REFORM OF THE STABILITY AND GROWTH PACT

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Abstract

In conditions of the single monetary policy and the decentralised fiscal policy in the European Monetary Union (EMU) it is necessary for the coordination of macroeconomic policy to be strengthened. The Treaty on European Union imposes conditions that relate to the size of the budgetary deficit and the public debt as criteria for the introduction of the euro in a given country. The Stability and Growth Pact (SGP) sets the fiscal framework of the European Monetary Union based on rules underpinned by these criteria.

Thus the SGP, as a kind of economic policy-coordination mechanism, has the task of ensuring fiscal discipline among the Member States of the EMU. The objective of this paper is to describe the recent reform of the Stability and Growth Pact that arose as a result of deficiencies observed in the original version of the Pact of 1997.

Key words: Stability and Growth Pact, European Monetary Union, coordination of monetary and fiscal policy, fiscal rules

1 Introduction

A unique feature of the Economic and Monetary Union consists of the centralised monetary policy in the sphere of competence of the European Central Bank (ECB) and the decentralised fiscal policy that remains within the accountability of the national governments of the Member States. Healthy public finances contribute to the achievement and maintenance of price stability and hence of sustainable economic growth. Hence common rules for the running of fiscal policy at national level have been defined and laid down at EU level. These rules, that is, the outline of fiscal policy founded on rules,

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are incorporated into the provisions of the Treaty on European Union (Maastricht, 1992) and, more particularly, in the Stability and Growth Pact, SGP. These documents, the first one as part of primary and the second one as part of secondary EU law, lay down the fiscal criteria – size of the budgetary deficit and of the public debt – that EU Member States have to satisfy in order to be able to bring in the euro as their national currency, in other words, for the achievement and maintenance of a stable budgetary position within the EMU.

In the less than a decade that Member States and EU institutions have had experience with the provisions of the SGP, the need for the existence of such a fiscal framework has been confirmed. But during its use several flaws have shown up, which set off more fundamental study of the way it functions and the role of fiscal rules in the monetary union and finally led to the need for reform. The objective of this paper is to describe reform of the fiscal framework of the EU that occurred in 2005.

After the introduction, in part two of the paper, a brief description is given of the rules that relate to the sustainability of public finances in the EU, in which a distinction is made between the Treaty on European Union and the Stability and Growth Pact, which is at the same time an introduction into part three of the paper. This section discusses the circumstances in which modifications to the Pact occurred, reforms of the Pact are described, and the basic features of the reform are discussed. The final part of the paper provides a conclusion.

2 Government finances in the European Union

2.1 The Maastricht Treaty

The Treaty on European Union, signed in 1992 in Maastricht, the Netherlands, set the foundation for the creation of the Economic and Monetary Union and the European Central Bank, as well as laid down the criteria that EU Member States had to meet to be able to take part in the EMU. These are price stability, a stable fiscal position, exchange rate stability and convergence of long-term interest rates[1].

The criteria of government finances are based on the principle of sustainable fiscal policy, which means a policy unlikely to increase the risk of a higher rate of inflation in the future. This risk is reflected in the likelihood that a government with a high debt-to-GDP ratio might prefer a high rate of inflation and in this way reduce the real value of the public debt. Hence for the sake of maintaining price stability and an equitable distribution of the costs and benefits of monetary union it was essential to establish criteria to ensure that each member state would run a sound fiscal policy (Faulend et al., 2005).

The Treaty includes a written definition of fiscal policy that supports the common monetary policy:

[1] See Treaty on European Union (consolidated text) Official Journal C 325 of December 24 2003. Denmark and the UK won a special status in this treaty (the so-called opt-out clause) exempting them from joining the EMU. States that became members of the EU after 1992 could not invoke the opt-out clause and are thus bound to introduce the euro.

