



## Reforming the Stability and Growth Pact

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### Tuomas Saarenheimo (Chair)

Tuomas Saarenheimo (Chair) opened the exchange of views on reforming the Stability and Growth Pact (SGP). The panel would speak about the review of the Two Pack and Six Pack legislative packages. This has been foreseen in the legislation itself, so it is a legal obligation to go through it. The European Commission was able to launch the consultation that started this review just before the pandemic interrupted the process. While the formal process was interrupted, the pandemic changed the economic realities of life and provided fuel for a fairly active debate on what to do with the SGP. The debate has been ongoing for the last year and a half while the consultation has been interrupted.

Tuomas Saarenheimo (Chair) noted that there are several existential questions around the European fiscal framework but asked the panellists to concentrate their initial remarks on three questions. The first is whether there is a need to rethink the fiscal framework; if so, panellists should describe why, how it should be rethought and what should be changed. The second question is whether the fiscal framework has been properly enforced; if not, panellists should describe how it should be improved and what the role of sanctions and/or incentives is in that process. The third question relates to the present day. The fiscal rules have been suspended through the general escape clause for an extended period of time and will remain suspended for a long time to come. Tuomas Saarenheimo (Chair) asked the panellists how they would reintroduce fiscal surveillance.

Tuomas Saarenheimo (Chair) asked Katja Lautar to answer first and noted that she represents the Presidency of Slovenia.

### Katja Lautar

Katja Lautar thanked Tuomas Saarenheimo (Chair) and the organisers. She stated that having rules is certainly better than not having them. This has proved to be efficient in the pandemic with the General Escape Clause, but there is always a 'but'. Katja Lautar has been advocating for many years that one size unfortunately does not fit all. It is necessary to rebuild trust and confidence in future fiscal surveillance due to the obligations that are ahead, especially if there is a desire to boost potential growth and not want hit fiscal objectives for the sake of hampering investment.

The role of fiscal policy should be retained. Katja Lautar would not go into detail about how and why but noted there are certainly some examples of how it can be done. Sustainability of public finance very much depends on country specific factors. Again, equal treatment does not mean "one-size-fits all" rules. It is necessary to look at the countries from a country specific perspective, to avoid being bound by very difficult observables and to stick to the nominal targets. Whether there is already room to discuss thresholds is uncertain.

Katja Lautar stated that she usually says that she is not sure that it is an appropriate idea, if someone is already in a difficult position, to give further financial sanctions. Every sanction needs a reason behind it that has to be objectively proven. There is a way forward with Recovery and Resilience Plans (RRP) because there is the 'carrot and stick'. With reforms and investment going hand in hand, it can serve the purpose well. Katja Lautar suggested waiting for the efficiency to come out of the Recovery and Resilience Facility (RRF) to see how EU fiscal rules can contribute to promote growth on a longer path.

Katja Lautar concluded by noting that the crucial point and momentum ahead is to define an appropriate path

for the recovery and gradually reduce the deficit. That is also why the structural reforms and investments play a crucial role. Katja Lautar also suggested finding some kind of flexible solution to support investments because the SGP does not provide sufficient flexibility and the only purpose of the EU rules should not be hitting the measurable observables at any cost.

### **Tuomas Saarenheimo**

Tuomas Saarenheimo (Chair) thanked Katja Lautar for her contribution. He introduced Minister Gintarė Skaistė from the Republic of Lithuania.

### **Gintarė Skaistė**

Gintarė Skaistė stated that she would try to look at the problems in the three questions raised, all of which were quite broad. She started with the question of whether to rethink the fiscal framework. Gintarė Skaistė stated that it needs to be rethought, but the discussion might be at different levels. It might be necessary to rethink some formal and instrumental points of the fiscal framework. Other countries might try to push through some radical reforms, but Gintarė Skaistė does not support such an approach. The system must be rethought, but it does not have to be rebuilt from the beginning.

We should not limit our discussion to numerical debt and deficit targets. Rather, it is necessary to consider how to ensure the fundamentals of a good fiscal system. Fundamentals that would prevent the build-up of macro imbalances and ensure fiscal sustainability over the medium and long term, as well as transparency, predictability, domestic ownership, and the equal treatment of countries. The system is fairly good but has some fairly specific points that could be improved, such as complexity and ambiguity of the system, element of discretion in formal surveillance procedures, challenges in determining the business cycle, and rules enforcement.

