What to Expect from the Latest Reform of the Stability and Growth Pact

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Before the crisis hit, many euro area countries had failed to create sufficient fiscal room for times of economic difficulty, which made a new reform of the Stability and Growth Pact inevitable. Above all, this most recent reform introduces an expenditure rule in the preventive arm of the pact, operationalizes the debt criteron in the dissuasive arm and imposes stricter sanctions in case of noncompliance. The reform strengthens the preventive arm by making it easier to measure compliance and launch procedures as well as by introducing symbolic sanctions. While the introduction of the debt rule certainly tightened the conditions of the dissuasive arm for highly indebted countries, it remains to be seen by how much, given the large number of exceptions. Notwithstanding the new voting procedure (which is designed to make it more likely that sanctions are in fact applied), we doubt that economically significant penalties will be imposed in the foreseeable future.

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The reverberations from the global financial and economic crisis have highlighted the importance of fiscal policy coordination in EMU: Given the high degree of financial integration and the looming risks of sovereign default, there is the risk that the difficulties some member states face in sustaining their public finances may spill over to the entire monetary union. This increases the probability of bailouts of countries in distress, which in turn increases the moral hazard problem.[2]

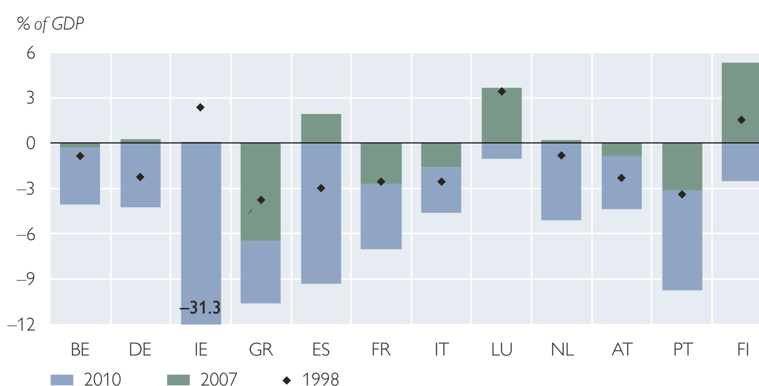
Against this background, this article addresses the most recent reform of the Stability and Growth Pact (SGP).[3] Section 1 discusses the shortcomings existing before the reform, while section 2 summarizes the most important changes made. Section 3 highlights the economic policy intentions behind these changes and provides an assessment of their implications, also taking into consideration the outlined shortcomings of the previous SGP. Section 4 summarizes our main findings.

1 Problems with the Previous SGP

Some of the problems encountered by Greece were of a statistical nature (massive ex post revisions of Maastricht deficit figures) and thus at least in part outside the scope of the SGP,[4] but many

Chart 1

Budget Balance (Maastricht)



Source: European Commission.

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[2] *The high level of financial integration in a monetary union increases the danger of individual member countries defaulting due to self-fulfilling prophecies (e.g. De Grauwe, 2011).*

[3] *The regulations in place for non-euro area countries are not analyzed.*

[4] *This aspect is increasingly taken into consideration as a result of the most recent reform, though (section 2.4).*

Chart 2

Public Debt (Maastricht)

% of GDP

Source: European Commission.

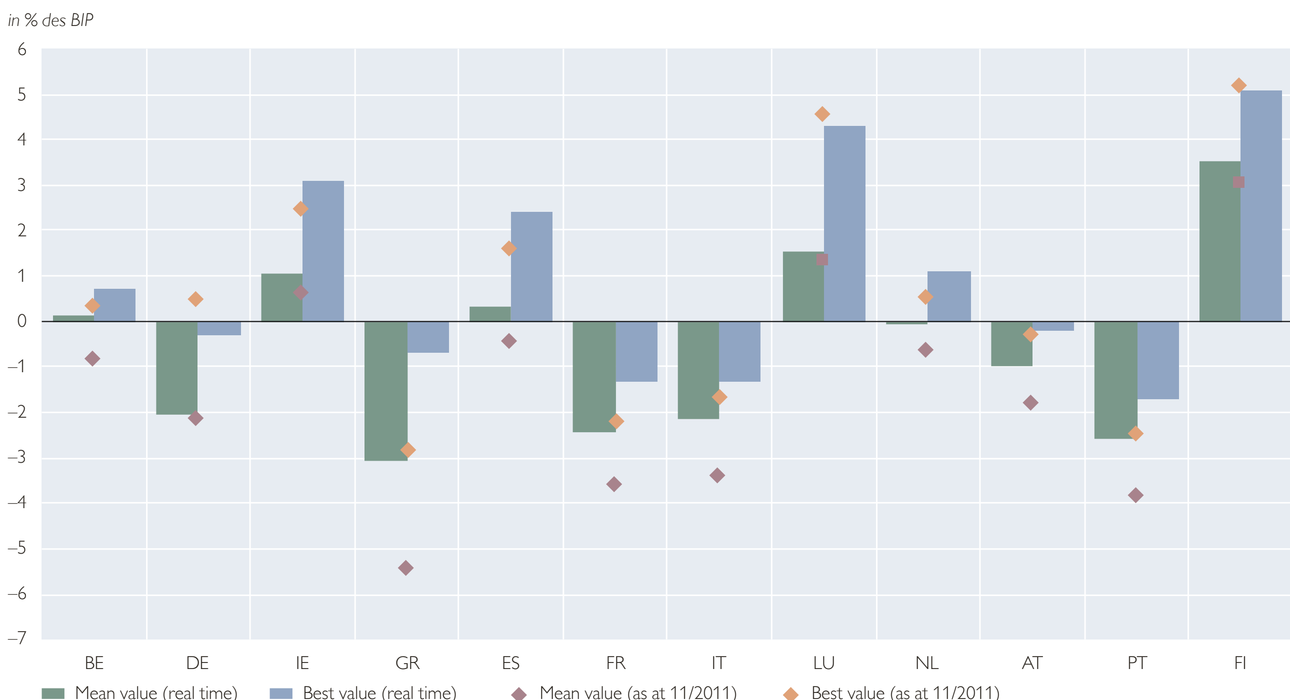
other negative fiscal developments in the euro area can be traced directly to shortcomings of the SGP.