- the annual budgetary deficit must not exceed 3% of GDP, with the provison that in the assessment of the fulfilment of this criterion a budgetary deficit above but close to 3% can be tolerated if some temporary or exceptional event is concerned[2];.
- the public debt must not exceed 60% of GDP, and there is a certain amount of flexibility in this criterion too, so it can also be considered to be satisfactory if a country with an exceptionally high debt/GDP ratio is approaching the reference value of 60% at a satisfactory pace.

Apart from the fiscal criteria for the introduction of the euro, the Treaty contains other provisions that relate to public finances in the Member States. The provisions of Articles 101-104 forbid the ECB and the national central banks to finance the government deficit, and also outlaw preferential access of public sector institutions to financial institutions. These provisions rule out any possibility of the EU or the EMU being responsible for the liabilities of Member States. This means that in the event of the insolvency of any financial institution, Member States of the EU (EMU) or some other state will not be considered responsible for the debt of the insolvent institution. In this manner the Treaty endeavoured to provide the conditions for stability, once established, to be maintained during the course of a country's participation in the EMU.

2.2 Stability and Growth Pact

The understanding that sound public finances are a necessary condition for the achievement and preservation of overall macroeconomic stability entailed the need for a stable framework for fiscal policy based on the rules. The final agreement on the wording of the Stability and Growth Pact was achieved in 1997. The Pact came into force on January 1 1999[3]. The main preoccupation of the Pact is to put forward fiscal discipline as the fundamental characteristic of the EMU. Fiscal discipline will enable states that have introduced the euro to strengthen the conditions for price stability and sustainable growth and will contribute to the preservation of the economic environment in which the common monetary policy can be devoted to achieving price stability.

The SGP defines in more detail the definitions of the Treaty on European Union and defines a sound fiscal policy as that in which the budget should be close to balance or in surplus[4]. Such a fiscal position would enable sufficient space within normal cyclical fluctuations for the fiscal deficit to be maintained within the borders of the reference value of 3% of GDP. The Pact also states the role of the automatic stabilisers at the national level, which, in the conditions of the loss of the instrument of the exchange rate, help economies

[2] Definition and interpretation of the provision about "temporary and exceptional event" in the excessive deficit procedure, EDP, was a topic of debates during the later reform of the Pact.

[3] Looked at from the legal point of view, the Stability and Growth Pact consists of: *Resolution of the European Council on the SGP; Council Regulation on the strengthening of the surveillance and coordination of economic policies, No. 1466/97; Council Regulation on speeding up and clarifying the implementation of the excessive deficit procedure, No. 1467/97; (Official Journal L 209, 02/08/1997),* and the *Council Regulation 1466/97 as amended by Council Regulation 1055/2005* and *Council Regulation 1467/97 as amended by Council Regulation 1056/2005 (Official Journal L 174, 07/07/2005).*

[4] In reform of the Pact there will be a closer definition of the concept of a budgetary position "close to balance or in surplus"

to adjust to asymmetric shocks[5]. However, the advantages of the automatic stabilisers will be achieved only if the budgetary positions of the countries are sustainable.

The Pact contains elements of *prevention* – by regular supervision of the public finances it is the Pact's objective to prevent budgetary deficits of members exceeding 3% of GDP; elements of *dissuasion* – in a situation in which a budgetary deficit does exceed the reference value of 3% of GDP, the Member State in question is asked to take corrective measures, and if the budgetary deficit during the given period does not reduce, it is possible to impose sanctions[6]; and *a political commitment* - all the parties involved (the European Commission, the Council of the EU and the Member States) have assumed the obligation to assure full and prompt application of the government finances surveillance process.

The documents that members of the EMU and members of the EU that have not yet introduced the euro prepare for the sake of the prevention of excessive deficits or in multilateral surveillance of public finances are the stability programmes and the convergence programmes. These programmes must represent the medium-term objective of the budgetary position and, if necessary, describe the way to reach such a position. The mainstay of the corrective part of the Pact is the excessive deficit procedure (EDP), which is defined in the Maastricht Treaty, and explained by the Council regulation, of which there will be more later on in this paper.

