable (possibly expenditure adjusted for discretionary revenue changes), so as to achieve a long-term debt objective. Including a measure of the output gap in such a formulation would allow fiscal policy to react to economic cycles, thus allowing the structural balance to vary, depending on the phase of the cycle, and granting room of manoeuvre for discretionary fiscal policies.
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1. INTRODUCTION

There is broad consensus that the Stability and Growth Pact (SGP) should be simplified. The need for a less complex and more transparent set of rules has been recognized by the European Commission (EC) (see European Commission, 2016), by international institutions, including the International Monetary Fund (Andrele et al, 2015) and by various commentators (see, for example, the Bruegel paper by Claeys, Darvas and Leandro, 2016).

Any proposal on how the European fiscal rules should be simplified needs to start from a clear understanding of the problem that we are trying to solve. Complexity is, in general, not without costs, but it may be necessary and its side effects may be minor. So, what exactly is the problem that we are trying to solve by reducing the complexity of the SGP rules? How significant are these problems and could they really be solved by simplifying the rules? This issue is discussed in section 2.

Before making proposals on how SGP rules should be simplified, it is also important to understand the sources of complexity, and to discuss the tradeoffs arising from any possible simplification of those rules. This issue is discussed in section 3, which looks at how a rule system that was initially fairly simple (with just the 3 percent deficit rule, coupled with a fairly generic commitment to reduce the public debt-to-GDP ratio at a “sufficient speed” if it were above 60 percent) became progressively what is now arguably the most complicated fiscal rule system in the world.

Having clarified all this, section 4 makes proposals for the simplification of the design of the SGP rules, discussing separately:

(i) those changes that are relatively minor (section 4.1);
(ii) those that are more comprehensive, but would preserve the current rule architecture centered on the existence of separate different rules for flow (deficit) and stock (debt) variables (section 4.2); and
(iii) those that, instead, would imply more radical changes, including the reliance on a single rule in which an operational target (a budgetary item such as the deficit or expenditure) would be adjusted annually to achieve a long-term objective or anchor (the public debt). Such a rule could possibly also include an explicit allowance for implementing counter-cyclical policies that go beyond the operation of the automatic stabilizers (section 4.3).

Section 5 summarizes the main conclusions of the analysis.

Before proceeding, two caveats are, in order:

- First, in making proposals for the SGP simplification, this paper assumes that the legislation regarding the SGP rules (including, in principle, Treaty changes) could be modified as needed. Indeed, without legislative changes (at least at the level of secondary legislation), only relatively small adjustments, of the kind proposed in European Commission (2016) and discussed in section 4.1, would be possible.

- The second caveat relates to the coverage of the proposals: the proposed changes focus only on the design of the rules (how many rules, which fiscal aggregates should be covered, what the rules should be conditioned by, etcetera). Proposals could also be made to simplify the surveillance system (the process leading to assessing non-compliance, the legal consequences of noncompliance, etcetera) but, while these are relevant issues, their nature is more legal than economical and, for the sake of focus, they are not considered in this paper.
2. WHAT IS THE PROBLEM THAT WE ARE TRYING TO SOLVE?

No other fiscal rule system remotely compares with the complexity of SGP fiscal rules. This is true for both the rules applying to the relationship between central and sub-national governments in federal nations and to the rules applying at the central level. The problem is not just the number of rules, but also the specific design of each rules, including the conditions under which the rule would be waived or, at least, modified. As to the number of rules, Eyraud and Gomez (2014) find that in fiscal federations sub-national governments are constrained on average by two fiscal rules, against four main ones in the SGP. As to the (growing) complexity of the SGP rules, it is enough to note that the latest edition of the manual published by the European Commission to illustrate those rules (the Vade Mecum of the Stability and Growth Pact, European Commission, 2017) is 221 pages long. Last, but not least, the rules are not the result of a single decision reported in a unique legislative text, but the outcome of separate and incremental decisions taken over time and included in several legislative and regulatory documents.

An excessive complication in the design of fiscal rules can be harmful to their effectiveness in various ways:

- Complexity reduces transparency and the perception of legitimacy of the system. Clear and simple rules that are easy to understand reduce the possible perception of arbitrariness in the constraints that are set on national fiscal policies.

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1 For information on fiscal rules in the world see Lledó et al. (2017) as well as the IMF fiscal rule data set in: http://www.imf.org/external/datamapper/fiscalrules/map/map.htm.

2 As Andrle et al. (2015) note, the complexity of the SGP system is such that even establishing the number of rules is a matter of judgment. These authors consider that there are four main rules: the 3 percent deficit rule, the 60 per cent debt rule, the expenditure benchmark, and the MTO (medium-term objective) defined in structural terms. One could challenge the comparison between the number of SGP rules and the average number of rules applying in the relationship between the centre and subnational governments, as, legally and economically, EU member states are not subnational governments. However, the comparison looks unfavourable to the SGP even if one looks at the average number of rules existing at the central government level (on average less than 2½ rules in the sample considered in IMF, 2009).

3 The term Vade Mecum (the Latin expression for “come with me”) is definitely a misnomer for a document that can hardly be carried in the pocket of your jacket.

4 The preventive arm of the SGP (see European Commission, 2017, pp. 18-22) is based on Article 121 of the Treaty on the Functioning of the European Union (TFEU) and its operation is set in Regulation (EC) 1466/97 as amended by Council Regulation (EC) 1055/2005 and in Regulation (EU) 1175/2011 of the European Parliament. The preventive arm is further specified in the Code of Conduct on the SGP (Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence programmes). In addition, in December 2016 the Council endorsed an agreement reached by the Economic and Financial Committee relating to the predictability and transparency of the SGP. However, the graduated enforcement mechanism is included in Regulation (EU) 1173/2011. Directive 2011/85/EU of November 2011 defines the requirements for budgetary frameworks of member states. In addition, the so-called “Two Pack”, is constituted of Regulation (EU) 472/2013 and Regulation (EU) 473/2013. To all this, one should add the technical rules regulating the calculation of the structural balance, whose complexity relates both to the procedures for cyclical adjustment and to the definition of one-off budget items. For the legislation related to the corrective arm, see European Commission (2017), pp. 59-65.
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- Complexity fosters non-compliance with the spirit of the SGP. As noted by Eyraud, Gaspar and Poghosyan (2017), simplifying the SGP rules would “reduce the loopholes and limit scope for interpretation”. This scope for interpretation, the current complexity of the rules, and the various avenues for flexibility increased over time, leave external observers, and perhaps even main stakeholders, with the impression that the fiscal adjustment that is required in member states is subject to annual negotiations, the opposite of what the existence of fiscal rules would imply. One could say that, to some extent, from the very beginning (starting with the breach of the 3 percent ceiling by France and Germany in the early 2000s) rules have been amended to fit behaviors. While this may have initially reflected the imperfection of the initial rules, the continuation of the process over time, which led to increased complexity, may have fostered the belief that rules could be adjusted at will or that, at least, there is always the possibility of a favorable interpretation that would allow member states, or at least some member states, not to comply with the spirit of the SGP.