– While the requirement that the deficit ratio must not exceed 3% (chart 1) was broadly fulfilled in the precrisis years, most euro area countries failed to achieve the medium-term objective (MTO) for the structural balance[5] specified in the preventive part of the pact.[6] Austria, for instance, has never achieved its MTO of a balanced structural budget (chart 3). Therefore the fiscal positions of many euro area countries allowed very little leeway for discretionary anticyclical policy measures. This situation was further

Chart 3

Cyclically Adjusted Budget Balance (Maastricht) 1999–2007

in % des BIP



Source: European Commission, spring forecasts (2000 to 2008), autumn forecast (2011).

[5] *The structural balance is calculated by adjusting the budget balance for cyclical factors (the result of this step is the cyclically adjusted balance) and certain one-off effects.*

[6] *In the first version of the SGP, the MTO was zero for all countries; the reform in the mid-2000s introduced country-specific MTOs, but specified that the structural deficit in euro area countries must be no higher than 1% of GDP. At present, Austria (like many other euro area countries) has an MTO of a balanced budget.*

exacerbated by measurement problems: For example, the structural budget balances of Spain and Ireland were significantly overstated in the precrisis years, as too little attention was paid to the fact that the growth of government revenues was driven by the real estate bubble and thus not sustainable in the long run.

– While the average debt ratio of the euro area countries declined until the onset of the crisis (chart 2), highly indebted countries like Greece and Italy failed to reduce their debt ratios even before the crisis hit.
– The fiscal difficulties can be traced above all to the incomplete enforcement of the SGP, that is, to the countries' lack of commitment to the SGP. No financial sanctions were imposed in the dissuasive arm of the pact (Diebalek et al., 2006), and only one early warning was issued (to France in January 2003[7]) despite repeated instances of noncompliance with the preventive arm in the euro area (European Commission, 2011b).

2 Main Changes to the SGP

The most important changes to the SGP are the implementation of an expenditure rule in the preventive arm, the introduction of an explicit debt rule in the dissuasive arm as well as additional and earlier sanctions in both parts.[8]

2.1 Implementation of an Expenditure Rule (Preventive Arm)

The preventive arm of the SGP (Article 121 of the Treaty on the Functioning of the European Union (TFEU) and Council Regulation No 1466/97) provides for requirements as to the structural budgetary position, i.e. the MTO, and – in case the objective was not met – as to the annual average adjustment path toward the objective. Since the first reform of the SGP in 2005, MTOs have been country-specific and have taken into account the expected cost of population aging and the debt ratio, among other things.

This set of rules is now complemented by an expenditure rule, which stipulates that the annual growth of primary government expenditure (= government expenditure excluding interest payments) must not exceed a certain benchmark. Discretionary measures on the revenue side are taken into consideration, so that the expenditure benchmark rises in case of tax increases and declines in case of tax cuts. By how much government expenditure is permitted to increase in real terms[9] depends on the fulfillment of the MTO at the starting point:

– If a country achieves its MTO, government expenditure may rise at the same rate as potential output.[10]
– If a country fails to achieve its MTO, expenditure growth has to be lower to an extent that ensures an "appropriate adjustment path" to the MTO. For Austria – like most other euro area countries – the benchmark will be roughly 1 percentage point below potential growth.[11] In countries with a small expenditure ratio, expenditure growth will have to be even lower so as to ensure an appropriate adjustment path.

[7] *This step was in fact irrelevant, though, as an excessive deficit procedure was initiated soon afterward.*

[8] *See Diebalek et al. (2006) for a detailed review of the SGP before the reform.*

[9] *Data are deflated using the GDP deflator.*

[10] *In our view, the legal text and the Code of Conduct are somewhat contradictory on this issue; we follow the interpretation given in European Commission (2011a).*

[11] *This corresponds to the value assumed in European Commission (2011a).*

– No ceiling on expenditure growth applies if a country overachieves its MTO – unless there is evidence that the MTO was achieved only thanks to significant revenue windfalls[12] and unless the plans outlined in the current stability programme are found to jeopardize future compliance with the MTO.