There is space for simplifying the system – for instance by putting more emphasis on observable indicators, such as growth rate and government expenditure. However, it is important to retain the complementarity role for indicators that permit assessing the business cycle, such as structural balance and output gap. The issue sometimes missed in the discussion is that the Stability and Growth Pact (SGP) is about both stability and growth. However, stability without growth may lead to stagnation. In other words, we must not forgo and forget the “G” in the “SGP”. That is why it is advisable to consider limited additional flexibility for growth-enhancing productive investments, combining it with appropriate safeguards. The evaluation of the quality of investments would be key in this regard.

Gintarė Skaistė stressed that the Recovery and Resilience Facility (RFF) mechanism is a fairly good example of how to evaluate reforms and investments and ensure their quality. When it comes to implementation of the fiscal rules, the current sanction regime is not viable and has never been used in practice. It is difficult to expect that it could be used in the future. This might be due to political considerations or potential negative spill overs at the EU level. This is not a positive situation.

Gintarė Skaistė added that the question is related to discretionary decisions and lack of transparency in

rule enforcement. It comes with less predictability and undermines equal treatment of member states. Simplifying the rules and providing a more pronounced role to European Fiscal Board (EFB) in the process could assist in reducing politicisation of the process. Also, we need to think about incentives to follow the rules, for instance while discussing additional flexibility related to growth-enhancing investments.

On the reintroduction of fiscal rules – there is no merit in trying to rush the process to reform the SGP to align it with GEC deactivation. The objectives for the potential SGP reform are much broader than merely COVID related issues and relate to longer-term structural challenges, such as ageing populations and other structural challenges. After the general escape clause is deactivated, it is advisable to come back to the existing rules with all available flexibility, while considering the uneven recovery of the member states.

### **Tuomas Saarenheimo**

Tuomas Saarenheimo (Chair) thanked Gintarė Skaistė for her contribution. He would ‘detour’ to Harald Waiglein to complete the set of member states before going to the institutions and the expert.

Harald Waiglein, Director General for Economic Policy, Financial Markets and Customs Duties, Federal Ministry of Finance, Austria & Chair, FSC

Harald Waiglein stated that he would try not to disappoint because he has been involved in the discussion of the SGP for a very long time. He asked that attendees forgive him if he is somewhat blunt.

Harald Waiglein stated that he would start with a comparison. Everyone has traffic rules in their countries, and yet countries have car accidents. Harald Waiglein asked if anybody really thinks that traffic rules should be abolished or made more lenient to facilitate more ownership. Harald Waiglein stated that he sticks more to principle than to details in the way he thinks about the SGP. However, the principle is important. It is possible to have very positive debates on whether the numbers in there are macroeconomically meaningful, but that is entirely beside the point.

The point of concern came less from a macroeconomist and more from a financial economist. Financial economists know a lot about moral hazards because that is all they deal with in the banking sector. Looking at the state or budget from a certain perspective, it is not very different from that of a financial institution. Another issue of moral hazard is a government always has a clear incentive to shift the burden of consolidation to another government in another term.

The agency problem is even worse because the electorate has the same incentive to shift the burden of consolidation to another electorate in the future. That is precisely the issue that needs to be addressed with a rule. The point is less the figure of 60% or 3% and more the prevention of that moral hazard. Now that those in the European Union have started to mutualise debt, it is a very bad time to put issues on the table that would effectively mean a watering down of the pact or making the obligations more lenient. This is due to the lack of the disciplining effect of exchange rates, which means markets cannot do the job anymore.

Harald Waiglein added that the aforementioned is an even bigger argument for having stringent rules. It is not clear that anyone would argue with that. The eurozone crisis would never have happened if the SGP had been implemented and executed to the letter. If Greece had stuck to the SGP, there would have been no eurozone crisis. However, the SGP had not been implemented and the rules had not been followed. That is something to consider. There is ample room for making the SGP more practical and usable.

Harald Waiglein agreed that the rules are too complicated. However, he remembers why they are complicated. There were nominal targets and the SGP was simple. People said it was simple, but it was also 'stupid' because it was procyclical. Very intelligent people reflected for years on how to make the SGP more intelligent. The more intelligent solution is what is on the table. It is the legacy of intelligent people in the past that intelligent people of the present are unhappy with. That is not to say that it cannot be improved, but, given the history, if the SGP were opened up, the result may not be much more intelligent than what currently exists. Harald Waiglein advised being very careful in starting that discussion.

Harald Waiglein stated that he would stick to principle. He would address the general escape clause in the next round, but the bottom principle is how to deal with the moral hazard issue in a credible way.