3 Reform of the Stability and Growth Pact

3.1 Circumstances leading to the reform

In November 2003 the Council of the EU determined to suspend the EDP for Germany and France, thus ignoring the recommendation of the European Commission that both countries should adopt fiscal consolidation measures. After this move of the Council, the European Commission referred to the European Court of Justice, for the Council of the EU had violated the procedure laid down in the provisions of the Pact.

This case was the culmination of several years of difficulties in implementing the Pact. The basic problem was the fact that the threat to impose sanctions was not credible. One of the main criticisms directed at the original version of the Pact was, then, its poor enforceability. This flaw was linked with the absence of any automaticity, that is, with the existence of discretionary decision making in the EDP[7]. The other flaw was that the original version of the Pact did not adequately incentivise countries to greater fiscal ac-

[5] According to some studies, thanks to the working of the automatic stabilisers a 1 percentage point increase in real growth of GDP in the eurozone will increase the budgetary position by 0.5 percentage points of GDP on average (ECB, 2002). Flores et al. (2005) cast doubt on the effectiveness of the automatic stabilisers, which depends a great deal on the kind of shock the economy has to face.

[6] Annet, Decressin and Deppler (2005) describe the difference between the preventive and the corrective part of the SGP. They say that the first one deals with maintaining a sound fiscal policy, while elements of dissuasion are aimed at avoiding errors in economic policy.

[7] For more about discretionary decision making and the problem of implementation see Calmfors (2005). It is interesting that during the drafting of the Pact in 1996, it was Germany that sought a greater degree of automaticity particularly in the imposition of sanctions (Stark, 2001).

countability in the various phases of the business cycle: fiscal discipline in the periods of upswing was inadequate to avoid high deficits in periods of severe cyclical downturns (Calmfors, 2005).

One of the causes of this state of affairs was probably the fact that fiscal consolidation had not been fully completed by the time the EMU started working. In the period from the establishment of the criteria for the introduction of the euro until the actual introduction of the currency in 1999, the EU countries had successfully carried out fiscal consolidation under pressure from the Maastricht criteria. They managed to bring their budgetary deficits down to the level lower than 3% of GDP, and the level of the public debt to below or close to 60% of GDP, that is, to start the trend towards debt reduction. In this period, in almost all the Member States improvements in budgetary positions were recorded, particularly in those that at the beginning of the 1990s had had levels of budgetary deficit in double-digits figures. However, the process of fiscal consolidation at the beginning of 1999 was not completed. Some countries joined the eurozone with budgetary deficits only a little lower than 3% of GDP[8]. They were far from the objective defined as "close to balance or in surplus". The same thing applied to public debts: although the levels of public debt had started to decrease, they were nevertheless, in a large number of countries, still considerably above the 60% of GDP level.

Notwithstanding the propitious economic climate at the very beginning of the creation of the EMU, most countries did not manage to carry on the process of budgetary consolidation. There was also a difference between the larger and smaller states in the Union – while some of the smaller countries had managed to achieve a balanced budgetary position, most of the big countries of the eurozone did not manage to improve their cyclically-adjusted budgetary positions. In the last few years a slowdown in the growth of GDP was considered the main factor in the weakening of the budgetary positions of the old Member States of the EU. However, this development can also be linked with the discretionary fiscal measures, and the deficiency of political will.

Not long after the Council had announced that there was a need to strengthen and clarify the implementation of the Stability and Growth Pact for the sake of encouraging transparency and national ownership of the fiscal framework, the European Commission tested out the ways in which the flaws of the existing fiscal framework could be repaired[9].