The country-specific growth rates will presumably correspond to the mean value of the European Commission's and the Economic Policy Committee's estimations of potential output growth for the past five years, the current year and the following four years.

The expenditure rule does not apply to the following types of expenditure: cyclical changes in unemployment benefits, expenditure offset by revenue from EU funds and expenditure in excess of the benchmark that is automatically offset by revenue increases. A smoothing period of four years is envisaged for government investment, given that its volatility is often very high.

2.2 Operationalization of the Debt Criterion (Dissuasive Arm)

The dissuasive arm of the SGP (Article 126 TFEU and Council Regulation No 1467/97) specifies deficit and debt thresholds in line with the Maastricht definition. While a deficit in excess of the 3% threshold automatically[13] will lead to the adoption of a report under Article 126(3) TFEU (and usually also to the launch of an excessive deficit procedure – EDP), noncompliance with the 60% debt threshold is tolerated as long as the debt ratio is considered to be "sufficiently diminishing."

How big the reduction must be to be considered sufficient has now been specified in the debt rule: When a country's debt in excess of the 60% reference value decreased at an average rate of one-twentieth per year over the previous three years,[14] the pace of debt reduction is deemed satisfactory and the debt criterion is considered to be fulfilled. Other factors that will prevent the preparation of a report under Article 126(3) TFEU and the launch of an EDP are compliance with the debt criterion according to the European Commission's forecast (assuming unchanged policies) or evidence that the benchmark was not met because of negative cyclical effects. In case these criteria are not fulfilled, the European Commission draws up a report under Article 126(3) TFEU, which addresses additional factors such as the composition of stock-flow adjustments[15] (e.g. the disbursement of bilateral financial assistance to euro area countries and the capitalization of financial institutions according to the Code of Conduct (2011); in addition, the accumulation of bonds and deposits is mentioned in European Commission (2011a)); these factors can still prevent the launch of an EDP.

A transitional period with lower requirements is foreseen for countries

[12] *This term is used to describe e.g. the upsurge in real estate tax revenues (above all taxes on transactions and on realized value increases) observed in Ireland and Spain until the mid-2000s. In contrast, revenue shortfalls are sharp decreases in tax revenues that cannot be explained by discretionary measures or cyclical developments.*

[13] *An exception is made in case of small and temporary breaches of the 3% limit due to exceptional circumstances (e.g. a severe economic downturn).*

[14] *The benchmark for a sufficient reduction of the debt ratio b_t will in all likelihood (according to the most recent version of the Code of Conduct) correspond to the suggestion made in European Commission (2011a). It is calculated as follows: benchmark for $b_t = 60\%+0.95/3*(b_{t-1}-60\%)+0.95^2/3*(b_{t-2}-60\%)+0.95^3/3*(b_{t-3}-60\%)$.*

[15] *Stock-flow adjustments (SFA) refer to the factors that lead to changes in Maastricht debt without influencing the Maastricht deficit. Typically, net purchases of financial assets are the biggest SFA item.*

that were subject to an EDP when the relevant Council Regulation was adopted.

2.3 Reform of Sanction Provisions

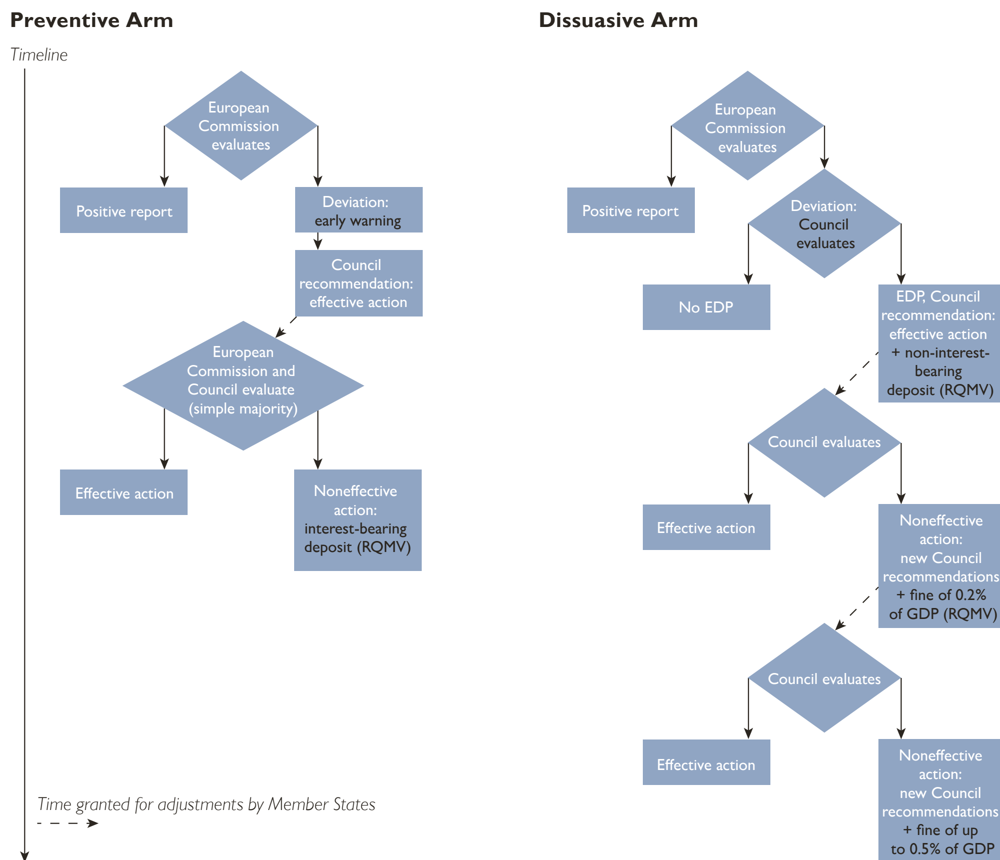
The introduction of new sanctions and the earlier application of existing ones, a strengthening of the European Commission's role in the preventive arm and a limit on the scope of discretion the Council of the European Union (hereinafter referred to as "the Council")[16] has in taking punitive action are the main changes made with regard to procedures and sanctions. Rather than describing the changes in detail, we chose to provide an overview of all regulations in place after the reform.

