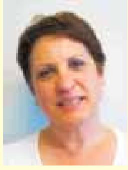
Comment

Does the EU Need the Stability and Growth Pact?



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Abstract
The Stability and Growth Pact was adopted by the Amsterdam European Council in 1997, for the purpose of preventing Member States from incurring excessive budgetary deficits in the euro area. Its implementation during the past five years has revealed how difficult it is for the Member States to comply with its strict requirements. The Stability and Growth Pact has twice been at the centre of a European debate regarding its objectives and inflexibility. The purpose of this article is to examine the provisions of the Pact and consider whether there is need for further co-operation on fiscal policy and what such co-operation may entail.

Introduction

Economic growth is facilitated by international co-operation on exchange-rate and monetary stability. No single nation can achieve prosperity by acting alone. This has been especially true for European countries.[1] During the process leading to the adoption of the euro, national governments found themselves in the unprecedented position of having to apply economic policy mostly through the instruments of taxation and government expenditure, i.e. fiscal policy tools. Even at that time monetary policy could not be used very much because national interest rates had to converge. This is even more so today when twelve EU Member States have a single monetary policy managed exclusively by the European Central Bank.

Since national fiscal decisions inevitably have spillovers into other countries, in the run-up to the adoption of the euro it became indispensable that national fiscal policy should be somehow co-ordinated and supervised centrally. For this reason Member States, at least those that aspired to converge and to eventually adopt a single currency, had to agree on measures to ensure sound management of national public policies. The result was the Stability and Growth Pact (SGP) which was adopted by the Amsterdam European Council in 1997.[2]

However, national authorities have seemed to "suffocate" under the strict fiscal rules of the Pact. There have already been problems, with weak compliance or even non-compliance in several Member States, i.e. Ireland, Portugal, Germany and France. In November 2003 the Commission proposed taking action against those Member States which had persistently breached the provisions of the Pact. However, the ECOFIN Council, taking a position contrary to the Commission's recommendations, decided not to penalise Germany and France. The Commission then initiated proceedings against the Council before the European Court of Justice, which is expected to issue its ruling soon. Irrespective of the judicial outcome, the Council decision has had serious political and economic consequences.

Seen in the broader historical context, co-operation on fiscal policy is neither novel, nor avoidable. Yet the events of the past twelve months have raised important questions as to where the boundaries of that co-operation may lie. The purpose of this article is to examine the provisions of the SGP, and to consider whether, after adoption of a single monetary policy, there is further need for co-operation on fiscal policy and what such co-operation may entail.

The two fundamental procedures of the SGP

The Pact is based on two fundamental procedures. The first incorporates the principle of Multilateral Surveillance. According to that principle, each Member State in the Eurozone should present to both the Council and the Commission a five-year[3] programme regarding public accounting objectives, beginning on 1 March 1999. After that date the Member States are expected to submit annual updates.[4] The fact that Member States outside the Eurozone are also obliged to submit convergence programmes shows that distortions of the real exchange rates can occur even for those countries which retain independent monetary policy. It is simply impossible for any single country to determine its own exchange rate, which is partly dependent on the policies of other countries as well.

The Commission's responsibility is to supervise development of the programmes, monitor implementation, and to draw up a report including proposals to the Council whenever a country is likely to breach the set limits. On the basis of these assessments, the Council makes recommendations to the country in question.

The Multilateral Surveillance maintains a constant "dialogue" on Economic and Budgetary Policy between Member States, the Council and the Commission. The chief element of this dialogue is the “Broad Economic Policy Guidelines” or BEPGs.

The second procedure is the Excessive Deficit Procedure (EDP),[5] which is activated whenever there are signs that a Member State’s budget deficit is likely to rise above the ceiling of 3% of Gross Domestic Product (GDP).

The SGP also incorporates sanctions for non-compliance. The Council may impose sanctions in the form of a non-interest bearing deposit with the Community. Deposits are converted into a fine after two years if the excessive deficit is not corrected. Certain arrangements for distributing fines are also included in the Pact.

Signs of trouble

Soon after the implementation of the SGP, its first signs of weakness appeared, as the Eurozone countries faced difficulties in meeting their medium-term obligations. The Council gave early warnings to two countries, first Ireland and then Portugal, while another two, France and Germany were subject to the full Excessive Deficit procedure. However, the ECOFIN stopped the procedure, just before the sanctions stage, on 25 November 2003. To many opponents of EMU, this is the date that the SGP came to an end.

The Commission, defending its role as “guardian” for the implementation of European policies, has initiated legal action against the Council. The Court’s ruling is expected soon. Irrespective of the legal arguments, the question in many peoples’ minds is whether a SGP is needed at all.

At present a number of national economies are clearly in breach of EU budgetary rules, and others are close to being so. In the light of the ongoing legal proceedings, the consequences are both economic and political.