3.2 The basic features of the reform

The basic feature of the reform of the SGP is that the quantitative constraints of the original Pact – a budgetary deficit of at most 3% of GDP and a public debt of at most 60% of GDP – were to remain unchanged. However, modified rules gave a somewhat different definition of the medium-term budgetary objective, taking into account diversities in

[8] Here it is worth remembering the example of Greece and its resort to "creative accounting" in the area of government finances. For fiscal consolidation on the eve of the beginning of the EMU see European Commission (2004a).

[9] See European Commission (2004b). The Communication of the Commission of September 2004, together with a large number of previous papers about the topic of improvement and necessary revisions of the SGP (see Buti, Eijffinger and Franco, 2003a; 2003b), was the foundation for the development of many possible scenarios for a revision of the SGP.

economic situation and budgetary positions of Member States and the impact of the ageing of the population on government finances over the long term.

The medium-term objective in the new version of the Pact, just as in the original version, is defined as structural (cyclically-adjusted) deficit, net of one-off and temporary measures. The first novelty was that the budgetary objectives in the medium term were to be reviewed every four years (and also after the application of any important structural reforms), so as to reflect potential growth, fiscal sustainability and the dynamics of public debt. The second new departure was that countries with lower public debts and higher growth potentials were permitted a budgetary deficit of 1% of GDP in the medium term[10]. Highly indebted countries with lower potentials for growth had to aim at a balanced budget or a surplus. From countries with a public debt greater than 100% of GDP, an explicitly positive budgetary bottom line is required.

Central elements of reform also include the requirement for the strengthening of the fiscal positions during "good years", good years being considered those in which GDP was above the potential level. In this part of the fiscal framework there is a special emphasis on the aim of the reform being to take early corrective measures – it is anticipated that countries should, during good years, reduce their budgetary deficit by 0.5 percentage points of GDP. It is also envisaged that the minimum budgetary effort in years of economic upswing should be greater than this, while in periods of low growth or recession it could be lower.

The Council also managed to broker an agreement on the treatment of structural reforms that in the short term tended to lead to deterioration in public finances, but over the long term would improve their sustainability. They were to be taken into consideration in the definition of the path to achieving the medium-term objective for those countries that had not yet achieved it and for those that temporarily did not comply with it. Only those structural reforms that had direct long-term effects on cost reduction could be taken into consideration, an additional condition being that the 3% of GDP constraint be still respected, and that during a programme period of four years the budgetary position be returned to the medium-term objective. This rule particularly referred to the reforms of the pension funds of the Member States. Structural reforms would have to be expounded and justified in detail in the convergence and the stability programmes.

The early warning system was part of the preventive elements into which changes were also brought. In the Report of the EU Council on improvement of the implementation of the SGP it is said that for the strengthening of the preventive character of the Pact, it is necessary to explain and expand the existing early warning mechanism. From this point of view, it was provided for that the European Commission should directly, without any involvement of the Council, give policy advice to those in charge of economic policy concerned with the realisation of the agreed on medium-term budgetary objective. However, the European Commission will be able to issue these early warning notices only when the EU Constitution has come into force.

[10] New countries, as catching-up economies, have higher potential growth and a higher rate of inflation (thanks to the Balassa-Samulson effect) and could stand higher levels of fiscal deficit without menacing the long-term sustainability of public finances (see Organ and Szapary, 2004).

In the part of the Pact that contains elements of correction, the main changes are in a definition of excessive deficit that covers the role of "other relevant factors" and a revision of the concept of "a serious economic downturn"[11]; the possibility for extending the deadlines for a correction of the deficit; greater focus to public debt and sustainability of public finances, and consideration of structural reforms in the context of the EDP. The Council pointed out that the EDP, whatever the changes, had to remain simple, transparent, equitable, and lead to a rapid adjustment of the deficit. Just like "other relevant factors", so the redefined concept of a serious fall of economic activity can be applied only on condition that it refers to a budgetary deficit close to the reference value and, in addition, temporary in its nature (see below).