- Complexity may result in an inconsistency between the rules. One example, noted in the 2017 report of the EFB (European Fiscal Board, 2017, pp. 19-20) is the fact that, in a low growth environment, meeting the Medium-Term Objective (MTO) under the preventive arm of the SGP (whose level should take into account the need to lower public debt at an adequate speed for countries exceeding the 60 percent ceiling) does not ensure the respect of the debt criterion under the corrective arm for some countries. This implies that being in line with the preventive arm would not ensure that an excessive deficit procedure could not be initiated. As a partial remedy to this inconsistency, it was stipulated that compliance with the debt criterion should take into account the so-called “other relevant factors”. However, these “relevant factors” had in turn to be clarified, thus adding further complexity and room for judgment.⁵

The success of the SGP in fostering the implementation of sound fiscal policymaking is at best mixed, according to various commentators. Eyraud, Gaspar and Poghosyan (2017) provide the latest assessment of some of the shortcomings of euro area fiscal policy making, including:

- A large share of non-compliance. This applies to all fiscal rules. For example, “the MTO was violated in 80 percent of observations under consideration, with almost two-thirds of countries exceeding the MTOs in every single year.”⁶ They also note that “governance reforms implemented over 2005-13, such as increased flexibility, greater automaticity in enforcement, and greater ownership supported by revisions in national legislation, have not had an evident impact on compliance ….”

- A persistent pro-cyclicality of fiscal policy: this means that, in practice, the automatic stabilizers were prevented from operating freely.

⁵ At present, the “other relevant factors” include the implementation of structural reforms, the presence of unfavourable macroeconomic conditions and the adherence to the MTO or to the adjustment path towards it. In addition, member states can put forward any other relevant factor.

⁶ I report in the text the original quote from the Eyraud, Gaspar and Poghosyan paper. One could note that, strictly speaking, not all these cases have ruled as “non-complying with the rules” by the Commission and the Council. Nevertheless, only few member states met their MTO according to the predefined timetable. In most cases, flexibility has been granted, and the timetable - or the MTO - have been revised. The wording in the citation “exceeding the MTO” is also not fully precise, as in many cases the MTO was zero or a positive figure: the expression should be intended as meaning a fiscal balance weaker than targeted.
This pro-cyclicality was, however, asymmetrical, being stronger in good times: this means that, while countries maintained relatively expansionary fiscal policies when output was below potential, they did not rebuild their fiscal buffers when output exceeded potential.

Weak composition of fiscal adjustments, with excessive reliance on increases in revenue and cuts in investment spending.

If, assessing the effectiveness of the SGP, we focus in particular on the latest years, success in fostering fiscal adjustment is definitely limited, in spite of the improvement in macroeconomic conditions. The average structural fiscal deficit in the euro area declined from 4.3 percent of GDP in 2010 to 1 percent of GDP in 2014, that is during a period of relatively low growth (the average real GDP growth rate was 0.4 percent per year during that period). It then remained broadly stable during 2015-17 (when growth averaged 2 percent), in spite of several countries still being away from their MTOs. Cases in point, among the largest members, are Italy, Portugal and Austria, where the structural balance actually widened, respectively, by 0.8, 0.5, and 0.3 percentage point of GDP during the period, as well as France, where the improvement was only 0.2 percent per year.\(^7\) In the same period, the progress in reducing public debt was limited, particularly in high debt countries: the public debt-to-GDP ratio in the eight countries whose debt exceeded 80 percent of GDP in 2014 (excluding Ireland) declined in the following three years by a (simple) average of 0.5 percent of GDP per year, a trivial decline, well below the 1/20\(^{th}\) of the excess of the debt ratio over the 60 percent ceiling required by the SGP debt rule.

Altogether, albeit in the context of difficult economic circumstances (the global financial crisis and the euro area crisis), the SGP has not fostered convergence in public debt ratios: for example, the gap between the public debt-to-GDP ratio in Italy and Germany increased from 35 percent of GDP in 2010 to 67 percent of GDP in 2017, the highest level in at least 20 years.

It is unrealistic to believe that these shortcomings in the effectiveness of the SGP are due just to the complexity of the SGP rules. Indeed, one could argue that quite the opposite is true, as discussed in the next section: the complexity was in part the result of the attempt to make the old rules less binding, or even to water down the new rules introduced with the specific purpose of strengthening the SGP framework. Even if it were so, the simplification of the SGP rules could provide the chance for defining a better and simple balance between the need to foster fiscal discipline and the need to avoid unnecessarily costly or anyway unrealistic fiscal paths.\(^8\)

On this account, before making proposals on how the SGP rules could be simplified, it is useful to look at how the SGP system became increasingly complicated. What motivated member states to add new and more complex rules?

Before proceeding, however, one can note that a new layer of complexity would be added if the Council directive “laying down provisions for strengthening fiscal responsibility and the medium-term budgetary orientation in the Member States”, proposed by the European Commission on 6 December 2017, were approved. The proposed directive requires the inclusion in national legislation of the MTO rule and of some form of expenditure rule similar (but not necessarily identical) to the expenditure benchmark existing of the SGP. This directive would not replace any of the existing SGP constraints, but would simply add to the constraints that arise from the SGP framework. It may be difficult to ensure

\(^7\) These data are drawn from European Fiscal Board (2017), Table A.5

\(^8\) The statement that the limited compliance with SGP rules reflects the unwillingness of member states (as a whole) to enforce them is also confirmed by the fact that, in spite of persistent lack of compliance, no penalty has ever been imposed.
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that the national rules introduced because of the proposal would be identical to those existing under the SGP. If it were so, this would create an additional source of confusion (for example for a member state that is in line with the national rules introduced following the directive, while violating some aspects of the SGP rules).
3. THE SOURCES OF COMPLEXITY

The original “Maastricht Treaty” rule framework was quite simple, involving only two rules, of which just one was really binding. The binding rule was the 3 percent deficit ceiling, while the other rule was the requirement to lower the public debt-to-GDP ratio at “a sufficient speed”, as long as it exceeds 60 percent of GDP. 

The 3 per cent rule set a ceiling on the overall deficit; nevertheless, it was not a target. This implied that member states that wished to allow the automatic stabilizers to operate fully (and, even more so, member states that wished to implement discretionary fiscal expansions to support economic activity), should have maintained the deficit below the 3 percent ceiling in “normal times” (i.e. when the output gap is zero) and, especially, in good times (when the output gap is positive). This would have avoided breaching the 3 percent ceiling in bad economic times (when the output gap is negative). However, none of this was explicitly stated in the Maastricht Treaty: member states were trusted to do the right thing, until the moment when they would breach the 3 percent ceiling.

As to the public debt reduction rule, it was not effectively applied because there was no clear definition of what “sufficiently diminishing” meant in the requirement to lower public debt for countries exceeding the 60 percent threshold, until the “six pack” regulation was introduced in 2011; therefore, the rule was almost ignored.

The changes introduced in the following years made the SGP fiscal rule framework much more complicated. By and large, they reflected two conflicting needs.

The first need was to make the rules more stringent in at least three respects:

• First, the debt reduction rule was made more binding. This was done by clarifying that the debt ratio had to decline at an average speed of 1/20 of the excess of the debt ratio over the 60 percent of GDP. Such a formulation of the required speed of decline implies convergence of the debt ratio to 60 percent only asymptotic, as the reduction (defined in terms of the remaining gap), becomes smaller and smaller in absolute terms over time. Why such an unusual formulation was adopted is unclear.

