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With the gradual exit from the pandemic and the strengthening of the recovery, the end of the suspension period of the Stability and Growth Pact is approaching. By the end of the year, the European institutions are expected to decide whether to reinstate the Pact as it was or to modify it, more or less profoundly.

In recent months, several arguments have been made in the academic, political and institutional world in favor of a profound change of the Pact. The reasons are many. The Pact is too complex and has not achieved its objectives, such as a sufficient reduction of public debt. The Pact is also criticized for its excessive pro-cyclicality (overly expansionary fiscal policy during the high growth periods and overly restrictive policies during the slowdown), the constraint on public investments, the lack of transparency of the procedures and the complexity of the rules. Finally, the change would be necessary because the post-Covid world will be different from the pre-pandemic one, with persistently low interest rates, a much higher public debt in all countries and the creation of the NextGenerationEU, which prefigures the core of an increasingly integrated European budgetary policy, financed with own resources and with a common debt instrument.

In this paper, I will focus on the proposals for reforming the Stability Pact, leaving aside other partly related issues concerning the creation of a European budget and the joint issuance of debt, the transformation of the NextGenerationEU into a permanent facility or the refinancing of the debt acquired by the ECB through another Community institution.

The discussion on the reform of the Stability Pact presents at least three risks. The first is a misdiagnosis, which would lead to reforming the Pact without really solving the problems. The second risk is that of implementing changes that produce pejorative effects compared to the current situation. The third risk is that the reforms will not be in line with the spirit of the treaty and will be rejected politically. If these risks are not properly taken into account, the reform could turn out to be worse than the current system.

1. Avoid a misdiagnosis

Before reforming the Stability Pact, as has already been done at least twice in the past, we must start by understanding what went wrong. In this analysis, we should avoid the mistake of assuming that there is one scapegoat for all public finance problems in Europe. This is a fairly common mistake when public institutions are involved. The most recent example is the revision of the monetary policy strategy carried out by central banks, which raised a great deal of debate. The reform promised much but delivered little because the problem was not so much the strategy itself, that is the so-called inflation targeting adopted in the past by the monetary authorities, as the way in which the central banks have applied it over time, including the large forecast errors about inflation. As recent events show, the change in strategy did not prevent forecast errors nor late decisions.

Returning to the Stability Pact, we must ask ourselves whether the problems related to budget deficits and debts are due to the Pact itself or to the way in which the Pact has been interpreted and implemented so far, in particular by the European Commission, the Council of the European Union and the Member States.

Take for example the critique of pro-cyclicality that is often leveled at European fiscal policies. Is pro-cyclicality due to the Stability Pact or rather to the way in which the Pact has been applied? If we want to change the Pact, we must first demonstrate that it is not possible to apply it in a different, less pro-cyclical way. Various examples demonstrate the opposite.

The excessive deficit procedure launched against Germany and France in 2003 is a case in point. The European Commission believed that the two countries were in excessive deficit, having both exceeded the reference threshold of 3%, which had to be corrected within the following year. The Council of the European Union, on the other hand, considered that the adjustment could take place in two years, given the particularly adverse economic conditions. That was an obvious case of different interpretations of the Pact by two European institutions. The Council voted against the Commission. History proved that the Council was right because the European Commission's interpretation was excessively pro-cyclical, with too restrictive an adjustment in a phase of low growth.

The reform of the Pact of 2005 made it possible to make the risk of pro-cyclicality more explicit and transparent, and to take into account the economic situation, the reforms in progress and the sustainability of the debt in the assessment of the fiscal adjustment. The criterion of the structural budget balance was therefore introduced, which excludes the effects of the economic cycle on public revenues and expenditures. A problem with that reform was, if anything, to give the European Commission almost exclusive competence over this assessment, reducing its transparency and exposing the institution to criticism of excessive discretion (European Fiscal Board, 2019).

Another example of pro-cyclicality in the implementation of the Pact is the European Commission's request for excessive and premature correction of the budget deficits in 2010, reversing the 2009 recovery plan (Blanchard, 2021). With hindsight, it is clear that that recommendation did not adequately take into account the fragility of the economic recovery in a deteriorating financial context, resulting from the contagion of the Greek crisis. In the face of the Great Recession of 2008-09, the European Commission and Member States could have used the Pact differently, allowing for more time before cutting the budget deficits in the face of a still uncertain recovery. In fact, the 2005 reform of the Stability Pact invited the European Commission and the Council to take into account in their assessment the possibility of a "severe economic recession". This possibility was nevertheless discarded, although the episode went down in history (also for Wikipedia) under the name of "Great Recession". It was clearly a judgment error.