2.3.1 Stronger Role for the European Commission in the Preventive Arm

As part of the preventive arm of the pact, the European Commission issues an early warning to Member States where significant deviations[17] from the

Chart 4

Stylized Course of Events in the New SGP



Source: Council of the European Union.

[16] *In this contribution, "Council of the European Union" (which is colloquially also called "Council of Ministers") is used synonymously for the Ecofin Council, which is composed of the economics and finance ministers of the EU Member States.*

[17] *Deviations are considered significant when the structural budget balance deviates from the adjustment path by 0.5% of GDP in one year or by an average of 0.25% in two consecutive years. Divergences from the expenditure rule are significant when they have a negative impact on the budget balance of at least 0.5% in one year or of 0.5% cumulatively over two consecutive years. Deviations are not considered significant if they are caused by a severe economic downturn or by unusual events outside the control of the Member State concerned, on condition that the country's fiscal sustainability is not jeopardized in the medium term.*

adjustment path toward the MTO have been observed.[18] Within one month of the adoption of the early warning, the Council draws up a recommendation that includes a set of measures to address the deviation and a deadline (three to five months) for adopting these measures. The recommendation can be made public at the European Commission's proposal.

If a Member State fails to comply with the Council recommendation, the European Commission and the Council determine in a multi-step decision process whether effective action has been taken; the decision requires only a simple majority in the Council. Once a country is found to have taken no effective action, the European Commission issues a recommendation to the Council to impose a sanction that requires the country concerned to lodge an interest-bearing deposit in the amount of 0.2% of the previous year's GDP. The deposit is payable unless the Council decides to the contrary by qualified majority within ten days. This voting procedure is called reverse qualified majority voting (RQMV). At the reasoned request of the Member State concerned, the European Commission can reduce the deposit amount or suspend the sanction altogether.

2.3.2 Earlier Application of Financial Sanctions in the Dissuasive Arm

When a country's public finances do not fulfill the deficit criterion or the debt criterion (or both), the European Commission draws up a report under Article 126(3) TFEU, taking into account various "relevant factors" that could, under specific circumstances, still prevent the launch of an EDP (for instance, the composition of the stock-flow adjustment described in section 2.2 in case of a breach of the debt criterion). On the basis of this report, the Council can, by qualified majority, initiate an EDP under Article 126(6) TFEU.[19] The EDP contains recommendations for the Member State in question and sets a deadline (three to six months) for taking "effective action." Once the EDP has been launched, the European Commission recommends that the Council impose a sanction that requires the country concerned to lodge a non-interest-bearing deposit. Unless the Council, by qualified majority, decides to the contrary within ten days, an existing interest-bearing deposit is transformed into a non-interest-bearing deposit, or, in the absence of an interest-bearing deposit, the country concerned has to lodge a non-interest-bearing deposit in the amount of 0.2% of the previous year's GDP in the case of serious noncompliance. As in the case of interest-bearing deposits, the European Commission can reduce the deposit amount or suspend the sanction altogether in light of exceptional economic circumstances or at the reasoned request of the country concerned.

If the Council finds that insufficient effective action has been taken in response to its recommendations within the period laid down (Article 126(8) TFEU), the European Commission recommends the Council to impose a fine in the amount of 0.2% of the previous year's GDP (if the country already lodged a non-interest-bearing deposit,

[18] *The cost of structural reforms that have a positive impact on the long-term budgetary position can be taken into account in the assessment of deviations. Special consideration is given to the cost of significant healthcare, labor market and – most importantly – pension reforms.*

[19] *The Council decision also takes into account the cost of pension reforms.*

this deposit is converted into a fine). The Council can prevent fines only by RQMV within ten days. The European Commission can again reduce or suspend fines.