• Second, a new rule was introduced, referring to the attainment and maintenance of the country-specific MTO defined in structural terms, i.e. correcting the headline deficit for cyclical factors and for one-off revenue and expenditure items. This rule would ensure that in good times member states would keep a low deficit level, in the absence of macroeconomic shocks: this would allow them to let the automatic stabilizers operate without hitting the 3 percent ceiling, in bad times. This objective required introducing penalties in the preventive arm of the SGP. It also required an agreement on the methodology applied to calculate cyclical adjustments, as well as on the definition of the one-off revenues and spending items used to compute the structural balance. Note that this step, perhaps unintentionally, also implied that countries would lose the possibility of running discretionary policies even if their deficit was below 3 percent (and debt was below 60 per cent). Countries at the MTO were just supposed to let the automatic stabilizers operate, but not to go beyond that. Discretionary expansion could only be run if the structural balance were stronger than the MTO.

9 In accordance to art. 126.2 of the TFEU, a Member State is regarded as non-compliant if the general government debt “exceeds 60 percent of GDP and is not sufficiently diminishing and approaching 60 percent at a satisfactory pace”. 

12 PE 614.503
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- Third, the governance process was revised, trying to limit the degree of discretion that political representatives (the Council) would have in rejecting proposals from the SGP technocracy (the Commission), including through reverse majority rules (which require a qualified majority to reject the Commission recommendation).

The second need, to some extent conflicting with the first, was to make the rule system more flexible in a number of ways. This need emerged in part, albeit not entirely, as a reaction to the introduction of more binding rules.  

There are several examples of this conflicting trend (the following list is by no means exhaustive):

- The required speed of fiscal adjustment was expressed in structural terms (in both the preventive and the corrective arms), thus becoming less demanding in terms of headline adjustment for countries growing less than the potential growth rates (and, symmetrically, more demanding for countries growing faster than potential growth). This focus on structural balances, required an agreement on the methodology applied to estimate potential growth rates, which has been in itself a source of additional complexity. The methodology has also been a source of controversy among members and external commentators, as the current method has yielded (for many countries) very low potential growth rates, as a result of the deep and prolonged post-2007 recession. This implied the need for large headline adjustment, in some cases even larger than those that would have been required if the speed of adjustment had been defined in headline terms. This said, the fact that the structural balances are computed by trying to remove only the effect of the GDP cycle on the primary balance, but not the effect of cyclical movements on the interest payment balance, has made it easier to meet the required fiscal adjustment when interest rates are low (and during recessions interest rates tend to be lower, as the ECB reacts counter-cyclically to weak economic conditions that affect inflation developments).

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10 “Not entirely” because the provisions introduced in 2005 to take better into account economic circumstances and country-specific characteristics when implementing the SGP were not the reaction to new rules. They originated from the breach by some countries (notably France and Germany) of the 3 percent ceiling, essentially due to cyclical developments (in particular the slowdown in economic activity following the so-called “dotcom” speculative bubble).

11 See, for example, Cottarelli (2015). The main problem arises because the techniques to compute potential output growth yield estimates of potential output that are still significantly correlated with headline GDP data. This is particularly true in case of prolonged and deep recessions, like the one that affected euro area countries after 2007. As a result, the potential growth rate of some countries that had suffered more from the recession (like Italy and Portugal) were estimated to have remained close to zero for some time, requiring a relatively fast reduction in headline deficit as soon as GDP growth turned positive (as any positive growth rates was seen as signalling a strong economic acceleration when compared with zero or even negative growth rates for the estimated potential output). The issue was so serious in terms of its implication for the implementation of the SGP rules that it led the finance ministers of several member states to write a letter to Commissioner Moscovici to underscore the need to revise the methodology for the calculation of potential output and cyclical adjustment of fiscal balances. Cyclical considerations also have to be taken into account to assess compliance with the debt decline criterion: a special methodology has been developed to correct the debt-to-GDP ratio for the effect of the cycle, based on the cumulative sum of cyclically-adjusted deficits and the cumulative growth rate of potential GDP. This methodology is therefore also subject to the same criticisms levied for the calculation of structural balances.
• With the communication on flexibility of January 2015 (European Commission, 2015), the appropriate adjustment speed in the preventive arm was made dependent not only on the public debt level, but also on the state of the economy, and, more specifically, on the size of the output gap. As a result of the clarification, the fiscal adjustment required in countries with larger output gap would become smaller. It is important to note, also in terms of possible future simplifications of the SGP rules, that this decision introduced an entirely new element in the SGP design. With the introduction of rules defined in terms of structural balances, the automatic stabilizers had been allowed to operate fully and the adjustment in headline balances had become dependent on cyclical developments. With the clarification on flexibility, even the change in structural balances became dependent on the state of the economy. Therefore, fiscal policy could now have a “discretionary” component (in the sense of going beyond the working of the automatic stabilizers), albeit discretion was constrained by linking the allowed change in the structural balance to the state of the economy (with some additional complexity). Note that making the speed of structural adjustment for countries not yet at their MTO dependent on the state of the economy is somewhat inconsistent with the approach followed for countries that are already at their MTO: a country that is at the MTO, and is supposed to remain there, is just allowed to let the automatic stabilizers operate in response to a recession, without any change in its structural balance. On the contrary, a country that is converging towards the MTO can respond to a recession by slowing down the pace of structural fiscal adjustment.

• In addition to the cyclical position of the economy, the assessment of compliance with SGP rules takes also into consideration other country-specific circumstances. These include: (i) aging, which is considered in setting the MTOs under the preventive arm; (ii) whether the country is implementing structural reforms (structural reform clause under the preventive arm); (iii) whether the country is increasing its spending for public investment (investment clause also under the preventive arm); and (iv) whether a country is, more generally, facing “unusual circumstances” (which are also relevant in affecting the speed of adjustment towards the MTO in the preventive arm).

• Compliance with the public debt rule is assessed based on both a backward-looking and a forward-looking way, with lack of compliance requiring breaching the rule in both ways, and only if the breach cannot be attributed to the influence of the cycle. Conversations with officials involved in the discussions leading to the introduction of the debt rule suggest that the inclusion of the forward-looking component reflected specifically the desire to reduce the stringency of the debt rule, which was being made operational by the specification of the 1/20th reduction speed. This focus on both backward-looking and forward-looking behavior in the debt ratio made the room less stringent (especially because the forward-looking component is based on plans that could be later revised). Thus, one should not be too surprised if, indeed, as discussed in section 2, the speed of decline in the debt ratio since the introduction of the rule has been very modest, in spite of the improvement of economic conditions, albeit in the context of still low inflation. Note finally that the introduction of rules specified in forward-looking terms require also assessing whether the macroeconomic assumptions underlying the authorities' forecasts are realistic (European Commission, 2017, p. 33)
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- Flexibility was also introduced by deciding that the debt rule would be assessed also taking into account inflationary developments. This is understandable. However, no allowance was made for the fact that what matters for debt dynamics is not inflation, and the growth rate of nominal GDP, but the differential between the interest rate on sovereign bonds and the GDP growth rate. Taking into account only the cyclical factors that affect the low nominal GDP growth (including low inflation), but not those that affect the level of interest rates, makes the debt criterion easier to meet.