One can certainly learn from past mistakes, as the recent decision on how to tackle the 2020-21 crisis shows. It is no coincidence that the Communication from the European Commission to the Council of March 3, 2020 to suspend the application of the Pact refers to the "escape clause" that was introduced *"as part of the Six-Pack reform of the Stability Pact in 2011, which drew the lessons of the economic and financial crisis. Notably, experience highlighted the need for a specific provisions in the EU's fiscal rules to allow for a coordinated and orderly temporary deviation for all Member States in a situation of generalized crisis ... "*

Moreover, the pro-cyclical nature of budgetary policies does not seem to be an exclusive feature of the euro area, especially in growth phases. Larch, Orseau and van der Wielen (2020), for example, show on the basis of a sample of 50 countries that the pro-cyclical nature of fiscal policies is primarily a political economy problem rather than the result of measurement error concerning the structural budget. Pro-cyclicality tends to emerge especially in highly indebted countries and generally derives from non-compliance with fiscal rules. Manasse (2006) points out that pro-cyclicality is often the result of weak institutions, rather than fiscal rules.

Another criticism that is made of the Stability Pact is that it is not transparent. Its current implementation is based on unobservable variables such as the structural budget, which corrects the public finance figure from the effects of the economic cycle. This correction is carried out using estimated variables and complex methodologies, in particular for the calculation of the output gap (the difference between the level of the product and its potential), which can lead to errors and accentuate the pro-cyclical nature of fiscal policies.

Also in this case, as with the inflation targeting of central banks, the question is whether the problem derives from the instrument itself or from the way in which the instrument has been used in practice, in particular concerning growth forecasts.

There are no doubts that assessing the cyclical position of the economy is a very difficult task, being largely based on growth forecasts compared to potential. The main international institutions, from the IMF to the OECD, have adopted their own methodology. The European Commission, for its part, decided, with the support of most countries, to use the more restrictive measure of the output gap, applying a simple statistical auto-regressive method, which accentuates the correlation between the estimate of the potential growth rate and the cyclical position. The result is to underestimate, more or less voluntarily, the size of the output gap. Again, part of the problem lies in the way the Pact has been interpreted over the years. An alternative solution would be to use different methodologies, perhaps with confidence intervals as suggested, for example, by Blanchard (2021) for the debt sustainability analysis (see below).

In summary, if we want to avoid repeating the mistakes of the past in the management of European public finances, the most efficient solution may not necessarily be to abandon the Stability Pact, but rather to try applying it better.

2. Do no harm

Before changing the structure of the Stability Pact, one should be convinced that the reform proposals produce better results.

The exercise is not trivial, for various reasons. The first was explained above and concerns the fact that any scheme depends on how it is used and implemented by the "operator", i.e. the European Commission and the Member States. The second reason is that besides the general criticisms, such as the lack of transparency and the excess of pro-cyclicality, each reform derives from different assessments and objectives. There is no need to deny that some proposals aim to impose greater discipline on some countries, in particular those with high debt, while others aim to allow more expansionary fiscal policies. The third reason is that, as Lucas (1976) teaches us, it is difficult to compare different rules and procedures without taking into account the incentives that these rules create among economic agents, in this case public authorities. A rule may seem better ex-ante but then be less efficient ex-post once agents adapt to it and exploit its full potential.

The reform proposals focus largely on simple rules, mainly concerning current expenditure and debt sustainability. Both rules are already part of the surveillance procedure included in the Pact.[1] It is therefore a question of understanding whether there is an advantage in giving almost exclusive pre-eminence to one of the two rules, ignoring the other indicators such as the structural budget balance (Darvas and Anderson, 2020) or the reference to particular situations such as the implementation of reforms or cases of severe exogenous shocks. These proposals go in the opposite direction to that of the last 20 years, which tried to reduce the "stupidity" of the overly simple rules of the Stability Pact, to paraphrase the then President of the European Commission, Romano Prodi, by introducing parameters allowing for a broader assessments of the different economic situations in the Member States.