The modified Pact contains several situations in which exceeding the budgetary limit will be tolerated. These are structural reforms and "other relevant factors" including expenditures for research and development, objectives of European policy (particularly in the context of accomplishing the Lisbon strategy), international solidarity, capital investment, reforms of the pension systems and extremely high EU dues. In deciding whether a country is in a situation of excessive deficit or not attention has to be paid to development of the medium term budgetary position, particularly to efforts to achieve fiscal consolidation in "good years"; the sustainability of the public debt; public investment and the overall quality of government finances. It has to be said that the concept of the "other relevant factors" also exists in the provisions of the Treaty of Maastricht, but was not often applied. In its Report on improving the implementation of the SGP, the Council said that other relevant factors could be taken into consideration only if the breach of the 3% reference value was temporary and still within reach of the 3% value. Furthermore, excessive deficit, except in cases when the economy slowed down very considerably or of recession would be permissible in cases of a "protracted period of economic stagnation" and "very low growth".

The new departures relating to the "other relevant factors" are considered to be perhaps the most important loosening of the Pact (Buti, 2006; Calmfors, 2005). In favour of such an opinion is the fact that a fairly broad scope of interpretation can be applied to other relevant factors, and so member countries are themselves entitled to consider certain factors important and thus to be taken into account in the EDP. Apart from that, there is no definition of what "close to the reference value" means with respect to the other relevant factors, except that this concept can be applied only if the divergence is temporary and anyway close to the reference value.

Modifications to the Stability and Growth Pact regulations envisaged an extension of the period for the reduction of the budgetary deficit to a level below 3% in exceptional circumstances, from one to two years. In determining an appropriate period for the correction of a deficit, care will be taken of the "other relevant factors" and of whether the minimum fiscal effort of 0.5 GDP percentage points per year has been taken. The

[11] The original Pact defines a "a serious economic downturn" as a fall of real GDP by 2% or more in a year. The Council of the EU can use its own discretionary decision to determine that this is an exceptional event or not and in line with this whether the country in question is in the situation of an excessive deficit. According to the changed Pact, there is even more room for interpretation of a serious fall of economic activity – such is the example of a negative rate of growth or accumulated fall of GDP during a period of low growth as compared to the potential.

deadlines are extended in other places in the EDP as well: the period for decision making about the existence of an excessive deficit in a given country is extended from 3 to 4 months; the period for undertaking effective actions in response to a recommendation of the Council is extended from 4 to 6 months; the period in which a country with an excessive deficit is sent a notification to undertake the measures necessary to amend the situation is extended by 1 month; and the period for undertaking measures after the Council has sent a warning according to Article 104(9) of the Treaty on European Union has been extended from 2 to 4 months; the total maximum period in which the Council has to make a decision about imposing sanctions in the case of a eurozone country not meeting the recommendations and decisions of the Council has been extended from 10 to 16 months. A new departure introduced by the revised Pact is that it is possible to retake steps in the EDP. The first recommendation of the Council that an excessive deficit should be corrected, and a later warning that effective measures should be taken to reduce the deficit, can be repeated and reshaped if during the course of the current EDP there were some unexpected negative economic trends and if a member state had applied certain earlier recommendations that nevertheless did not result in a reduction of the deficit.

The revised provisions of the Pact bring into focus the problem of the sustainability of the public debt and charge the Council with preparing recommendations about debt dynamics in its opinion about stability and convergence programmes. This would lead to fuller implementation of the provisions of the Treaty on European Union, and the framework for surveillance of a debt should be strengthened by the concept of "sufficient diminishing and approaching the reference value at a satisfactory pace" for the public debt, taking into account the macroeconomic conditions and debt dynamics. The modified Pact did not define this concept in greater detail.