Criticisms of the SGP

Since 25 November 2003, doubt has been cast on the feasibility of controlling national fiscal policies, and on the willingness of Member States to comply with the rules in the future. On one side of the fierce debate that has broken out are those who believe that the SGP serves no useful purpose. Summarising their main criticisms,[6] the SGP:

- is unable to cope with large-scale recessions and adverse economic shocks;
- is asymmetric in that it makes no arrangements for savings during prosperous economic years to be used during recessions;
- discourages public investment;
- focuses on short-term commitments disregarding structural reforms;
- lays down rules which are too uniform, leading to equal levels of budget deficit for countries with different debt levels;
- does not sanction politically-motivated fiscal policies;
- is wrong in its underlying philosophy that fiscal deficits cause inflation (Bofinger);
- focuses on fiscal outcomes instead of fiscal procedures-institutions (Eichengreen);
- suffers from an unfortunate timing between the adoption of the rules and their implementation (Thygesen);
- lacks economic foundations and its rules are arbitrary and easy to breach;
- is a static instrument not promoting growth (Prodi).

Despite these criticisms, the crucial point here is that EU institutions and Eurozone countries have twice committed themselves to the SGP rules: initially in December 1991, when the political decision was taken, and again in October 2002, when the Eurogroup agreed to reduce underlying deficit by 0.5% of GDP a year from 2003 onwards.

Which are the likely consequences of non-compliance?

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There are serious economic consequences in the sense that the required mix of fiscal and monetary policy for stability and growth in Europe is not forthcoming. Too lax fiscal policies can jeopardise the ECB’s monetary policy. This is because there is a clear risk that the ECB will be forced to raise long-term interest rates. Such a decision by the ECB will affect the exchange rate of the Euro. If nominal interest rates go up this will have a negative impact on investment, which in turn will affect economic growth and employment. Moreover, increased interest rates will have a negative impact on countries with high public debt further, worsening their public finances.

Politically, it is likely that there will be “anarchy” in the Eurozone, as the small economies, expecting to receive the same treatment as France and Germany, may relax their fiscal policies too. If fiscal policies are suddenly relaxed, then the foundations of the EMU will be at risk. Moreover, the present situation has cast doubt more generally on the effectiveness of European institutions.

Proposals for reform

Three main approaches prevail in the current debate about the SGP's future which may be referred to as the "Community" approach, the "governmental" approach, and the "reform" approach.

According to the first, the SGP is appropriate in its current form. There is neither any need for changing the EC Treaty, nor to reform the SGP. It is the national governments which should bear the blame because they have been unable to manage their fiscal policies properly. The supporters of this approach – that is, the Commission (although not unanimously), the ECB[7] and a number of EU countries including Italy, the Netherlands, Portugal, Spain, Estonia and Poland[8] – argue that the Community should insist on strict compliance with its rules. Furthermore, the role of the Commission should be enhanced to safeguard implementation of the SGP. Monitoring of the budgetary developments should be improved and be based on rigorous accounting rules and timely provision of data. The sanctions procedure should become more automatic and, most important, should be removed from the Council's discretionary authority.

To the advocates of the governmental approach, on the other hand, fiscal policy at the EU level is inefficient. National authorities should be given a more proactive role, and decisions on fiscal rules should be taken at national level. They argue that more fiscal policy autonomy for the national authorities and softer co-operation within the EU will be beneficial for all players and will lead not only to stability but also to sustainable growth. They propose replacing the SGP by new EU rules on fiscal policy, focusing on long-run sustainability targets and short-term stabilisation targets (Lars Calmfors).

Those in the third category believe that the five-year implementation record has shown that the SGP should be reformed but not abandoned. The proposals found in the literature range from minor to radical: that is, from shifting the focus of the SGP from public deficit to public debt, through to the complete centralisation of fiscal policy following the monetary policy paradigm. Among these suggestions are the following.

- The SGP should be improved through minor revisions of the existing rules, mainly by diversification of the medium-term targets. Such a revision should include greater transparency, better monitoring mechanisms to correct misbehaviour in good times, tackling pro-cyclical fiscal bias in good times, stronger discipline and more flexibility (Eijffinger).
- National fiscal assessment should be based on an institutional index, according to which countries will or will not be subject to the EDP (Eichengreen).
- The role of short-term fiscal stabilisation should be given to an autonomous agency, whereas national governments deal with long-term budget sustainability.
- Independent national bodies should be created with responsibility for fiscal policy. National governments should decide on the levels of expenditure and taxation, and the independent fiscal authority will ensure that the budget is in balance or near surplus (Hefeker).

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An assessment

There are no simple or equitable solutions that will satisfy all Member States. On the one hand, change is necessary. On the other, changing the rules or the focus of the rules would be unfair to a number of Member States of the EU and of the Eurozone that are faced with high levels of public debt. These countries have exercised budgetary discipline which has caused hardship for their populations: fulfilment of the convergence criteria and the SGP requirements has demanded long periods of economic austerity. However, changing the focus of the present rules will favour the new Member States with low debt levels and public deficit over 3% GDP.

Independently of what has been claimed about the SGP's "death", the EU should judge the current situation more pragmatically. There is considerable support for the SGP. Any new rules must be feasible. The SGP should be revised in such a way as to take into account the differences among EU countries. For instance, it makes sense to adopt a less homogeneous approach on the terms of application of the SGP in Member States with different medium and long-term prospects. So, the rules should be neither too demanding for Member States with sound fiscal positions, nor too onerous for those Member States that have a long way to go regarding structural changes and real economic and social convergence.