Additional fines can be imposed if the country still fails to comply with the Council's recommendations. These fines contain a fixed component (0.2% of GDP) and a variable component, which equals one-tenth of the difference between the country's deficit ratio of the previous year and the 3% deficit limit (breach of the deficit criterion) or one-tenth of the difference between the country's deficit ratio of the previous year and the deficit ratio specified in the Council's notice (breach of the debt criterion). A single fine cannot exceed 0.5% of the previous year's GDP. The Council decides in annual assessments whether additional fines should be imposed because the action taken has again been insufficient. Taken together, these fines may exceed 0.5% of GDP. The amount of additional fines is determined using the calculation method for the variable component. A direct Council decision is required for the imposition of such fines (no RQMV).

Fines and interest earned on non-interest-bearing deposits are assigned to the European Financial Stability Facility (EFSF) or its legal successor.

2.4 Other Changes

Council Regulation No 1173/2011 addresses the issue of data quality: In case of data manipulations that lead to a misrepresentation of deficit or debt figures (whether intentional or due to serious negligence), the Council can, on a proposal from the European Commission and by simple majority, impose a fine of 0.2% of GDP.

The SGP 3.0 also aims at increasing transparency in the European Commission's and the Council's decision-making processes, e.g. by allowing the competent committees of the European Parliament to invite an exchange of views in which the country concerned shall have the opportunity to participate.

The new rules for economic and fiscal surveillance in the EU consist of five regulations and one directive ("six-pack"): three regulations that reform the SGP, two regulations addressing macroeconomic imbalances as well as Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States. According to this directive, the Member States should implement numerical fiscal rules that promote compliance with the SGP as well as medium-term budgetary frameworks.

3 Assessment of the New SGP Provisions

The provisions of the preventive and dissuasive arms of the SGP work side by side. Therefore, we have to look at the interaction between them to assess the impact of individual provisions. Essentially, the preventive arm of the SGP aims at the early prevention of noncompliance with the debt and deficit criteria defined in the dissuasive arm. To be effective, though, the rules of the preventive arm must be binding before the provisions of the dissuasive arm are invoked. Adherence to the MTO would make it relatively unlikely that a country breaches the provisions of the dissuasive arm, as country-specific MTOs provide for a safety margin with respect to the 3% limit of the deficit ratio, and assessments of the debt position automatically consider stock-flow adjustments and cyclical effects. In the event of deviations from the MTO, the debt criterion (as well as the deficit criterion) can imply stricter (deficit) requirements in the first years of adjust-

ment than foreseen in the preventive arm of the pact. As mentioned in section 2.3, though, the sanctions for noncompliance with the dissuasive arm of the SGP are much higher.

3.1 Expenditure Rule Is Reasonable but Complex

The preventive arm of the SGP aims at balancing out the procyclical effect that materializes when a country merely fulfills the minimum requirements of the dissuasive arm. Its provisions have been largely ignored in the past, however (section 1).

The structural balance rules already existing and the expenditure rule newly introduced in the preventive part of the SGP work hand in hand but also compete with each other. For instance, if a country's expenditure growth benchmark is 1 percentage point below potential growth (because of noncompliance with the MTO), and assuming a revenue elasticity of 1, a constant interest expenditure ratio, a long-term multiplier of zero and an adjusted[20] primary expenditure ratio of 50%, the requirements regarding the adjustment path toward the MTO will exactly match the criteria of the expenditure rule (i.e., a structural improvement by 0.5% of GDP). Yet if the revenue elasticity is greater than 1 (e.g. owing to revenue windfalls in economically good times), the expenditure rule will require a faster adjustment to the MTO and thus becomes the binding criterion (the argument is derived in European Commission, 2011a).

Measurability is one great advantage the expenditure rule has over the structural balance rule: Both expenditure growth and the effects of revenue legislation can be measured with a relatively short lag, and the underlying potential output growth rate can be determined in advance. In contrast, making real-time estimates of the structural balance is difficult for various reasons, but above all because of difficulties in assessing a country's cyclical position and in identifying revenue windfalls or shortfalls.[21] Both would be necessary for estimating the cyclical component of the budget balance.

A look at Ireland and Spain – which seemed to have strong fiscal positions before the crisis – highlights the scope of the problem. Despite several tax cuts, Ireland had a relatively constant tax ratio from 1998 (O'Leary, 2010; Morris et al., 2009), which was attributable to a massive real estate boom that led to substantial revenue windfalls. Primary expenditure increased sharply in the same period. The windfall revenues partly masked a deterioration in the actual structural primary balance; at the same time, potential output growth was thought to be very high and – thanks to high output growth and low interest rates – Ireland's interest payments in percent of GDP declined sharply. Before the dramatic deterioration in the Irish economy from 2007, the country's fiscal position had thus been much weaker than the indicators of the previous SGP suggested. Rather similar developments were observed in Spain.