- Additional flexibility is provided by making allowance for the magnitude of deviations from the rules. For example, in the preventive arm, certain provisions relate to whether the size of the fiscal slippages are large enough to justify the initiation of an excessive deficit procedure; (European Commission, 2017, p. 53) and on whether the country, while violating a rule, is on the right path.

- In assessing compliance with the rules, consideration should be given to certain economic shocks that do not depend on the authorities' actions. For example, in assessing the speed of structural adjustment under the MTO rule, consideration must be given to “unusual events outside the control of the Member state …or in periods of severe economic downturn” (European Commission, 2017, p. 36).

- In any case, the assessment of most rules involves the use of some judgment and no automaticity (e.g. in assessing whether a deviation is significant in the preventive arm; European Commission, 2017, p. 55).

The introduction of the expenditure benchmark deserves a special discussion. The expenditure benchmark requires that public spending be maintained in line with the potential growth rate of the economy, adjusted for changes in taxation and one off items, and has increased over time its importance both in the preventive arm and in the corrective arm. For example, in the preventive arm annual expenditure growth (adjusted for changes in taxation) should not exceed the potential growth rate minus a margin needed to ensure that the structural balance converges at a sufficient speed towards the MTO (European Commission, 2017, pp. 47-48). In the corrective arm, the expenditure benchmark is also set at a level that ensures the timely correction of the excessive deficit, as long as macroeconomic developments are in line with the excessive deficit procedure scenario (European Commission, 2017, p. 83).

It should be understood that, from a conceptual point of view, the expenditure benchmark is entirely equivalent—indeed mathematically equivalent—to any rule specified in terms of change in the structural balance. More specifically:

i. if spending is in line with the potential growth rate and there are no changes in taxation, the structural balance (as a ratio of potential GDP) will be unchanged;

ii. any desired change in the structural balance (also as a ratio to potential GDP) can be expressed in terms of keeping the growth rate of spending (adjusted for taxation) below the level for which the structural balance would be unchanged.

Let’s focus, for simplicity on (i) and, also for simplicity, let’s assume that the elasticity of revenues to GDP and of spending to GDP are, respectively, 1 and 0 (a fairly common assumption and one that is a reasonable approximation of actual elasticities in most countries). Under these conditions, the
relationship between structural balance (in this case, the cyclically-adjusted balance, as we are not considering any one-off items) and the headline balance (see, for example, Escolano, 2010, p. 16) is simply given by:

\[ b^P = b - e \alpha \]

where \( b^P \) is the cyclically adjusted balance as a ratio to potential GDP, \( b \) is the headline balance as a ratio to GDP, \( e \) is the public expenditure (E) to GDP ratio and \( \alpha = \frac{Y - Y^P}{Y^P} \) is the output gap (with \( Y \) being GDP and \( Y^P \) being potential output). Then, by replacing the output gap definition into (1), recalling that \( B = tY - E \) (with \( t \) being the tax rate, which is assumed to be constant for simplicity) and assuming that the growth rate of spending is equal to the growth rate of potential GDP, it is easy to show that \( b^P = 0 \). So, keeping the growth rate of spending in line with potential GDP, and keeping tax rates unchanged (which means that the expenditure benchmark is met), implies an unchanged structural balance (see point ii above), or that, in other words, the MTO rule is met for a country that is already at its MTO.

Given this relationship between changes in the structural balance and dynamics of public expenditure, the two rules (stability of the structural balance at the MTO and keeping expenditure in line with potential growth) differ only because of: (i) the specific definitions used in setting the features of the expenditure benchmark; and (ii) the different way in which potential output growth is computed under the two rules. More specifically, the main differences are the following:

- in the MTO, the structural balance includes all spending, including for interest payments, and the methodology to compute potential output is based on a (very complex) production function approach in which potential output depends on the actual capital stock, employment (when the latter is equal to the non-accelerating inflation rate of unemployment) and a measure of technical progress.

- The expenditure benchmark excludes interest payments, and nationally-financed investment spending is averaged over a four year period; moreover, the potential output growth rate is computed in a simpler way (a ten year average of actual growth, half backward looking and half forward looking).

These differences are not at all trivial. On the one hand, the inclusion of interest payments from the MTO rule makes this rule easier to meet at times of recessions: as already noted, the weakening effect of the cycle on the headline balance is corrected through an (albeit imperfect) process of cyclical adjustment, while the strengthening effect of lower interest payments, related to the decline in interest rates that typically characterize a recession, is not netted out. On the other hand, the partially forward-looking and simpler way in which potential growth is computed in the expenditure benchmark reduces, at least in some cases, the above-mentioned risk of underestimating potential growth that characterizes the methodology of cyclical adjustment in the MTO rule; hence, the expenditure benchmark may be easier to meet for countries that have suffered a major and/or prolonged recession.

Different views can be taken about the different merits of the two rules, but it is not clear why, if the definition of the MTO rule appeared inadequate (for example because it was focusing on the overall balance rather than just on the primary balance), it was decided to add an additional rule, rather than to modify the old one. Note also that the expenditure benchmark does not have implications for the choice between expenditure cuts and revenue increases in implementing fiscal adjustment (and, thus, on the size of government), as the changes in expenditure are adjusted for any discretionary changes.

12 While the identity between the MTO rule and the expenditure benchmark has been proved only under simplifying assumptions, the relationship holds also under more general assumptions.
in tax rates. Perhaps the intention was simply to add a “second opinion” with respect of the adequacy of the fiscal plans followed by member states. Perhaps, the addition of the expenditure benchmark reflected a compromise between those who regarded the MTO rule as insufficient (and wanted to introduce a rule - the expenditure benchmark - more transparent and easier to communicate) and those who favoured the MTO rule as a consolidated practice. Nevertheless, the addition of the expenditure benchmark to the previously existing rules has added further complications.
4. WHAT CAN BE DONE TO SIMPLIFY THE DESIGN OF THE RULES

Various approaches could be followed to simplify the existing SGP rule system, depending on the ambition of the reform and the depth of the legal changes regarded to be feasible. This section: (i) discusses briefly whether “housekeeping” simplifications, which is relatively modest simplifications that, most likely, would not even require legal changes, would be useful; (ii) considers simplifications that, while requiring legal changes, would not alter the overall SGP rule system with respect to the current one maintaining, in particular, its focus on the two twin rules of deficit and debt ceilings; and (iii) considers proposals for a major simplification in which deficit and debt objectives would be condensed in a single rule.

4.1 Housekeeping simplifications

An example of simplifications that can be provided without legal changes is the one endorsed by the ECOFIN Council of 6 December 2016. On that occasion, the Council decided that the expenditure benchmark would play a key role also in the corrective arm of the SGP, as it would be a key factor, together with other considerations, in affecting the outcome of the “careful analysis” of the factors that caused a lower than agreed improvement in the structural balance. This replaced the previous approach, which was “based on the adjusted change in the structural balance and the bottom up approach” (European Commission, 2016, p. 11).