The Pact should be reformed in such a way as not only to guarantee stability but also to promote strong growth in line with the Lisbon Strategy's goals. As a growth-promoting factor, it should accommodate structural reforms which have beneficial effects in the longer term. For this purpose, it must not be short-sighted: it should not focus narrowly on annual budget deficits, disregarding economic potential during the business cycle. As many economists have suggested, the Pact should allow deficits over 3% of GDP when they are accompanied by structural reforms.

Moreover, deficits should be assessed in the context of the business cycle which by nature is longer than any calendar period. A solution could be the adoption of adaptable (rolling) margins according to the economic prospects and/or the degree of structural changes in Member States. This is in line with proposals already made such as the use of an index of institutional reform (Eichengreen) or the so-called "golden rule" (the exclusion of growth-promoting public investment from the calculation of the public deficit).

However, these proposals are not sufficient to remedy the problem. In addition, we need to reach consensus on the methodology and the mechanisms to be adopted for the effective implementation and the efficient monitoring of such multi-dimensional solutions. As the current legal dispute between the Council and the Commission has revealed, it would hardly be appropriate to adopt rules without having beforehand in place monitoring and evaluating mechanisms. Since the European Commission would have the task of overseeing compliance, it should make relevant proposals soon. Unfortunately, it seems that the present Commission is unlikely to put forth any proposals before its term expires in October. The EU is therefore in a state of "suspended fiscal animation". Even though reform of SGP is important, the impending institutional changes will delay it for a considerable time.

The EU needs to adopt a feasible strategy that matches the current situation with objective and rational mid-term targets that can withstand the impact of enlarged membership.

Conclusion

There is no doubt that Europe has come a long way in economic and especially monetary cooperation, and that it has learnt some tough lessons. What is needed now is a comprehensive review of the achievements so far, together with an honest assessment of the gaps and weaknesses of the present system. The EU needs to adopt a feasible strategy that matches the current situation with objective and rational mid-term targets that can withstand the impact of enlarged membership.

Undoubtedly, discipline is needed to safeguard the proper implementation of whatever strategy is eventually adopted. Fiscal co-ordination should not be abandoned. What should be abandoned is the inflexibility of the rules. The EU needs an improved SGP rather than more onerous fiscal rules or no rules at all.

Annex I: Major Steps in International Cooperation on Economic Policy

During the last 60 years, the following episodes in international cooperation may be identified:

- The establishment of the Bretton Woods System in July 1944 by the ruined Europe and the United States.[9]
- The Treaty of Rome in 1957, although the leaders of the founding Member States did not consider at the time the need for a common monetary policy.
- The Barre (1969) and Werner (1971) reports on European Monetary Union.
- The narrowing of the currencies' fluctuation margins on an experimental basis in March 1971.
- The introduction of "the snake in the tunnel" mechanism in order to control currency fluctuations against the US Dollar, in March 1972.
- The establishment of the European Monetary System in March 1979, which had an Exchange Rate Mechanism, the successor of the "snake in the tunnel".
- The adoption of the "Single Market" programme in 1985-87 and the elimination of remaining restrictions on the free movement of capital within the EC.
- The Delors Committee's proposal in April 1989 for implementation of EMU in three stages.
- The Treaty on European Union that came into force in 1993, according to which European monetary unification should be completed before the end of the century in three stages. The Treaty laid the foundations of European macroeconomic policy harmonisation. This was realised by the convergence criteria of the second stage of EMU and by the budgetary discipline the EU countries should obey, i.e., keeping government budget deficit (BD), lower than 3% of GDP and public debt (PD), below 60% of GDP. Furthermore, by the independence of the Central Banks and the establishment of the European Monetary Institute (EMI)[10] were also provided by the same Treaty.

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NOTES

[1] See Annex I for an account of the major steps in economic policy cooperation in Europe.

[2] Official Journal C 236 of 02.08.1997.

[3] The current year, the preceding year and the three coming years.

[4] In accordance with Article 4 of Council Regulation 1466/97.

[5] Article 104c of the Treaty of the European Union, & the Protocol of the Excessive Deficit Procedure. Council Regulation (EC) No. 3605/93/22.11.93 amended by Council Regulation 475/2000/28.9.2000. Council Regulation 1467/97/7.7.97 for speeding up the clarification and the implementation of the EDP.

[6] Eijffinger, S. C. W., in a paper published in Intereconomics, January/February 2003, groups the debate’s criticisms into six main lines, reported above.

[7] Papademos, L., Vice-President, ECB, 3 May 2003.

[8] In a letter sent on 6 February 2004 to the Irish presidency, these countries refer to the SGP as the necessary condition for sustained growth in Europe.

[9] Before the US dollar, the UK sterling was the currency linked to gold in the Gold Standard System.

[10] Treaty of the European Union, Article 109f and Protocol on the Statute of the EMI. ❑