[20] *In this context, adjusted primary expenditure is defined as primary expenditure excluding unemployment benefits and expenditure items with a direct counterpart on the revenue side. For Austria, this ratio would be roughly 46% of GDP in 2010 (= total expenditure – interest payments – social transfers for unemployment – social security employer contributions for public sector employees – taxes paid by government – output produced for own final use – EU transfers to the Austrian public sector).*

[21] *Another problem is the discrepancy between results depending on the method of adjustment for cyclical effects (e.g. Bouthevillain et al., 2001).*

The expenditure rule does not completely solve the problem of measuring, in real time, a country's cyclical position and the scope of windfall revenues, as it is not applied to countries that overachieve their MTOs. According to the European Commission's assessment, Spain and Ireland overachieved their MTOs most of the time in the precrisis years (chart 3), even though they would have repeatedly failed to meet the expenditure rule (despite the assumed very high potential output growth). It is difficult to say in retrospect whether Spain and Ireland would have qualified for an exception from the exception for countries with substantial revenue windfalls described in section 2.1.

The necessary adjustment of expenditure data by discretionary revenue measures gives rise to another problem: It is as yet unclear what exactly constitutes a measure (does the nonindexation of income tax brackets or of nominal excise duties qualify as a measure?) and how implementation risks should be handled (are the measures adopted actually implemented?). Another issue in this context is the handling of substantial uncertainty regarding the size and timing of additional revenues, above all in connection with reforms of profit-related taxes and measures to prevent tax fraud.

Other matters of detail that still have to be resolved are the treatment of mandatory indexing[22] and substantial one-off effects (e.g. deficit-increasing capital injections for public enterprises or nationalized banks) in the adjustment of expenditure data and the handling of automatic revenue increases offsetting expenditure in excess of the benchmark (section 2.1).[23]

These details indicate that the lower procyclicality of the new expenditure rule (compared to other EU fiscal rules) comes at the price of high complexity.

3.2 Some Conceptual Weaknesses in the Debt Rule

In the past, EDPs were triggered, if at all, only by a breach of the 3% deficit threshold. Debt ratios in excess of the 60% threshold did not have any consequences, even though the debt ratios of some high-debt countries did not decline at all.

This is problematic in two respects: First, merely achieving the 3% deficit limit is not enough to reduce the debt ratio below the 60% reference value in the long run, given that most euro area countries post low nominal trend growth, as has been evidenced by the case of Italy, even before the crisis hit. Here, compliance with the new and stricter rules of the preventive arm would indeed reduce debt ratios significantly, but it remains to be seen whether these rules will actually be implemented given the low incentive levels and past experience (many countries that fulfilled the 3% deficit limit most of the time did not meet the requirements of their MTOs). Second, real-time debt developments can provide more meaningful information than deficit developments. The major revisions required in Greece, above all, tended to have a larger impact on the deficit ratio than on the debt ratio.

[22] *While past inflation is taken into account in the mandatory adjustment of pension benefits in Austria, current price developments (GDP deflator) are used for deflating expenditure.*

[23] *Adjusting by items that are completely offset by revenues – in particular taxes paid by government units (e.g. social security employer contributions for public sector employees) – seems an obvious choice. It is unclear, though, in how far the induced rise in wage tax revenues should be counted as offsetting a sharp rise in compensation for public employees or pension benefits. Our estimate of Austria's adjusted primary expenditure ratio was based on the assumption that only the first point will be considered.*

One reason why the debt criterion was never applied is the lack of a numerical benchmark for assessing whether the debt ratio was "sufficiently diminishing" (a requirement that was already stated in the dissuasive arm of the previous SGP). While the new debt rule addresses this weakness by operationalizing the debt criterion with exact reference values, it has some significant shortcomings.

Of all the relevant SGP indicators (debt ratio, deficit ratio, adjusted expenditure growth, structural balance), the debt ratio responds most to cyclical developments, which implies that the influence of policy measures is smallest in the short run. Economic developments impact not only the numerator of the debt ratio (as automatic stabilizers add to the deficit), but also the denominator (GDP).[24] Another problem lies in the fact that the Maastricht debt level is gross debt, i.e. financial assets of the general government are not considered[25] (even if they are liquid or relatively liquid, like cash or securities).

The most recent SGP reform addresses both problems: According to the new debt rule, a severe negative effect of the economic cycle or the buildup of substantial amounts of certain financial assets may remove the requirement for an EDP (section 2.2). These exceptions create strong asymmetry, however, as meeting the benchmark only by tapping into cash reserves or because of favorable economic conditions will avert an EDP. While there are also some exceptions to the existing deficit rule (sections 2.2 and 2.3), they come without such major asymmetries.