Housekeeping simplifications of this sort are of course useful. However, they are unlikely to imply any significant change in the perception of complexity of the SGP rules. The main source of complexity—the fundamental contrast between the need for more stringent rules and the attempt to make the rules more responsive to current economic contingencies—would remain unaffected. Yet, this contrast is, as argued above, the key reason behind the complexity of the rule system. The kind of housekeeping simplifications that would be possible without altering the current balance between the two opposite needs is, anyway, rather limited. It is not by chance that the only proposal made by the European Commission to simplify the rules is the inclusion of the expenditure benchmark in the corrective arm, exception made for what could be regarded as the “prelude” to a systemic change (discussed at the end of section 4.3), which, however, at present has been simply proposed as an addition to the existing system.

4.2 Simplifications that would not alter the overall SGP rule system, but only the balance between stringency needs and flexibility needs

While widely criticized, the initial SGP framework was not excessively complicated nor arbitrary, compared with other fiscal rules systems. There were two rules: the 3 percent deficit ceiling and the requirement for public debt to decline below 60 percent, at a sufficient speed, if it were above 60 percent. Many argued that these rules are no longer consistent, because of the current growth rates of nominal GDP: keeping the deficit at 3 percent of GDP, with nominal growth rates of, say, 3.5 and 4 percent would imply a long-term debt ratio of, respectively, 86 and 75 percent.\(^\text{13}\) However, such a

\[^{13}\] The long run relationship between deficit and debt ratios is given by

\[
d = \frac{(1 + g)}{g} \cdot df
\]

Where \(d\) is the debt-to-GDP ratio, \(df\) is the deficit-to-GDP ratio and \(g\) is the nominal GDP growth rate.
How could the SGP be simplified?

critique is not justified: the deficit was not expected to exceed the ceiling of 3 percent (even during recessions), and it was expected to be kept, on average, well below 3 percent.

Keeping the average deficit below 3 percent was initially left to the willingness of member states, but this approach did not yield good results in terms of compliance, especially in terms of building sufficient buffers in good times (the 2000s). Therefore, countries did not have large enough buffers when times turned bad (the 2007-13 period), when deficits largely exceeded the 3 percent threshold and some countries (like Italy) could not even afford running discretionary fiscal expansions to support the economy. It was therefore reasonable to introduce a preventive arm focused on maintaining an MTO defined in structural terms, i.e. one that would allow the automatic stabilizers to operate, while avoiding the breach of the 3 percent ceiling.

However, one issue, partly related to the issue of simplification, is whether the MTOs have been set at a level that is too tight, given the goal of keeping debt below 60 per cent. MTOs have been set having in mind the need to avoid breaching the 3 percent ceiling, taking into account the size of output volatility, as well as debt convergence needs (and ageing considerations). A country with an MTO of 0.5 percent and a nominal growth rate of 4 percent would converge to a debt level as low as 25 percent, well below the 60 percent debt level. The rationale for this could be that the SGP also includes various sorts of escape clauses, which, de facto, would imply that the average debt increase would tend to be higher than the one consistent with the MTO. This could happen, for example, as a result of a large recession of the sort observed in 2008-09, or even milder. This kind of shocks are unlikely to be offset by positive shocks of equal size, given the fundamental asymmetric nature of fiscal shocks. This said, considerations could be given to setting MTOs at a less stringent level if, as a result of the simplification of the SGP rules, there were a reduction in the degree of flexibility. Such a reduction would imply that the average deficit would tend to be lower than the one prevailing under the current rules. Correspondingly, the 3 percent ceiling may possibly be raised to 4 percent in order to maintain consistency between the (somewhat higher) MTOs and the need to avoid breaching the headline ceiling, although this would require a Treaty change.

This brings us to the issue of how the current SGP framework, still focused on separate debt and deficit rules, could be simplified. As discussed in section 3, the complexity of the current rule system is largely explained by the attempt to introduce flexibility when, at the same time, the rule system was being tightened, to make it more responsive to the need of medium-term fiscal consolidation and convergence. Trying to anticipate all the contingencies under which a slower pace of adjustment would be deemed appropriate simply adds more complexity (in addition to being partly in conflict with the need to promote fiscal adjustment).

It should be realized that reducing complexity does imply some loss of flexibility, unless it is considered to be preferable simply to go back to the original SGP 1.0 version, which, however, was not considered, and appropriately so, as sufficiently binding during good economic times. There is little one can do about this trade off between increased flexibility and increased complexity, short of introducing profound changes in the rules framework, of the sort discussed in section 4.3.

If one were willing to reduce the degree of flexibility, and increase the weight given to the need of fostering fiscal consolidation, the following changes could be introduced:

- Remove the dependency of the speed of adjustment in the preventive arm on the state of the economy, and, more specifically, on the size of the output gap. The automatic stabilizers would still be allowed to operate, but the “discretionary” component (i.e. the one that would require

14 See Escolano and Gaspar (2016).
specific policy action) would be eliminated. As noted, this would be consistent with the fact that a country that is at the MTO is just supposed to let the automatic stabilizers operate without adding any discretionary fiscal action. The same would happen to a country that is converging towards the MTO.

- Remove all other considerations that relate the speed of compliance with convergence to the MTO on other country-specific circumstances, such as whether the country is implementing structural reforms, whether the country is increasing its spending for public investment, and whether a country is, more generally, facing “unusual circumstances” (but with the caveat mentioned below).

- Request that compliance with the debt rule only be based on the backward-looking criterion, as the forward-looking component not only complicates the rules system, but also leaves just too much room for future policy developments and policies that could be eventually reversed. Compliance should, however, preferably be based on cyclically adjusted data, as the effect of the economic cycle are even larger on the debt-to-GDP ratio than on the deficit-to-GDP ratio. Whether to maintain the consideration of low inflation as a mitigating factor in assessing compliance with the debt rule is debatable, but, on balance, keeping it seems to be preferable.

In exchange for these simplifications, which would reduce the room for flexibility, considerations could be given to the following steps that, without adding any complexity, would reduce the constraints set by the SGP rule system:  

- The MTOs could be relaxed somewhat. As noted, the current MTO levels would imply convergence to debt levels well below the 60 per cent debt ceiling (although this convergence would occur only quite slowly), implying some inconsistency between the MTO and the debt rule, even allowing for the asymmetric nature of fiscal shocks. Correspondingly, the 3 percent ceiling could be raised somewhat, but this would require a Treaty change.

- The removal of the flexibility related to the size of the output gap in the preventive arm could be replaced by a general escape clause that would suspend the adjustment as long as the country is experiencing a (strong?) decline in GDP. Low but positive growth would not, however, relax the speed of the required adjustment.

- The speed of debt reduction in the debt rule (1/20 of the excess of the debt ratio over 60 per cent) could perhaps be lowered. This said, the current pace of reduction seems broadly adequate, in light of the experience of advanced economies that succeeded - over the last thirty years - to lower the debt ratio by a sizable amount (see Table below). In revising the debt rule, it would be useful to eliminate the current formulation that implies convergence to the 60 percent ceiling only asymptotically and not in a fixed number of years. This could be done by

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15 One caveat. It could be argued that the flexibility clauses in the current SGP allow short-term flexibility, while maintaining the stringency of the rules in the long-run. Therefore, it would be inappropriate to relax the long-term targets in exchange for the elimination of short-term flexibility. While this is a reasonable objection, one should consider that, in practice, the short-term flexibility given to flow variables (deficits) adds to the debt stock, and therefore its elimination allows a less stringent approach to long term flow targets.
How could the SGP be simplified?

defining the speed of adjustment as $1/20$ of the initial difference between the debt level and 60 percent, and requesting that speed to be maintained until compliance with the 60 percent debt ceiling has been achieved.