Modified provisions also reflect concern for the reforms of the pension systems. The Commission and the Council of the EU when assessing whether a Member State has managed to reduce its budgetary deficit will take into account the costs of such reforms. The development of the nominal budgetary deficit and the net costs related with the application of the second pillar of pension system will be compared. During the first five years from the beginning of the reform, the amounts of the budgetary deficit will be adjusted by the net costs of the reforms carried out. The adjustment will be carried out for 100% of the amount of the net costs of reform in the first year, for 80% in the second year and so on until the fifth year, when adjustment will be made for 20% of the next costs of the reform. In states that have already carried out a reform of the pension system, this mechanism of allowing the costs of reform during five years will be applied retroactively, starting from 2006. Although these provisions are shaped in such a way as to provide for long-term sustainability of the pensions system, there are particularly crucial for the new Member States, which recently started out on reforms of their pension systems and which are in a situation of excessive deficit. For this reason such a treatment of the reform of the second pillar of the pension system could affect the assessment of the fulfilment of the convergence criteria (European Commission, 2005).

These modifications in the corrective elements of the Pact could be characterised as a considerably weakening of the corrective dimension in the Pact[12]. It is held that frequent use of the clause about "other relevant factors" could jeopardise the 3% of GDP reference value, and that the absence of any firm constraint might set off future growth in deficits.

4 What can be expected from the modified Pact?

Several features of the reform of the Stability and Growth Pact might affect the future functioning of the fiscal framework of the EMU. Reform has increased the complexity of the excessive deficit procedure, which is a departure from the simplicity that is one of the much-emphasised advantages of the original version of the SGP. In this manner, the transparency of the whole framework has also been reduced, and the risk of ambiguous interpretations and discretionary powers of Member States, the European Commission and the Council of the EU has been increased. From the viewpoint of the theory on optimum fiscal rules it can be said that in one part of the Pact a certain departure from good rules has been made[13]. At the same time, the better economic foundation of the rules of the Pact – primarily the differentiation of the medium-term budgetary objective and the explicitly set demand for minimum fiscal effort – means an advance. Also worth mentioning is that there is a certain trade-off between flexibility on the one hand and simplicity and enforceability on the other.

It is interesting how the European Central Bank understands the changes described[14]. The ECB thinks it imperative that all three parties – the Member States, the European Commission and the Council of the EU – should apply the revised framework in a rigorous and consistent manner. It also says firmly that the fiscal framework of the EMU has to remain clear, simple and applicable in order to ensure transparency and equal treatment in the application of the Pact. In general, the ECB is "seriously concerned" because of the changes and says that the excessive deficit procedure should be effective and credible. Hence the ECB does not support the changes in the Regulation on speeding up and implementing the excessive deficit procedure. But it does support the intention to improve multilateral surveillance and coordination of economic policies among member countries from the modification of the Regulation adopted in 1997.

Criticising the revised Pact for the weakening of its strength, Calmfors (2005) points out that the aspect of the reform that gives most cause for concern is not the real changes but the fact that rules are endogenous and that they can be changed again, particularly if one of the big countries infringes them. Such a development can lead to serious consequences for the credibility of the whole framework for the future.

[12] The ECB and the German Central Bank had particularly harsh criticisms of this part of the reform of the SGP (Deutsche Bundesbank, 2005).

[13] Buti, Eijffinger and Franco (2003a; 2003b) consider SGP from the standpoint of the criteria for ideal fiscal rules (Kopits and Symansky, 1998). One should, however, mention that these criteria are formed for an assessment of domestic fiscal rules, and that the multinational character of the SGP will affect individual criteria (particularly the implementation of the rules).

[14] At the request of the European Commission, the ECB made a statement including an opinion about the reforms agreed on (ECB, 2005b).

We can conclude that the important changes in the section relating to the excessive deficit procedure can be explained as a loosening of the corrective dimension of the Pact and as greater tolerance for excessive deficits, which could lead to a weakening of fiscal discipline in future. For this reason all parties that in the preparation of the reform confirmed their political will and bound themselves to respect the rules should behave responsibly and with discipline, literally apply the provisions of the Pact, and by so doing help the European Central Bank in the preservation of monetary stability.

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