The debt criterion is weakened further by the fact that it also takes into account whether the benchmark is forecast to be breached in the future (section 2.2). Table 1 highlights the problem of this approach by looking at past debt ratio forecasts for Greece, one of the countries that have often been cited as a reason why it is necessary to introduce a debt rule (European Commission, 2011a). Judging from the first ex post data submitted during the EDP

Table 1

European Commission Forecasts of the Greek Debt Ratio

Forecast year	Budget balance	Public debt						Sufficiently diminishing	
	t–1	t–4	t–3	t–2	t–1	t	t+1	t–4 to t–1	t–2 to t+1
	% of GDP								
2000	–1.6	111.3	108.5	105.4	104.4	103.7	99.7	no	yes
2001	–0.9	108.3	105.5	104.6	103.9	99.9	98.0	no	yes
2002	0.1	105.0	103.8	102.8	99.7	97.9	95.2	no	yes
2003	–2.6	105.1	106.2	107.0	104.9	101.0	97.0	no	yes
2004	–3.0	106.2	106.9	104.7	103.0	102.8	101.7	no	no
2005	–4.4	114.8	112.2	109.3	110.5	110.5	108.9	no	no
2006	–4.5	107.8	108.5	107.5	104.6	100.9	97.6	no	yes
2007	–2.6	110.7	107.8	108.5	107.5	105.0	102.1	no	yes
2008	–2.8	98.6	98.0	95.3	94.5	92.4	90.2	no	yes

Source: European Commission spring forecasts (2000 to 2008).

[24] *While this effect can also be observed for the actual and structural budget balance as percentage of GDP, it is much smaller (as deficit ratios are much closer to zero than debt ratios).*

[25] *Government-held bonds and intra-governmental loans are important exceptions.*

Table 2

Budget Balance Required for a Sufficient Reduction of the Debt Ratio[1]

Nominal GDP growth in %	Previous year's public debt											
	% of GDP											
	70	80	90	100	110	120	130	140	150	160	170	180
0	0.5	1.0	1.5	2.0	2.5	3.0	3.5	4.0	4.5	5.0	5.5	6.0
1	–0.2	0.2	0.6	1.0	1.4	1.8	2.2	2.6	3.0	3.4	3.8	4.2
2	–0.9	–0.6	–0.3	0.0	0.3	0.6	1.0	1.3	1.6	1.9	2.2	2.5
3	–1.5	–1.3	–1.1	–0.9	–0.7	–0.5	–0.3	–0.1	0.1	0.3	0.5	0.8
4	–2.2	–2.1	–2.0	–1.8	–1.7	–1.6	–1.5	–1.4	–1.3	–1.2	1.0	–0.9
5	–2.8	–2.8	–2.8	–2.8	–2.7	–2.7	–2.7	–2.7	–2.6	–2.6	–2.6	–2.6
6	–3.5	–3.5	–3.6	–3.7	–3.7	–3.8	–3.9	–3.9	–4.0	–4.1	–4.1	–4.2

Source: OeNB.

[1] *Assuming zero stock-flow adjustment.*

notification rounds, Greece would have breached the debt criterion every year since 1999 even before the onset of the crisis (table 1, column "Sufficiently diminishing, t–4 to t–1"). If we also use the European Commission's forecast,[26] as foreseen in the debt rule, the results are completely different. Based on these forecast data – which turned out to have been overly optimistic – the Greek debt ratio would actually have diminished sufficiently in most years under review, thus meeting the debt rule requirements (table 1, column "Sufficiently diminishing, t–2 to t+1"). The only exceptions are two years (2004 and 2005) in which Greece recorded a Maastricht deficit of 3% of GDP or higher even on the basis of the data available at that time.

Still, like in the case of the expenditure rule, past problems are not necessarily indicative of the future usefulness of the rule. At present, it seems highly unlikely that future forecasts of nominal economic growth in euro area countries would be as optimistic as they had been for Greece, Ireland or Spain before the onset of the crisis.

In light of significant asymmetries and the consideration of forecasts, it is impossible to say conclusively whether the debt rule will, as intended, impose stricter requirements on highly indebted countries than the deficit rule. Excluding the exceptions mentioned earlier, it would indeed be the case for countries with moderate growth rates (= nominal growth ≤ 5%) (table 2); in Greece, average nominal growth was much higher than that before the onset of the crisis.

Table 3 gives a somewhat exaggerated example of how the debt rule could be circumvented.[27] Let us assume that Austria pursues the strategy of keeping its debt ratio constant at 71.8% of GDP from end-2010. In this case, it would still be in compliance with the debt rule if it made temporary stock-flow adjustments (e.g. by accumulating cash reserves) equivalent to 4.1% of

[26] *This calculation is based on data from the respective European Commission spring forecasts (which should, as a rule, correspond to the data reported in the first ex post notification rounds). The benchmark for a sufficient reduction of the debt ratio b_t based on forecast values will probably be calculated as follows:* $b_{t+2} = 60\%+0.95/3*(b_{t+1}-60\%)+0.95^2/3*(b_t-60\%)+0.95^3/3*(b_{t-1}-60\%)$.