One additional issue is the coexistence of the MTO rule and the expenditure benchmark. As discussed in section 3, these two rules are conceptually identical: they both aim at keeping a certain structural fiscal variable at a certain level, while allowing the automatic stabilizers to play fully. For the MTO, that structural variable is explicitly the overall deficit. For the expenditure rule (in spite of its name and in spite of the exclusion of interest payments from the definition of expenditure) that structural variable is, ultimately, also the MTO, thanks to the convergence margin that forces changes in the structural primary balance until a certain MTO target has been achieved. 16 There are certain differences in the short-term implications of the two rules, noted above, including the focus of the expenditure benchmark on the primary balance (in terms of annual objective, although not in terms of convergence, as the expenditure rule ensures convergence to the MTO) and the smoothing of spending for public investment in the expenditure benchmark. Nevertheless, they do not alter fundamentally the nature of the two rules, which is very similar. The question is then to establish whether one of the two is redundant and which one should be dropped. Altogether, if the goal were to simplify the SGP, it would make sense to drop one of the two rules. But which one?

There are no strong reasons to prefer one or the other approach, including because, as noted, the two rules are fairly similar. The expenditure benchmark is, according to many, more easily understandable in terms of budget preparation, as it forces ministers to focus on something they are familiar with, i.e. spending ceilings. This argument does not seem to be too strong, though: ministers are equally familiar with the concept of budget balances. The expenditure benchmark uses a simpler way of computing potential output growth, but there is nothing that would prevent using the same approach in calculating potential output growth for MTO purposes. One difference, at first sight, is that the MTO requires the calculation of the output gap (a level concept) and not just of potential growth (a flow concept), but this difference is misleading, as also the expenditure benchmark requires knowledge of the output gap level because of the convergence requirement.

Altogether, the two approaches are equally feasible. The choice could then be driven by preference and views regarding the respective appeal in terms of transparency and communication, something that could be left to the choice of politicians.

Once a decision is taken on which one to retain, it would be important to evaluate whether changes in the definition of the surviving rule are appropriate, in particular with respect to the following points:

- Should the rule focus on the primary or the overall balance? The focus (as in the MTO) on the overall balance implies including an element (interest payments) that governments do not control and that, as noted, are cyclical. The process of cyclical adjustment, however, only adjust

---

16 At first sight, the two rules look different. The MTO rule is defined in terms of levels and convergence towards that level. The expenditure benchmark is defined in terms of change in the revenue-corrected spending increase (that is in terms of change in the structural primary balance), but such a difference is immaterial. The convergence margin in the expenditure rule ensures the convergence towards a certain MTO and once that MTO is achieved the rule implies that a member countries should remain at the MTO, although the rule focuses on the component of the structural primary balance (spending net of its most important cyclical component, that is unemployment benefits, and discretionary changes in taxation).
the headline fiscal balance for the effect of the economic cycle on the primary balance, not on interest payments. Therefore, the structural balance includes an expenditure component that remains cyclical, as interest payments tend to be lower in weak economic phases (leading to an underestimation of the structural deficit in recessions) and higher in strong economic phases (leading to an overestimation in expansions). This problem, however, is to some extent offset by the shortcomings in computing potential growth rates according, at least, to the current MTO methodology, which, as noted, has exactly the opposite effect on the overestimation or underestimation of structural balances. In theory, it would be preferable to fix both problems (following the old adage that “two wrongs don’t make a right”). But, pragmatically, the current approach—focus on the overall balance and continuation of the current cyclical adjustment methodology—could perhaps be retained if discussions for an overall revision were regarded as too divisive.

- A related issue is the choice of the cyclical adjustment process. If the simple approach of computing potential output by a centered 10-year average of actual GDP is regarded to be good enough for the purpose of calculating the expenditure benchmark, why not retaining it also for the MTO rule, in case the latter rule were the one to survive? The 10-year centered moving average is simpler and more transparent. In addition, the current complex approach still yields potential output levels that retain some degree of cyclicality. So, short of improving the current more complex methodology, it may be preferable just to use the 10-year centered average approach. In any case, there is a need for consistency. One could even follow both approaches (the production function approach and the moving average approach) as a first step, taking then the average of the two approaches as the final measure of potential output. However, it does not make much sense to use two different definitions of potential output in the MTO rule and in the expenditure benchmark.

- An alternative would be to allow judgment to play a greater role in estimating potential output growth. The complexity of the current approach also reflects the desire to ensure objectivity in the calculation of potential output growth. That objectivity is needed to avoid that this critical decision becomes subject to political pressures. At the same time, the current approach is too rigid, with the result of being misleading: as noted above, the current approach results in some cases in potential growth rates that are still very much affected by cyclical conditions especially in case of prolonged recessions. To avoid this rigidity, while maintaining objectivity, consideration could be given to allowing space for judgment by independent experts, to be found outside the staff of the European institutions, as it is done, for example in Chile, where the estimation of potential output, as well as of the copper price to be used for the calculation of Chile’s structural balance, are delegated to two independent expert groups, who use for the assessment all the information they deem appropriate, as well as their own judgment.

- Finally, a decision would have to be taken regarding the smoothing of investment spending. Here the logic followed by the expenditure benchmark (considering average investment spending over several years in the calculation of the expenditure benchmark, rather than investment spending in a single year) seems to make sense: investment spending can be lumpy, especially for small countries, and some smoothing would be preferable. Smoothing
How could the SGP be simplified?

Investment spending would also be a way of allowing investment to be maintained at a higher level in the initial phase of a recession, playing a sort of countercyclical role.

### Countries that have reduced the debt-to-GDP ratio through a sizable average primary surplus

<table>
<thead>
<tr>
<th>Country</th>
<th>Period</th>
<th>Initial public debt (in % of GDP)</th>
<th>Change of the debt-to-GDP ratio</th>
<th>Number of years of decline in the debt ratio</th>
<th>Annual average reduction (in % of GDP)</th>
<th>Average primary surplus in the period of debt reduction (in % of GDP)</th>
<th>Average GDP growth rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Zealand</td>
<td>1987 - 2001</td>
<td>54,6</td>
<td>-30,2</td>
<td>14</td>
<td>-2,2</td>
<td>4,0</td>
<td>2,5</td>
</tr>
<tr>
<td>Ireland</td>
<td>1991 - 2001</td>
<td>93,9</td>
<td>-60,6</td>
<td>10</td>
<td>-6,1</td>
<td>4,4</td>
<td>6,4</td>
</tr>
<tr>
<td>Belgium</td>
<td>1993 - 2007</td>
<td>138,1</td>
<td>-51,1</td>
<td>14</td>
<td>-3,7</td>
<td>4,9</td>
<td>2,1</td>
</tr>
<tr>
<td>Netherlands</td>
<td>1995 - 2001</td>
<td>73,6</td>
<td>-24,5</td>
<td>6</td>
<td>-4,1</td>
<td>3,6</td>
<td>4,0</td>
</tr>
<tr>
<td>Denmark</td>
<td>1996 - 2007</td>
<td>68,3</td>
<td>-40,9</td>
<td>11</td>
<td>-3,7</td>
<td>4,9</td>
<td>2,1</td>
</tr>
<tr>
<td>Finland</td>
<td>1996 - 2008</td>
<td>55,3</td>
<td>-22,7</td>
<td>12</td>
<td>-1,9</td>
<td>5,5</td>
<td>3,7</td>
</tr>
<tr>
<td>Canada</td>
<td>1997 - 2007</td>
<td>95,6</td>
<td>-28,7</td>
<td>10</td>
<td>-2,9</td>
<td>3,3</td>
<td>3,2</td>
</tr>
<tr>
<td>Spain</td>
<td>1997 - 2007</td>
<td>64,4</td>
<td>-28,8</td>
<td>10</td>
<td>-2,9</td>
<td>2,4</td>
<td>3,9</td>
</tr>
<tr>
<td>Sweden</td>
<td>1998 - 2008</td>
<td>66,8</td>
<td>-29,0</td>
<td>10</td>
<td>-2,9</td>
<td>3,5</td>
<td>3,0</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td><strong>1987 - 2008</strong></td>
<td><strong>79,0</strong></td>
<td><strong>-35,2</strong></td>
<td><strong>10,8</strong></td>
<td><strong>-3,4</strong></td>
<td><strong>4,1</strong></td>
<td><strong>3,4</strong></td>
</tr>
</tbody>
</table>

