Píldora 5: The Stability and Growth Pact revisited

1. What's new in the revisited SGP pact

The Commission communication COM (2004) 581 final, on "Strengthening economic governance and clarifying the implementation of the Stability and Growth pact" contains the following major new elements:

i. Surveillance of the budgetary positions will focus more on government debt and debt sustainability. In particular a reference rate for the satisfactory pace of debt reduction will be set up for highly indebted countries. It will take into account country-specific circumstances like the impact of ageing and contingent liabilities, the initial debt level and the potential output growth conditions.

ii. When defining the medium-term deficit objective of 'close to balance or in surplus' or the path to achieve it, greater consideration will be given to country-specific circumstances. Deviations from its achievement will be assessed in light of national debt levels, potential output growth, inflation, existing liabilities related to ageing populations, the impact of structural reforms carried on. The need for additional net investment could be considered.

iii. Country-specific circumstances will also be taken into consideration for the definition of the adjustment path to correct excessive deficits, the related deadlines will be fixed according to the cyclical position and debt levels of the economy under scrutiny. Moreover, the exceptional circumstances clause will be modified in order to include protracted periods of sluggish economic growth.

iv. The preventive side of the action to avoid budgetary imbalances will be strengthened implying: (i) running symmetric fiscal policies over the cycle to both prepare for the ageing of the population, and create sufficient room of manoeuvre for the full working of automatic stabilisers; and (ii) using the BEPG more effectively to prevent pro-cyclical policy in good times.

v. The surveillance of fiscal policies will be encompassed in a broader perspective in the sense that economic and budgetary policies need to set the right priorities towards economic reforms, innovation, competitiveness and strengthening of private investment and consumption linking them to the wider macroeconomic goals of the EU, including the Lisbon strategy. Therefore, more emphasis will be put on the growth and employment enhancing role of public finances. This calls for a better coordination between the BEPGs, the SGP and the national budgetary processes. A revision of the economic calendar is proposed.

2. Assessment

i. We should welcome the Commission's call for the use of more judgement and a greater discretion in the implementation of the fiscal rules since has they will be carried on along directions which are consistent with the recommendations from economic theory. This is likely to enhance the legitimacy and enforceability of those rules. In particular, the higher weight given to debt with respect to deficit makes is likely to reduce moral hazard by member states, through fewer incentives for one-off or cosmetic operations just meant to bring deficit below the 3%. However, the partial shift from rules to discretion is not guarantee for greater consideration of policy concerns in the reshaping of the fiscal framework. There is not necessarily an equivalence between rules and stringency, on the one hand, and discretion and loosening, on the other. The dilemma between strict observance of rules and reasoned exercise of discretion is more apparent than real: (i) rigid adherence to rules in circumstances that call for the use of judgement and some discretion is inimical to the very existence of the rules themselves; and (ii) the longevity of rules in economic policy depends on the ability to adapt them when conditions warrant.

ii. The stronger emphasis on the growth enhancing role, long-term sustainability and country specificities paves the way to ask for considering, within the implementation of the budgetary surveillance, the total amount of *human capital*-enhancing spending[1], like *education, training and ALMPs*, which improves the future macroeconomic performance in terms of productivity, growth and employment thereby helping to cope with the ageing issue. If those policies are properly targeted to older workers they delay the actual exit age from the labour market, leading to a direct relief for pension systems. Moreover they help to prevent skills mismatch in the labour markets. Higher flexibility in the close to balance budget target, or in the path for excessive deficit correction (if not even in the threshold relevant for the latter) could be allowed when a significant share of GDP devoted to government expenditure – namely capital formation, including human capital – fall in the above items.

iii. One should ask for a different approach in the assessment of the quality of public expenditure under which social expenditure could be no longer regarded as unproductive. Looking at spending aggregates which are arbitrarily defined as productive or unproductive is inappropriate. Therefore, one should stress that every type of public expenditure can be more or less productive, depending on whether it meets real needs in the most cost effective way. Moreover, the social returns of policies against poverty (in terms of e.g. lower criminality and health care costs) should be recognized.

iv. In the area of social expenditure, incentive effects are particularly important. This touches upon the issue of making work pay and the degree to which tax-

[1] We must avoid any approach that looks at the share of such spending in overall public expenditure as this will be distorted by the choice between public and private pension and health care provision. However, it would more make sense to look at the share of GDP devoted to capital formation (including human capital).

benefit systems provide the right incentives for unemployed people to take up even low-paid jobs, for workers to progress towards better paid jobs (through the right level of marginal effective tax rate), or for workers to remain longer on the labour market. An interesting example of the complexity of the issue is the size of unemployment benefits which is shown to be negatively correlated with employment protection legislation in the Western countries. Higher spending on such benefits appears to be more efficient than employment protection legislation in facilitating structural change, enhancing economic performance and raising employment. Clearly the emphasis between the two policy tools is also a matter of Member States' preferences and traditions and there is no national model that should be systematically adopted by the other countries. Still, this evidence shows that an approach relying on supposedly unproductive expenditure can be more efficient than an approach which does not show up in public expenditure at all.

v. Regarding future liabilities linked to ageing, it is important to avoid a too narrow view. Considering only the total amount of implicit liabilities (present value of the future stream of pension payments that would be due according to current legislation) is not sufficient. This will be high for countries which rely primarily on public pension provision, but these countries are generally also able to raise more revenue for such schemes (need to consider acceptance of contributions/taxes for financing public pension schemes). So the revenue side also needs to be considered. It is also important to take into account the adequacy situation: countries with generous pension systems (high replacement rates available at a relatively young age) have room for manoeuvre and can reduce future liabilities more than countries where benefits are already low (two contrasting examples could be Greece and the UK). Finally, room for manoeuvre might come from the increase in employment rate, as long as a country is willing to carry on the necessary policies to prompt it. Similar considerations can be applied to the area of health and long-term care where ageing is also expected to lead to increased expenditure (although this is even more difficult to quantify than pensions' expenditure).

vi. A more sophisticated analysis of a country's ability to cope with the impact of ageing will be required in the framework of revised Stability and Growth Pact. Currently, the assessment is too much based on simple projections of public spending without taking into account any of the considerations mentioned above. The OMC on pension and health/long-term care will have to play an important role in developing a more comprehensive assessment of the long-term sustainability of the social protection systems.