[27] *This scenario (and the study as a whole) does not consider the transitional provisions until the debt rule is fully applied.*

Table 3

Scenario for Circumventing the Debt Rule

Year	Debt ratio	Compliance with the debt rule[1]		
		t–3 to t	t–1 to t+2	Total
–2	71.8	×	×	×
–1	71.8	×	×	×
0	71.8	×	×	×
1	75.9	no	yes	yes
2	71.8	yes	yes	yes
3	71.8	yes	no	yes
4	71.8	yes	yes	yes
5	75.9	no	yes	yes
6	71.8	yes	yes	yes
7	71.8	yes	no	yes
8	71.8	yes	yes	yes
9	75.9	no	yes	yes

Source: OeNB.

[1] *Compliance to be established in the following year.*

GDP every four years.[28] Table 3 shows that – based on the formula given in European Commission (2011a) – the debt criterion would only be breached every four years. On the assumption that the European Commission's forecasts are exact, these breaches would not lead to the adoption of a report under Article 126(3) TFEU, as the rule would be fulfilled again in the near future according to the forecast.

3.3 Will the Application of Sanctions Become More Likely?

Under the previous SGP, the criteria set out in both arms were breached repeatedly and markedly. The response to noncompliance depended on whether it affected the preventive or the dissuasive part of the pact: While the Council in most cases rejected the issuance of an early warning as foreseen in the preventive arm, EDPs were usually launched in the case of breaches of the deficit threshold in the dissuasive arm.

The measurement problems outlined in section 2.1 cannot account for all instances of noncompliance with the preventive arm that were observed in almost all euro area countries before the most recent reform. Other major factors were the absence of financial sanctions, the Council's comprehensive powers and the Member States' lack of commitment to budgetary discipline as set out in the SGP as well as the fact that the national fiscal frameworks did not provide for sufficient budgetary discipline. The reform of the preventive arm addresses these problems by introducing numerical benchmarks (expenditure rule), strengthening the European Commission's role and introducing sanctions (the country concerned has to lodge an interest-bearing deposit in case of noncompliance with the adjustment path prescribed by the Council). The most recent reform makes it easier to issue early warnings, as they are now addressed by the European Commission and no longer require approval by the Council. However, the Council is still in charge of drawing up the recommendations for the necessary policy action following the issuance of an early warning. Given that the deposits are interest bearing, though, their effect on the country's net assets is rather negligible[29] and thus essentially limited to possible reputational costs. Moreover, they are not imposed automatically: The Council can prevent

[28] *4.1% of GDP roughly correspond to Austria's stock-flow adjustment in 2008 excluding the participation capital for Hypo Alpe-Adria-Bank AG. Alternatively, we could assume higher initial levels and/or a trend rise in debt ratios, but in that case, the stock-flow adjustment required every four years to ensure "compliance" with the debt rule would become very large.*

[29] *0.2% of GDP multiplied by the sovereign interest rate equals around 0.01% of GDP. In the case of Austria, this would be about EUR 30 million, which is less than the country's additional payments to the EU budget to offset the rebates granted to the United Kingdom, Sweden and the Netherlands.*

their imposition by simple majority. In addition, several exemptions apply (section 2.3). Also, it remains to be seen whether the European Commission (whose role has been strengthened in both the preventive and the dissuasive arm of the pact) will come under more pressure from the Member States.

As a result of the reform of the dissuasive arm, financial sanctions are now applied at an earlier stage. In situations when countries in EDP were formerly only required to make adjustments, they are now required to lodge non-interest-bearing deposits. Interest-bearing deposits in the previous SGP have been replaced by fines in the amount of 0.2% of GDP. The sanctions for repeated noncompliance with Council recommendations have remained unchanged, however. Even though recommendations by the European Commission regarding interest-bearing deposits or fines in the amount of 0.2% of GDP can only be rejected by qualified majority in the Council (RQMV), it is unclear whether financial sanctions will be imposed more often. In the dissuasive part, it is still the Council that decides, directly and by qualified majority, if an excessive deficit exists and if the country concerned has taken effective action. Unless the Council adopts these decisions, the above-mentioned sanctions cannot be imposed. Compared with the conditions for launching an EDP, the effectiveness of a country's corrective action in particular leaves ample room for interpretation. For instance, both Germany (2003 to 2005) and Greece (from 2010) failed to meet their Maastricht deficit targets, but both countries implemented comprehensive measures in this period.

4 Conclusions

The fact that the preventive arm of the SGP has been strengthened – by introducing numerical benchmarks, making it easier to launch EDPs and introducing (symbolic) sanctions – can be considered a remarkable step, especially because the preventive arm aims at balancing out the procyclical effect that materializes when a country merely fulfills the requirements of the dissuasive arm.

In light of the many exceptions, though, it remains highly questionable whether the debt rule will actually, as intended, impose stricter requirements on highly indebted countries.

Despite the new voting procedure which is designed to make sanctions more likely, we doubt that economically significant sanctions will be imposed in the foreseeable future. Still, we expect that the new and earlier sanctions (interest-bearing deposits in case of noncompliance with the provisions of the preventive arm and non-interest-bearing deposits in case of breaches of the deficit criterion or the debt rule) will be imposed.

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