### **Tuomas Saarenheimo**

Tuomas Saarenheimo (Chair) thanked Harald Waiglein for his contribution, noting that he certainly did not disappoint, and turned to the institutions.

Gilles Mourre, Head of Unit, Fiscal Policy and Surveillance, Directorate-General for Economic and Financial Affairs (DG ECFIN), European Commission

Gilles Mourre stated that he was very honoured to take part in the panel and represent Declan Costello. Gilles Mourre began by elaborating on the process and method. In the coming month, the European Commission would have to confirm its intention to deactivate the general escape clause for 2023 based on the economic forecasts. Secondly, it would have to come up with ideas for the future of the EU economic governance (including EU fiscal rules) based on the public consultation that was likely to be relaunched in the autumn. Thirdly, the European Commission would have to provide fiscal guidance to Member States when the general escape clause had been lifted if the discussions around the fiscal rules was still work in progress by that time.

Gilles Mourre stated that the debate had already started in many fora, but he could not help noting the many mischaracterisations of the fiscal rules, even in academic circles. There was an obsessive focus on the 60% level of debt rather than the operational pace of debt reduction. Rules were often regarded as a mechanical straitjacket that had imposed a balanced budget in all countries, a low level of public investment and procyclicality. Some, at the other end of the spectrum, had argued against changing anything in the design of EU rules, focusing only on better enforcing the existing rules. However, the reality appeared much more nuanced than these polar views. Fiscal rules were applied with considerable flexibility since the euro area debt crisis and failed to lower debt before the outbreak of the COVID crisis in

some large economies, increasing fiscal heterogeneity in Europe. A real question appeared to be what the realistic ability of the Stability and Growth Pact was to actually influence the behaviour of fiscal sovereigns given strong national preferences.

Gilles Mourre stated that there was a need for consensus on the main challenges lying ahead and the diagnosis on past implementation. In this regard, the detailed review of the economic and fiscal governance published by the European Commission just before the pandemic outbreak should be a starting point, not least because it provided a balanced and evidence-based picture.

Gilles Mourre stated that his second point was to draw the lesson of the crisis. His third and last point was the importance of the RRF. The recovery would be like never before, being much richer in terms of investment thanks to the Recovery and Resilience Facility (RRF). The RRF would provide a supportive fiscal stance, which would allow countries with high debt to run prudent national fiscal policy to improve their debt sustainability. The fiscal effort should focus on current expenditure, preserving nationally financed investment, which would complement investment financed by RRF grants.

### **Tuomas Saarenheimo**

Tuomas Saarenheimo (Chair) stated that European Commission enforcement is improving by the day. He thanked Gilles Mourre and introduced Jacques de Larosière, who has been an expert with Eurofi for a long time and has recently been active in writing about these issues.

### **Jacques de Larosière**

Jacques de Larosière stated that he was most grateful to have been selected as a member of the panel. A fiscal framework is necessary because not having it would allow negative externalities to play a role. A system without too much moral hazard must at least have strong cooperation. In a monetary union, there should normally be a common fiscal policy, but, if that is impossible, a great deal of cooperation is necessary.

The issue is how to make the aforementioned happen. Rather than relying only on global percentages, like 60% for public debt and 3% for the deficit, a more tailor made and personalised set of rules should consider the situation of each country. Jacques de Larosière advised keeping the 3% deficit rule because it is already very tolerant. He is more sceptical on the 60% one because it does not really consider important parameters like the level of savings or economic potential.

A new standard is absolutely needed. Some countries rely too much on public expenditure, which then deteriorates all their fiscal situation. A precise rule is therefore necessary. According to this, any country that exceeds the 'average normal' of public expenditure to GDP in the eurozone would have to eliminate the difference in the period of five years or less, for example. In order to make it happen, it is necessary to recognise that the present system of sanctions has not been observed. Jacques de Larosière stated that it has not been observed because the figures and norms that were in action were considered as externally imposed.

Jacques de Larosière suggested that there should be a European independent fiscal authority that would help



the country in question fix its personalised standards in collaboration with the authority and each member. The rules absolutely must be internalised in domestic frameworks, and the standard that would emanate through each country from this discussion should be a condition for the presentation of the national budget to the national parliament. This, by definition, would be better than pretending to apply sanctions.