1 Source: WEO, IMF October 2017 for New Zealand and Canada; AMECO for Netherlands, Finland, Spain and Sweden; AMECO e WEO, IMF October 2017 for Ireland, Belgium and Denmark. Osservatorio CPI - Unicatt calculations.

2 The period considered extends from the end of the first year to the end of the last year reported.
4.3 Simplifications that would alter in a more fundamental way the SGP rule framework

Proposals for a more radical simplification of the SGP have been put forward by different sources. The most commonly proposed alternative is to replace the current four-rule system with a single formula that would constrain a flow variable (typically expenditure adjusted for discretionary revenue changes), the “intermediate target”, so to achieve a debt objective, the “anchor”. The constraint on the flow variable could also depend on cyclical considerations, such as the size of the output gap.

The approach is reminiscent of some rules used to define monetary policy, such as the so-called Taylor rule. The latter implies that the central bank should set its main tool (the interest rates) as a function of the distance of inflation from the inflation target (the anchor) and of the difference between actual output and its full employment level. In the same way, a certain fiscal flow aggregate (the structural balance, the structural primary balance or the revenue-adjusted expenditure), would be the “intermediate target” (in fiscal policy this would play the role of the “tool” in the monetary policy rule, as the government does not have full control of any fiscal flow variable) and would depend on the distance of debt from its objective, as well as on the size of the output gap. This approach has been followed, for example, in two papers written by staff of the International Monetary Fund (Eyraud and Wu, 2015, and, especially, Andrle et al, 2015), as well as by the Bruegel think tank (Claeys, Darvas and Leandro, 2016).

While the details of the two proposals differ, the overall approach is similar. In a nutshell, there would be only a single rule, whose general form would be:

$$\text{Def}_t = \text{Def}^* - \alpha \left( \text{output gap}_t \right) - \beta (\text{Debt}_{t-1} - \text{Debt}^*)$$

Where $\text{Def}_t$ is the deficit to GDP ratio, $\text{Def}^*$ is the targeted structural deficit (essentially the MTO), and $\text{Debt}^*$ is the targeted public debt-to-GDP ratio and the other symbols are self-explanatory. $\text{Def}_t$ could be either the overall or the primary balance, preferably defined in structural terms, so that the rule, other conditions being the same, would allow not only the operation of the automatic stabilizers, but also changes in the structural deficit in response to the economic cycle. Alternatively, the rule could be expressed in terms of revenue-adjusted expenditure as:

$$100 \times \log(\text{Exp}_t) = 100 \times \log(\alpha Y^*_t) - \beta (\text{Debt}_{t-1} - \text{Debt}^*)$$

where $Y^*_t$ is potential output. The above formulation implies that the revenue-adjusted expenditure would rise in line with potential GDP, except when the debt-to-GDP ratio exceeds the targeted value. Andrle et al. (2015) do not include in the latter equation a term for the size of the output gap, contrary to what they do when the fiscal rule is expressed in terms of deficit, but this could also be considered. Of course, a convergence path could be established if the level of the intermediate target at the time of the introduction of one of the two new rules reported above largely exceeded the one produced by the current rule, but this would be just a matter of temporary transition. Once the target is achieved, there would be only one rule.

It is important to underscore that the inclusion of the output gap in some of the above formulations implies that fiscal policy would react to the economic cycles not only by allowing the automatic stabilizers to operate, but also by allowing the structural balance (or possibly the growth rate of the revenue-corrected expenditure) to vary depending on the phase of the economic cycle. This would go beyond the current approach that only allows the structural balance to reflect cyclical conditions only: (i) as a result of the flexibility rules relating to the speed of convergence to the MTO under the

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17 Andrle et al. (2015) also considers a version of the rule in which Def is the headline balance.
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preventive arm; and (ii) for countries that, having exceeded their MTO targets (actually ceilings) are willing to use the available space to counter unpleasant cyclical developments.

The advantages and disadvantages of the single rule approach, in either the structural balance or the expenditure formulation, are the following:

- The approach is analytically simple and, especially, ensures the consistency of the deficit target with the goal of achieving the debt target. Based on simulations of the implications of different variants of the above rules, Andrle et al. (2015) conclude that the best performing rule is one defined in terms of expenditure ceilings, as these would minimize the variance of macroeconomic and fiscal variables in the presence of aggregate demand shocks. According to the authors, the approach is easy to communicate to policy makers, as it focuses on an aggregate (expenditure) that is at the core of the budget preparation. This argument, however, does not seem to be fully convincing. First of all, the aggregate in question is not expenditure but expenditure adjusted for revenue changes and (possibly) one-off changes in spending. Second, the spending rule would not be simple (e.g. to keep spending constant) as differences across countries and time in allowed expenditure would depend on differences of potential growth rates, the size of the output gap and the distance of debt from its target. This second argument also applies in case the fiscal rule is expressed in terms of structural balance.

- The approach allows changes in the structural balance, which, in principle, make the fiscal stance more adequate to the business cycle than just allowing automatic stabilizers to operate. Whether to move in that direction or not needs to balance the advantage of a more effective countercyclical policy with the risk that, in spite of the symmetrical formulation of the fiscal rule, fiscal policy continues to show a persistent deficit bias. The evidence presented in section 2 suggests that this bias was indeed strong when the fiscal rules did not even contemplate the possibility of expansionary changes in the structural balance. How would that bias be affected by the explicit inclusion in the fiscal rule of the possibility of implementing discretionary changes in the structural balance is hard to say. On the one hand, allowing expansionary changes in the structural balance, albeit constrained by the above rules, may simply make that bias stronger. On the other hand, one could argue that the explicit inclusion in the rule of the requirement to tighten fiscal policy during economic expansion may reduce the bias. If the risk of fostering the deficit bias of member states were considered to prevail, then it would be preferable to avoid including in the single rule the magnitude of the output gap. The role of performing countercyclical actions could then be left to a central euro area budget with increased fiscal capacity; or, simply, to monetary policy (although of course this would not help address idiosyncratic shocks). Consideration could also be given to the possibility of allowing countercyclical policies only once the debt ratio has fallen below a certain threshold. This would also provide a “reward” for countries that managed to lower public debt sufficiently.

