Comment: Saving the stability pact from itself

By Tito Boeri and Guido Tabellini

At their meeting in Scheveningen, the Netherlands, the EU's economic ministers (Ecofin) once again confronted the need to reform the Stability and Growth Pact (SGP). The issues surrounding reform remain controversial and unsettled, but this time, the ministers laid their cards on the table.

The SGP's fundamental problem is that it must strike a balance between two contradictory goals: it must retain bite against excessive debt accumulation, yet it must also give governments more maneuvering room to enact structural reforms and restore Europe's competitiveness. As it stands, the SGP is an obstacle to such reforms. European leaders waste political energy and capital to meet demanding budget targets, while nothing is done to address the really vital challenges: aging populations, high tax burdens, declining competitiveness.

The reason is that structural reforms tend to pay off in the long term, but cost money in the short term. The SGP originally aimed to protect European citizens from myopic governments, but it has ended up forcing even more myopic behavior.

Take pension reform, which aims to reduce the scope of state-run, pay-as-you-go systems and expand private, fully funded schemes. This requires cutting compulsory contributions to the public system, while maintaining benefit levels for current retirees. The result is a temporary increase in budget deficits; the fiscal benefits appear only when private schemes start taking over pension liabilities from the state-run systems. But the SGP's current rules discourage this kind of reform by prohibiting temporary increases in the budget deficit - even if they promise long-term fiscal consolidation.

European policymakers are becoming aware of the problem. Some EU countries - particularly new members in Central and Eastern Europe - have committed themselves to use privatization receipts to finance pension reform. But even this may not be enough to cover the cost.

To overcome the SGP's bias against structural reforms, the European Commission asked at this last Ecofin meeting for more discretion and to put more emphasis on (explicit) debt: countries with a lower debt-to-GDP ratio would have greater freedom in fiscal policy. Economic ministers suggested that pension reform and long-term fiscal sustainability should also guide country evaluations under the SGP, while some countries insisted that it should be linked to the Lisbon agenda. This would give more flexibility on budget deficits to countries that are making progress towards meeting the agenda's reform targets.

Some of these innovations would be useful. But they risk giving too much discretion to the Commission or to future European Council decisions. The rules-based approach of the SGP is fundamentally sound, but it requires operational criteria that can be defined with some precision. Otherwise, the rules become unenforceable.

Consider the proposal to link the SGP to the Lisbon agenda, which contains more than 100 indicators. What happens if a country makes progress in one dimension, but regresses in another dimension? Inevitably, the Commission would have to decide the relevance of the different indicators - thus intervening in the national policymaking process with no political legitimacy. At the same time, if so much

unchecked discretion was left to the Council, rather than to the Commission, "peer pressure" to restore budget balance might easily turn into "peer protection."

So, can the SGP be made to work in favor, rather than against, structural reforms, without abandoning the rules-based approach of the SGP? We think so. The key is to select some comprehensive but operationally precise indicators of structural reforms, and then apply the same idea suggested by the Commission for public debt: countries that are making more progress on these indicators can get more leeway on their budget deficit.

An obvious indicator that would meet this purpose is the implicit debt of public pension systems – i.e., the present discounted value of all future pension expenditures under existing legislation. Future deficits could, in theory, be reduced through higher contributions, but social security contributions are already far too high in Europe, inhibiting job creation and economic growth. The only way to restore growth without compromising the future is through pension reform that reduces future outlays from the state-run system.

Of course, any estimate of the implicit pension debt requires caveats and arbitrary assumptions. But so does the SGP's current implementation – for example, in the conventions that define how budget deficit are measured and what qualifies as government revenue. Moreover, the Commission has already worked to harmonize the assumptions needed to forecast public pension outlays and achieve cross-country comparability. Finally, to strengthen cross-country comparability further, the benchmark should be variations in the stock of pension debt under given economic and demographic assumptions, rather than the debt level itself.

There is also a more fundamental reason to focus on future variations in the stock of pension debt associated with pension reforms: the EU has no business interfering with pension liabilities of individual member states. Why should the rest of Europe care if, say, Spain preserves a generous pension system?

The extra focus on implicit pension debts would also help to inform citizens. Surveys reveal that most European citizens are not fully aware of the extent of intergenerational redistribution. Many even believe that their contributions accrue to an individual, capitalized, account, rather than financing the benefits paid to current pensioners.The good news is that these surveys () suggest that better-informed citizens are more supportive of reforms and official estimates of the implicit pension debt would increase the transparency of the intergenerational redistribution implicit in pay-as-you-go systems. Thus, governments stand to gain stronger political support for reforms that cannot be postponed any longer.

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