Stability and growth pact : the last Commission's Communication

Hugo de Sousa presents last European Commission's communication to the Council and European Parliament on the Stability and growth pact, adopted on 3 September 2004, and reminds us of the initial objectives and main evolutions of the pact.

1 What led to the creation of the stability and growth pact?

The stability and growth pact was formally agreed at the Amsterdam European Council in June 1997 and since than it has never been a consensual instrument (for a discussion on the topic see Navarro, 2001). Some important aspects led to its creation:

1. When the Maastricht criteria were defined, few expected that 11 countries would adopt the Euro immediately. The economic records of these countries were very different, with some countries showing a record of high deficits and high debt while others showed the opposite. Germany, for example, had traditionally been used to fiscal discipline and to a credible central bank (the Bundesbank). Therefore, German public opinion was reluctant to join such a large monetary union that would encompass traditionally less credible countries, such as Portugal and Spain, and the stability and growth pact was created to ensure that fiscal discipline would prevail.

2. A feeling of mistrust which existed among Member States played a role. This was linked to the fact that the monetary union would encompass all the Mediterranean countries. As said, the record of these countries in terms of monetary policy was not brilliant and there was a fear that these countries once in EMU would behave as free riders, that is to say individual Member States would have an incentive to pursue their own policies irrespectively of the Euro, as the negative externalities that could emerge from the domestic policy would likely be dissolved in the other eurozone economies. This mistrust led to the creation of fiscal rules aimed at preventing such behaviour.

3. The stability and growth pact had, initially, as its objective, the maintaining of fiscal policy stability. The addition of growth as an objective was the conclusion of a higher level discussion that culminated in attributing an objective (growth) to a mechanism (the stability and growth pact) but no means to achieve it. The stability and growth pact was hence created to act as a guardian of European public finances and not as a mechanism to foster European economic growth.

4. Economic rationale. One of the purposes of the stability and growth pact was to avoid policy conflicts between monetary and fiscal policies. It aimed at preventing countries from running higher than desirable budget deficits (as could be tempted to do) in a monetary union, as the effects resulting from such a deficit would spread around the entire MU, thereby diluting the negative effects in the domestic country. Furthermore, it was meant to ensure some economic policy co-ordination and together with the broad economic policy guidelines it provides the only economic policy co-ordination mechanism in the EMU.

1.1 The most recent events

Europe has been facing economic difficulties since 2001. Indeed, during the last two years, Europe went through a situation of stagnation with nearly zero growth. Deficits went up in most countries as a consequence of the use of the automatic stabilizers. However, some countries were not able to let them play fully their role because they had already surpassed the deficit ceiling imposed by the stability and growth pact. Countries such as Portugal and more recently Germany and France illustrate this point. These two countries represent the bulk of economic activity in the Eurozone.

The fact that some countries could not govern their public finances according to the fiscal rules, symbolized in the stability and growth pact, led to a series of events. It started at an informal meeting that took place at the beginning of September 2002 which had as main point the announcement by the European Commission that economic recovery in the EU would be slower than initially expected; to be more exact the EU would grow “marginally less than 1%” that year against the 1.4% forecast before. The then Commissioner, Pedro Solbes, also recognized that this slow recovery would have an adverse impact on the consolidation of the deficit objective for this year, namely due to a predictable loss of revenues. He also sustained that on an analysis that had yet to be done there would be an element of nominal deficit and one of “structural deficit”, which is the deficit corrected for cyclical fluctuations.

On September 24th 2002, the European Commission proposed that the balanced budget objective should be postponed until 2006, justifying its decision with the slowing down of the European economy. It however stressed the point that countries needed to present a quantified strategy concerning the reduction of their structural deficit. The countries in question, Portugal, Italy, France and Germany, needed to reduce their structural budget deficit by, at least, 0.5% per year. On the same day, the Commission adopted its report on Portuguese public finances. This report was the first step towards the excessive deficit procedure (art. 104.3 of the Treaty) as the Portuguese deficit proved to be higher than expected, 4.1% (against the 2.6% originally forecast). The ECOFIN council, based on the Commission report, urged Portugal to reduce its budget deficit by 2002. Moreover, the Commission adopted the same procedure regarding Germany as its deficit was officially recognized as being 3.8% of GDP and also launched an early warning against France. In fact, in June 2003, the ECOFIN Council recommended France to take all the necessary measures to bring its deficit back to 3%, at the latest by 2004. Despite that, the French Government predicted a deficit of 3.6% for 2004. The Commission then proposed to the Council that it officially recognizes that France had not respected its recommendation and should therefore be sanctioned. The Council was supposed to have analyzed this issue on November 4th, but its decision was postponed to the November 27th 2003 meeting in a move to allow some extra time for a consensus to be found. Within a month, the ECOFIN could ask France to implement measures to correct the excessive deficit situation (following a Commission recommendation). If France would not take any corrective measures, sanctions would be imposed within a two month period. This would have been the normal procedure.