This European authority would also be free to establish the fundamental macroeconomic assumptions behind the budget with the assistance of academics. Jacques de Larosière stated that he has spent a large part of his life on article 4s in the International Monetary Fund (IMF). They were an open discussion between the economists of the IMF, which were absolutely independent, and the country in question. Eventually, enlightenment arrived. Figures and realities are just that. The country would agree with the thrust of the article 4 discussion, and then it would be up to the country to apply the programme. Therefore, strong fiscal positions (primary surpluses) and a shift toward quality of expenditure and investment are needed to face the challenge of infrastructure, investments, and ecological policies. Jacques de Larosière advised against abolishing the EU fiscal framework.

#### **Tuomas Saarenheimo**

Tuomas Saarenheimo (Chair) thanked Jacques de Larosière for his contribution. He had four follow-up questions for panellists to choose from. Firstly, there is an idea of excluding some classes of expenditure from the regional rules. There is talk of investments, growth enhancing investments and productive investments. Tuomas Saarenheimo (Chair) asked where the panellists draw the line and what is productive. He asked if education or health are productive and if it is really implementable. He asked if those present can agree on a line to be drawn somewhere.

Second, there seems to be a general tendency towards agreement that the rules should be simpler. At the same time, there is a desire to maintain the countercyclicality of the framework. The President of the European Commission spoke years ago about 'simple and stupid' rules, which did not have the countercyclical element. Countercyclicality was then brought in and made very complicated. The unobservables are there to cater for the countercyclicality. Tuomas Saarenheimo (Chair) asked which way to go given the choice between 'simple and stupid' and 'clever and complicated'.

Third, Tuomas Saarenheimo (Chair) asked if panellists believe in the customisation of limits for country specific circumstances, and, if so, on what basis. He also asked what a fair basis on which to set country specific limits would be. Tuomas Saarenheimo (Chair) asked if it is advisable to work from economic first principles or political realities, both of which lead to very different conclusions.

Finally, on Jacques de Larosière's point on fiscal councils, Tuomas Saarenheimo (Chair) asked how much power and what kind of power to give to them, and whether the panellists see a risk of giving too much power to a non elected body. The power could be of a political nature, so this could mean creating a technocratic body doing political work.

#### **Katja Lautar**

Katja Lautar stated that there is a chance to have some kind of short term solution for RRF or green investment. There is room to manoeuvre because this does not require changes of the SGP at the moment, although it might be in the future if that is agreeable. It is necessary to define a proper path for recovery. The SGP procedure provides a lot of room to manoeuvre to have clever, but very simple, rules because it is fairly clear. However, a proper path and time after the current crisis are necessary.

Katja Lautar addressed customisation, noting she has been "in the business of path calculations" for many years. If a staff report could customise countries, different kinds of economies, and different kinds of convergence process, the European Commission would have a great deal of knowledge and several ideas on how this could be more customised. This is easy to say from an expert point of view, but much more difficult to say from the political point of view.

Katja Lautar stated that the fiscal council instructions/opinions are necessary. However, it is very difficult to give the Council that type of responsibility in terms of political power and consensus. At least in small, open, and transparent countries, it is a tremendous obligation that always hits within the political and economic cycle, which is not easy.

Katja Lautar stated that really efficient implementation of RRF will have important implications for the future fiscal framework. The European Fiscal Board recommendations are there to be used, while waiting to see what it can improve in terms of unobservables.

#### **Gintarė Skaistė**

Gintarė Skaistė addressed the question related to the expenditure rule. It should be stressed that the currently available flexibility clause for investment has never been used. Therefore, it is advisable to consider how to broaden the possibilities of using it in practice to support long-term sustainable growth. There is also merit in looking at possibilities for encouraging green investment, bearing in mind the ambitious climate agenda and the amount of resources that will be needed to implement it.

Gintarė Skaistė stated that ensuring the quality of this expenditure is absolutely key. The RRF experience and structure can be used as a model. Every country would have something to say about the RRF: how strict the European Commission is; how they have to talk extensively about concrete milestones and targets, structural reforms and investments; and how they fit with one another. This framework and experience could be used to assess whether expenditures and investments, for which additional flexibility could be foreseen, will lead to growth or not. The RRF has not been fully implemented yet and it remains to be seen what results it will bring, but it could be a useful case point.

#### **Harald Waiglein**

Harald Waiglein stated that, excluding investment or some classes of expenditure from the EU fiscal rules would not make sense because it comes from the illusion that financial means are not scarce. Scarcity is an economic concept, so certain priorities must be dropped

to invest in others. However, the approach cannot be to say that everything is equally important and to bend the rules for things that cannot be afforded, because the sustainability is also a market fact. It is nowhere in the rules. Investors would not have cared about that if they had been told that it was making use of the flexibility in the case of Greece and that there was not really a debt sustainability problem. It is really a matter of refocussing the priorities.