The risk of the Stability Pact becoming "stupid" again should not be underestimated, for various reasons. The first is that reality is a bit more complex than the economists' models, often based on simplifying assumptions. The subsequent reforms of the Pact have made it more complex not by the will of a

[1] Article 5.1 b) of the Six Pack says: *"For Member States that have not yet reached their medium-term budgetary objective, annual expenditure growth does not exceed a rate below a reference medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures."(...) "The expenditure aggregate shall exclude interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure."*

perverse mind but in order to capture the complexity and diversity of the situations to which applies. Furthermore, the goal of the Stability Pact is to assess whether a country's budget law represents a "gross error" and whether it produces negative externalities on the rest of the Union. To convince national governments and parliaments that they have made a gross error with their budget law perhaps requires a little more than an equation or a simple rule.

In any case, the rules should be analyzed carefully.

The rule setting a ceiling on current expenditure entails a series of problems. First, it is based on growth forecasts, which are just as difficult to formulate and involve the same risks of errors as those involved in the estimate of the output gap used to calculate the structural balance. To avoid that the rule is pro-cyclical, the expenditure ceiling needs to be adjusted for the effects of the economic cycle, using estimates of the elasticity of expenditure with respect to the cycle, or by classifying the various expenditure items according to their sensitivity to the cycle or according to investment objectives (such as the so-called “spending for the future”, Giavazzi et al, 2021). The task may look simple on paper, but risks being very complex and not very transparent. It is easy to foresee lengthy discussions between the Member States and the European Commission to include the expenses in the most convenient segment in order to circumvent the rule, with the result of increasing the degree of discretion and the risk of errors. It is the same problem that has so far made it difficult to implement the proposal to exclude public investments from the calculation of the deficit, according to the so-called Golden Rule.

In practice, a rule based on an expenditure ceiling can be more restrictive in the face of exogenous shocks and prove to be more pro-cyclical than the current system. For example, the budget deviation decided by the Italian government on February 17, 2020 to cope with the expensive bills, financed through the "treasury" obtained by higher-than-expected growth, would not be consistent with the spending rule, unless offset by a reduction in other expenses or by an increase in revenue. In the current Pact, however, this measure could fall within the flexibility margins granted by virtue of the cyclical position of the Italian economy, which has not yet recovered the pre-crisis level of income.

The second proposed rule is based on debt sustainability. Even in this case, however, non-observable variables are used, such as long-term growth forecasts, the structure of interest rates and projections relating to budget revenues and expenditures and their impact on the economy. Forecast errors can be significant, as can be seen from the experience of international institutions, such as the IMF. Experience shows that decisions on a country's debt sustainability have a strong discretionary component. An example is the assessment of the sustainability of the Italian debt carried out as part of the Convergence Report of the European Monetary Institute, which changed in a few hours in the night between March 24 and 25, 1997 (Battocchi, 2021).

Furthermore, the assessment of debt sustainability is subject to the well-known problem of multiplicity of equilibria. An interest rate shock, for example, can produce uncertainties on debt sustainability, which can further increase country risk with spiraling effects. Publishing data on a country's debt sustainability could trigger self-fulfilling market dynamics. To overcome this problem, Blanchard (2021) proposes to carry out probabilistic analyses, using fan charts. However, it is not clear how this would contribute to the transparency of the process or to avoiding errors of judgment.

Moreover, the debt sustainability criterion is not immune from the pro-cyclicality problem, since an unexpected cyclical slowdown or an exogenous increase in interest rates can worsen debt sustainability in the short-to-medium term and require premature corrective budgetary measures. For example, the increase in the level of interest rates at medium and long maturities recorded on Italian government bonds, by more than 100 basis points in the last 6 months, should, if the rule was applied automatically without discretion, lead to increase the primary balance necessary to bring the trajectory of public debt back to a sustainable dynamic.

In summary, before changing the current system for assessing the Member States' public finances and restricting the field of analysis to a single rule, we need to be sure that the advantages outweigh the shortcomings. Otherwise, it may be preferable to try improving the way the existing framework is implemented, also based on the experience gained so far.

3. Respect the Treaty

The third aspect to be taken into consideration in assessing the proposals for reforming the Pact is the consistency with the spirit and letter of the Treaty. We should not forget that budgetary policy, in particular decisions concerning the composition and level of expenditures, taxation, the deficit and public debt, are the responsibility of the Member States. The Treaty puts limits on the exercise of national sovereignty only to the extent that national policies produce negative externalities on the Union and other members. To this end, the Stability Pact distinguishes the powers conferred on the Union to identify and sanction "gross errors" in the conduct of budgetary policies (corrective arm) from the powers to prevent such "errors" through recommendations (preventive arm).