Altogether, both the single rule approach discussed in this section and the current approach, with the simplifications and adjustments discussed in section 4.2, provide an adequate way forward. The single rule approach would probably be superior only if it were felt that there is a major need to allow fiscal policy to play a countercyclical role, going beyond the operation of the automatic stabilizers. One important factor in favor of the current approach may also be the difficulty of altering completely the current SGP framework, something that should not be underestimated.

A final consideration on the relative merits of the current and the “one rule” approaches relates to the elimination of the 3 percent ceiling defined in headline terms that would be implied by the “one rule” approach discussed in this section. Such a removal would have the advantage of more flexibility in responding to unusually large fluctuations, while not going to the extreme of relying on an escape clause, triggered under those circumstances, that would suspend entirely the rule system. However,
one disadvantage of dropping the 3 percent headline ceiling would be the full reliance on a rule that requires the difficult estimation of potential output, a non-observable variable. Thus, the 3 percent ceiling plays the role of a “finale defense” to avoid excessively high deficits. If this were the case, however, one could perhaps consider raising such a ceiling somewhat, for example to 3.5 or 4 percent, while relying primarily on the single rule discussed above.

Before concluding, it is worth mentioning another possibility of radical simplification. As noted above, the draft directive proposed by the European Commission on 6 December 2017 would require member states to introduce in their legislation the MTO rule and the expenditure benchmark. At present, this is seen just as an addition to the current rule system. However, the focus of the Commission on those two rules may indicate its intention to give them a higher status over the other rules. This could be seen as a “prelude” to a possible major simplification of the SGP, involving the possible replacement of the current SGP framework with just those two rules, thus implying the elimination of the 3 percent ceiling and of the debt rule.

Such a step, should that be the intention, would appear to be too radical. First of all, as already noted, the MTO rule and the expenditure benchmark are essentially identical except for definitional issues. In any case, they both are “flow” rules, and focusing just on them would overlook the focus on the important stock variables. It is of course true that, for a given nominal growth rate of the economy, there is a one-to-one long term relationship between deficit and debt to GDP ratios: keeping the deficit-to-GDP ratio constant at a certain level would eventually imply the convergence of the debt-to-GDP ratio to a level equal to:

\[
\text{debt ratio} = \frac{(1+g) \cdot \text{deficit ratio}}{g}
\]

Where \(g\) is again the nominal growth rate of GDP. But this relationship only holds in the very long run. If the debt ratio were shocked by large exogenous event, like a banking crisis, convergence to the long term debt ratio would take quite a long time. Moreover, countries with a higher GDP growth rate would be characterized, for the same deficit target, by a lower debt ratio, while one could argue that debt tolerance is higher in faster growing countries.

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18 It is worth recalling that the balanced budget rule (in terms of the MTO) has already been included in national legislation, in accordance with the Fiscal Compact.

19 For example, suppose the nominal growth rate of the economy were 4 percent and that the deficit target were set at 1 percent of GDP. The public debt ratio would converge over the long run to 26 percent of GDP. If the debt ratio increased as a result of a shock (for example a banking crisis requiring government intervention) to 80 percent, the debt ratio after 25 years would still be as high as 46 percent, quite far away from the long term target.
5. CONCLUSIONS

The main conclusions from the above analysis can be summarized as follows:

- The SGP is definitely far more complex than any other system of fiscal rules in the world and its complexity may have contributed to its weak performance in defeating the deficit bias and the pro-cyclicality of fiscal policies in the euro area. A major simplification would provide the opportunity for addressing some of the other existing shortcomings of the SGP, such as internal inconsistencies.

- To a large extent, the SGP complexity has been caused by the conflict between, on the one hand, the need to make the original SGP rules more effective in reducing the deficit bias and in promoting the reduction in public debt in the countries where it exceeded the 60 percent ceiling, and, on the other hand, the need to ensure that the SGP rules would not prevent an economic recovery in the aftermath of the largest economic shock since the 1930s. As a result, as new and, in principle, more binding rules were being introduced, various margins for flexibility and room for interpretation were also added.

- Now that the effects of that economic shock on GDP growth are fading away, consideration could be given to a major simplification of the system by removing some margins of flexibility. This includes the elimination of various flexibility clauses (for investment, for structural reforms, for the size of the output gap) and the maintenance of only the backward-looking criterion for assessing compliance with the debt rule, as this criterion does not rely on debt projections and policy actions that could be reversed in the future. At the same time, some of the long-term SGP parameters (the country-specific MTO value, and, perhaps less convincingly, the speed of adjustment of the debt ratio towards its target value) could also be relaxed, although this is not strictly necessary. This relaxation would also allow the removal of the current possible inconsistency between fiscal balance flow targets and public debt targets. The coexistence of the MTO rule and of the expenditure benchmark should also be reconsidered, as they play the same role and are virtually identical, except for definitional considerations that are not well motivated (e.g. focus on the overall rather than the primary balance). In any case, the rationale for the coexistence of two different methodologies for the calculation of potential output for the MTO rule and for the expenditure benchmark is not at all clear. If it is deemed preferable to continue to use both rules, there is a need to use a single definition of potential output for both rules (which could possibly be the average of the estimated potential output under the current two approaches).

- A more radical solution would be to replace the current approach, based on separate rules, with a single rule, in which a flow “operational target” (the deficit, the primary deficit, the revenue-adjusted expenditure, all corrected for cyclical effects) would respond to the deviation of public debt (the final anchor) from its target and, possibly, to the magnitude of the output gap. This would have the advantage of ensuring full consistency between the budgetary variable under the most immediate control of the policy makers and the final objective of keeping the public debt-to-GDP ratio sufficiently low. If it were decided to include in the single rule also an output gap component, fiscal policy could also be used in a countercyclical way, in addition to what would be possible just by letting the automatic stabilizers operate, thus ensuring a better tailoring of fiscal policy to the economic cycle. This advantage would need to be weighed against the need to avoid the risk that, in spite of the symmetry of the rules, fiscal expansions end up being difficult to reverse, thus fostering the deficit bias that has characterized at least the first decade of the SGP, when relatively good economic conditions were not used by all countries to lower their public debt sufficiently. A possible compromise
against these two conflicting needs would be to allow the use of countercyclical policies only in countries where the debt ratio is below a certain level. Other countries would only be allowed to let the automatic stabilizers operate. This provision would also create an incentive to lower public debt in countries with high debt ratios.
How could the SGP be simplified?

6. REFERENCES


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The complexity of the SGP, which may have contributed to its limited effectiveness, reflects largely the conflict between the need to make the original SGP rules more stringent and the desire to allow flexibility with respect to various country circumstances. Now that the effects of the largest economic shock since the 1930s are fading away, a major simplification of the system could be achieved by removing some margins of flexibility, while possibly relaxing some of the SGP long-term parameters. The coexistence of the MTO rule and the expenditure benchmark could also be reconsidered. A more radical solution would involve shifting to a single rule in which an “operational target” responds to deviations of public debt from its long-term objective.