On simpler rules, Harald Waiglein stated that if he was at a party and wanted to choose a drink, he would go for 'simple and stupid'. However, the situation is real life, so the choice must be 'clever and complicated'. Customisation for countries is a very interesting concept because the macroeconomic circumstances and the debt dynamics are different for every country, so a case could be made. However, the outcome may not always be favourable.

Harald Waiglein noted that Jacques de Larosière mentioned he was suspicious of the 60%. In some cases, simpler rules might mean having a lower debt ratio than 60%. Taking the example of some countries outside Europe, debt sustainability becomes a problem after reaching 30%, so this could be explored. There is a case to be made economically. It would probably mean more difficult categories for some countries, and it would not be possible to agree on a political concept.

Harald Waiglein moved onto fiscal councils being independent. Good independence and guardianship of the greater good is the job of the European Commission. That is why the European Commission has been given that role. However, political reality shows that, once an institution is burdened with such a fundamentally political role, it cannot remain unpolitical. If the European Commission created such a fiscal council, every member state would immediately try and put as many of its nationals in there as possible to influence the decisions and the way it operated. It looks good in theory, but it is much more difficult in practice.

### Gilles Mourre

Gilles Mourre first addressed the fiscal council question. He agreed that there was a more general question about the realistic ability of an enforcer – be it the European Commission or the independent fiscal institutions (IFIs) – to actually influence the behaviour of a fiscal sovereign. On the other hand, the IFIs were national bodies, so strengthening their role would increase national ownership. This would also require that they had enough means to fully play their role.

Gilles Mourre moved onto the challenge regarding investment. There was an estimated investment need for the climate and digital transition of over 600 billion per year over a period of 10 years. The issue was how the fiscal rule could incentivise investment. There were many ideas floating around, such as the golden rule. At the same time, it was key to frame the expectation correctly about what the fiscal rules could reasonably deliver since unsustainable public finance is not conducive either to investment.

Gilles Mourre finished with the question on the nature of public investment. There might be a case to make for green investment because green investment not only served a local or national purpose but was also related

to the provision of a global common good, namely the reduction of CO2 emissions.

### Jacques de Larosière

Jacques de Larosière thanked Tuomas Saarenheimo (Chair) for his questions and asked to isolate "virtuous" expenditures in terms of investments or ecologically. Jacques de Larosière agreed with Harald Waiglein. If there is a manageable pedestal and someone adds a "virtuous statue" for positive items, such as ecological ones, the addition will create a worse macroeconomic problem than the one that existed before. Therefore, taking more virtuous actions means cutting back some of the less virtuous ones that are presently absorbing the fiscal potential.

Customisation is absolutely indispensable because the 60% and 3% rules are not taken seriously by the nations when they are too general and come from outside. They are considered an intrusion. Therefore, it is necessary to tailor make the system for it to work.

The last question is very good. It is the question of whether, in doing so, political power is given to a technocratic fiscal authority. Jacques de Larosière stated that he diverges from what others have said on that point. He highlighted matters as different as article 4 by the IMF or the way the CEO oversees the budget and criticises executive power in terms of public expenditure in the United States. There is much to glean from these experiences. Jacques de Larosière highlighted Harald Waiglein's point that countries would want to staff this organisation with their own nationals. When Jacques de Larosière was at the IMF and one wanted to nationally staff the article 4 matters, he offered his resignation. It is intolerable. Economists have to be there and do the work.

Jacques de Larosière explained that the system is complex, but so is the reality. In order to understand the situation of a country like France in terms of its fiscal compliance, it is necessary to study the subject in a comprehensive way. Therefore, it is necessary to have this dialogue like the one for article 4 with an independent institution. If the country refuses to hear the macroeconomic intelligence behind the discussion at the end of the exchange of views, this is not going to work. The peers of that country will rebel. Therefore, eventually the economic situation dictates political rule. It is a Socratic discussion leading to a quantum of realism. This is a better position than having a few external arithmetical rules that will never be applied.

### Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) thanked Jacques de Larosière for his contribution. He summarised that the rich discussion is not simply about fiscal rules. It is not about the 3% and 60% figures; it is about much more. It is about ownership, the willingness of countries to internalise the European fiscal framework into their own domestic processes and promoting transparent discussion on fiscal issues. It is also embedded in the broader discussion in the future of European fiscal cooperation. Tuomas Saarenheimo (Chair) thanked the panellists and closed the session.