Some reform proposals risk being in contrast with the spirit of the Treaty to the extent that they give to the Union new powers, in particular by transforming powers of recommendations into powers of approval and validation of national budgets. This occurs in particular when the approval and sanctioning powers of the Union (European Commission and Council of the European Union), granted as part of the corrective arm of the Stability Pact, are extended to the preventive arm of the Pact. An example in this sense concerns the proposal that high-debt countries agree their adjustment plans with the European Commission, on the basis of binding trajectories (Martin et al, 2021 and Bordignon and Pisauro, 2021), which must be submitted to the approval of the Council. The proposal gives the Council the power, not currently envisaged by the Treaty, to validate the budget laws of Member States. The proposal is motivated by the objective of limiting the incentive that governments and national parliaments have to adopt "opportunistic behavior" in drafting budget laws (Amato et al 2021). However, the European Union is not entitled to use its powers to limit this type of behavior in Member States, but only to prevent the Member States' budget policies from creating problems for other countries and for the Union as a whole.

The issue is not only institutional but also political. No national government or parliament would currently agree to empower the Council of the European Union to validate or invalidate its budget laws. This transfer of competences cannot take place in a "creeping" way, without a modification of the legal and constitutional texts. Such a move would risk fueling anti-European reactions, with the opposite result to the desired one.

Another risk is that, once reformed, the Stability Pact will, de facto, become applicable to only a sub-group of countries. This would violate the principle of equal treatment, which underlies the legitimacy of the Pact and the acceptance of the transfer of sovereignty from the Member States to the Union. Equal treatment does not mean the same judgment and recommendations for all countries. It means that the procedure, in its corrective and preventive arms, is applied to everyone. In fact, the implementation of the Pact determines a greater adjustment for high-debt countries, especially in periods of higher growth, and allows to take the different conditions into account, in particular concerning the implementation of reforms.

One of the greatest risks for the legitimacy of the European institutions is that their action is perceived as an interference in the democratic functioning of some countries, but not of others. Without reference to a general framework that guarantees the principle of equal treatment, the application of the Pact - or even the public perception that the pact is applicable - to high debt countries only, poses a serious problem of legitimacy. To which countries would the new procedure or rules apply, and according to what criteria? What debt/GDP threshold would trigger the procedure? If it is 130%, for example, according to the data at the end of 2021 only Greece and Italy would be subjected to the procedure; on the other hand, if the threshold was raised to 110%, Belgium, France, Portugal and Spain would also be included. Who would make this choice and on what basis?

From Italy's point of view, the risk of abandoning the general surveillance framework in favor of separate rules for each country, or which are applied only to a limited number of countries, must be carefully assessed. The democratic legitimacy of this new facility could be seriously undermined.

What should be done?

Is it conceivable to reintroduce the Stability Pact, as it is, without any reform, when the suspension comes to an end?

An obvious problem concerns the numerical references contained in the Treaty and in the Regulations, in particular the 3% for the deficit to GDP ratio and 60% for the public debt ratio, in addition to the one twentieth per year effort required reduce the debt. As a result of the pandemic crisis, the Italian debt has risen to 150% of GDP, 90 points above the 60% threshold. A debt reduction by one twentieth a year would require an adjustment of 4.5 points of GDP per year, which is difficult to achieve. This is the reason why a change in the Stability Pact is being requested.

In reality, the issue is somewhat different, for various reasons.

The first, explained above, is that the Stability Pact is not a set of fixed rules, but a procedure for assessing whether public deficits are excessive. The second reason is that the numerical criteria are "reference parameters" on the basis of which the procedure is triggered, which takes a series of factors into consideration, including "the effects of the cycle on the pace of debt reduction," the possibility of "a severe economic recession," "the net savings position of the private sector," "the primary current and capital account expenditure," "the implementation of policies in the context of a common growth strategy of the Union," " the overall quality of public finances," "developments in the medium-term public debt position, its dynamics and sustainability, including in particular the risk factors." In other words, the current procedure already provides for an in-depth analysis of the country's economic situation, which makes it possible to take the effects associated with the pandemic crisis into account, including the increase in debt. It also allows, as shown above, that the increase in the debt produced in the context of the NRRP be treated separately.

The flexibility of the procedure is confirmed by past experience. In the years preceding the crisis, the 1/20 parameter was used as a reference, not as an absolute rule. From 2014 to 2019, for example, the Italian public debt fell from 135.4 to 134.6% of GDP, which corresponds to a rate of 0.2 points per year, well below the 4 points envisaged, without incurring penalties. If the method of analysis remains the same, once the Pact is reintroduced, the increase in the benchmark from 4% per year to 4.5% should not lead per se to major changes in the implementation.