However, the ECOFIN council eventually took a different decision. Indeed, given the difficulties both Germany and France were facing, the European Commission decided to recommend to the Council to continue with the excessive deficit procedure against both countries but it conceded them an extra year to get in line with the pact rules. This last attempt to save the SGP was however not successful as both France and Germany, supported by all Member States with the exception of Spain, the Netherlands, Belgium and Austria, did not agree to further reduce their deficits. The Council ended up by not endorsing the Commission's recommendation instead adopting a text proposed by the Italian Presidency, by which Germany and France pledged to respect the SGP but at the same time were not sanctioned.

Moreover, there were constant and public disagreements not only between the European Commission and France but also between France and small countries. Indeed, at the ECOFIN meeting in Stresa, the Dutch finance Minister said that "invoking particular circumstances" not to respect the SGP rules "was a complete nonsense". The Austrian Finance Minister said that "all the possible political creativity" would not be enough to see France as a case to justify the invocation of special circumstances.

Not satisfied with the Council decision, the Commission decided to recur to the European Court of Justice which on July 13th decided in its favour.

1.2 **The most recent Communication of the European Commission**

All the events described above implied that changing the stability and growth pact became unavoidable. Building on its communication of June 24th the Commission has now formally presented its proposals which build on the following points:

i) "placing more focus on debt and sustainability in the surveillance of budgetary positions";

ii) allowing for more country specific circumstances in defining the medium-term objectives of "close to balance or in surplus";

iii) considering economic circumstances and developments in the implementation of the Excessive deficit procedure

iv) ensuring earlier actions to correct inadequate budgetary developments"[1].

Regarding the first point of its communication, the Commission argues that an evaluation that aims at looking on the sustainability of public finances needs to pay close attention to public debt issues. It is argued that the stability and growth pact could clarify the treaty provision of "satisfactory pace" of debt reduction, notably to take into account the impact of population ageing, country specific initial debt levels and potential growth. One of the hypotheses is, according to the communication, to assess potential growth so that if a country is growing below its potential, the pace of debt reduction is slower while the opposite would hold if growth is above its potential. It is also underlined that an increased focus on debt levels does not imply deficit levels will no longer be assessed.

In its second point the Commission suggests a path that takes into account country specific circumstances when defining the medium term deficit objective of "close to balance or in surplus". The Commission claims that the "increased economic diversification in an EU of 25 Member States" makes the existence of uniform objectives more difficult to apply as it lacks an economic rationale behind it. It is suggested that this medium term objective could be based on current debt levels meaning it would be more stringent the higher the debt level.

In its third point, the Commission qualifies the exceptions to the principle that countries recording deficits or debts levels above the reference values as "restrictive". Consequently it suggests the stability and growth pact should cater for periods of slow growth, albeit positive and therefore asks for a redefinition of the severe economic downturn, which currently means the substantial figure of

[1] Commission communication to the Council and the European Parliament, 09/03/04

-2% economic growth. Here the objective is to make the SGP more compatible with its growth component. Moreover, presently any country that surpasses the 3% deficit has to correct it in the year after. It is argued that a “one size fits all” deadlines for the deficit correction is a limited approach as it does not distinguish between countries with different debt levels and with different cyclical developments. Henceforth, it is suggested that despite the fact that the launch of the deficit excessive procedure would still occur and rapid correction would be expected, the pace of adjustment could differ between Member States. The appropriate pace would be defined according to relevant economic conditions and to debt levels.

Finally, in the fourth point of the communication the Commission explores paths to ensure an earlier action so as to prevent an inadequate budgetary development. It claims for an improvement of the peer review mechanism and for a more prominent role of the BEPG.

In its communication the European Commission also argues for better co-ordination or budgetary policies and suggests the reinforcement of the link between the BEPG and the SGP. This would be done by revising the timetable concerning the submission and assessment of the stability and convergence programmes by bringing those more into line with the national budgetary process. It is also said that the stability and convergence programmes could spell out the medium-term budgetary strategy at the beginning of an electoral mandate for new governments and its updates would be done earlier in the year. That would, according to the Commission, imply that “the BEPGs and the opinions on the programmes to be taken into account in the preparation of national budgets by governments”. The communication also mentions “the effectiveness of the peer pressure to discourage Member States from not complying with their legal obligations, in the form of naming, shaming and, if necessary, blaming, could be enhanced”.

1.3 **The reaction to the Commission communication**

The recent meeting of the Ministers of Finance considered the communication of the Commission to be a “good basis for discussion” but failed to agree on any concrete aspects of the reform. Indeed, Ministers have claimed for the treaty to be respected and that “the 3% deficit and the 60% debt criterion in the Treaty remain of paramount importance”. More precisely, “changes to the regulations should be minimized, if necessary at all”. Reacting to the failure to agree on a reform at the meeting of the Ministers of Finance, the Commissioner Joaquin Almunia said that “Ministers will have to make the hard choices if we are to restore credibility in our budgetary co-ordination process” and said he was surprised if this discussion would continue into the Luxembourg Presidency.