The procedure followed to validate the debt relief is criticized not only for its excessive rigor but also for the excessive discretion granted to the European Commission, in particular in the excessively "political" application of the "general escape clause" provided for by the Pact (European Fiscal Board, 2019). Especially towards Italy, which is the only country that has not significantly reduced its debt. In the five-year period considered, from 2014 to 2019, Belgium reduced the debt to GDP ratio by 9 percentage points (from 107% to 98%), Portugal by 13 points (from 130% to 117%), Spain by 5 points (from 101% to 96%).

There is no doubt that behind some proposals to modify the Stability Pact, in particular those based on simpler rules and with few margins of flexibility, lies the objective of reducing the Italian public debt more rapidly. However, it may be questioned whether this objective is more easily achievable through a change of the Stability Pact's, with the risks identified above, or through a different application of the Pact less discretionary and more transparent, aligning the margins of flexibility granted to the effective control of the commitments, for example in terms of reforms. In fact, if the application of the Pact has lost credibility, this is mainly due to the divergence between the conditions set for the use of flexibility and the verification of their implementation.

In conclusion, the greatest risk in the discussion on the reform of the Stability Pact is to believe that the change of some of its elements, and the adoption of a few simple rules, could relieve the European institutions, i.e. the Commission and the Council of the European Union, from the responsibility of analyzing, assessing and explaining why a country's fiscal policy creates a problem and needs to be corrected. It is not possible, nor advisable, to artificially simplify a complex issue such as that of the public budget, which is at the heart of a country's political choices. The risk of making serious mistakes, such as those already committed in the past, with damage to the credibility of the institutions, could increase. As the recent experience of central banks shows, credibility is not regained simply by changing the tools or the strategy but rather by demonstrating that they can be used better. Changing for the sake of change risks losing the credibility that is left.

The discussion on the reform of the Pact could have been set up in a different way. Rather than asking for contributions and proposals from various parties, the European Commission could have prepared an analysis of the extent to which the Stability Pact, applied in light of the experience acquired, represents an obstacle to the achievement of the shared public finance objectives in the post-pandemic phase. From the statements made so far, it is clear that the priorities for the next few years will be to increase public investments and favor differentiated, realistic and conditional debt reduction paths. It is not clear why the current version of the Stability Pact should be an obstacle to achieving these objectives. Provided, of course, that there is political will on the part of the EU institutions and Member States. In the absence of such will, no reform of the Pact can solve the problem.

Post Scriptum

It is surprising that in the public debate on the reform of the Stability Pact there is no reference to one of the main public finance problems which has affected the euro area in recent years and which is likely to remain in the coming years. Indeed, there is no discussion of the negative externalities that can arise from an excessively restrictive adjustment of a country's public finances. The Pact assumes that only excessive deficits can create negative externalities. This stems from the fact that most countries were in deficit at the time the Treaty was negotiated. It is well known in the literature, from Keynes onwards, that even overly restrictive policies, and in particular persistent budget surpluses, especially in systemic countries, can have undesirable effects on the rest of the Union.

The most emblematic case is the German constitutional rule which obliges the country to be systematically in surplus, except in conditions of severe recession. The implementation of this rule has led the German budget to accumulate a growing surplus and a rapid decline in public debt, from 76% of GDP to 59% in the above five-year period. This has resulted in an excess of savings which has translated into a surplus of the current account balance of over 8% of GDP every year. The fiscal tightening has had a deflationary effect across the Union, overloading monetary policy with respect to its price stability objective.

The recurrence of such behavior in the post-pandemic period risks creating strong divergences in the dynamics of public debts. According to IMF forecasts, Germany's public debt should return to 60% of GDP by 2026, which was basically the pre-crisis level. By that time, the euro area average debt should instead be higher than its pre-crisis level by about 9 points. Italy's debt is expected to be around 12 points higher, France's 19 points and Spain's 22 points. For comparison, in 2026, US debt is expected to exceed the pre-crisis level by 27 points of GDP, that of the United Kingdom by 26 points.

Consequently, the gap between the supply of German government bonds and those of other European countries is expected to rise significantly in the coming years, putting relative yields under pressure. This can become a factor of financial tension within the Union.

It is certainly not easy to revise the Stability Pact to ensure greater adjustment symmetry. However, it is difficult to understand why this is not being discussed at all.

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