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Task Force on
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Briefing 24
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The Stability and Growth Pact

Briefing prepared by the Directorate-General for Research
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The principal elements of the Stability and Growth Pact were put in place at the Dublin Summit in December 1996. The Pact will act as a deterrant to "excessive deficits", and envisages sanctions in the event of failure, except in "exceptional" circumstances.

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BACKGROUND: EXCESSIVE DEFICITS

Article 109e(4) of the Treaty, as amended by Maastricht, provides that:

> *"In the second stage [of Economic and Monetary Union], Member States shall endeavour to avoid excessive government deficits".*

This has applied to *all* Member States since EMU Stage 2 began at the beginning of 1994.

From the start of EMU Stage 3 at the beginning of 1999, this will be replaced for *participating* Member States by the text of Article 104c(1)

> *"Member States shall avoid excessive government deficits".*

However, the original 109e text will continue to apply, under Article 109k, to "Member States with a derogation" (i.e. the "pre-ins"); and under Protocol 11(6) also to the United Kingdom.

Article 104c continues by outlining an "excessive deficit procedure" for application after the start of Stage 3:

- paragraphs 2 to 8 lay down how national budget deficits are to be monitored and reported on by the Commission; and how the existence of an "excessive deficit" is to be established. These provisions (which have effectively applied since the start of Stage 2) will continue to apply to *participating and non-participating countries alike.*

- the remainder of the Article then outlines procedures under which countries with excessive deficits will be induced to eliminate them, beginning with confidential recommendations, and ending with possible financial sanctions. These procedures will *not* apply to non-participating countries.

Defining "excessive"

The existence of an excessive deficit is established by the Council of Economic and Finance Ministers (ECOFIN), voting by qualified majority on a recommendation from the Commission, and having received the opinion of the Community's Monetary Committee[1].

Member States' "compliance with budgetary discipline" is judged against two "reference values", fixed in Protocol 5.

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[1] Which will become the "Economic and Financial Committee" at the start of Stage 3.

- "*3% for the ratio of planned or actual government*[2] *deficit*[3] *to gross domestic product at market prices*".

- "*60% for the ratio of government debt to gross domestic product at market prices*".

Contrary to much popular belief, the Treaty does *not* require these reference values to be applied as *maxima*.

Budget deficits are not to be considered excessive if the ratio to GDP

> *"has declined substantially and continuously and reached a level that comes close to the reference value";*

nor if

> *"the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value".*

Similarly, an excessive deficit is not created in the case of overall debt if

> *"the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace".*

Moreover, when reporting on whether deficits are to be considered excessive the Commission must take into account:

- "*whether the government deficit exceeds government investment expenditure*"; and

- "*all other relevant factors, including the medium-term economic and budgetary position of the Member State*".

Deficit-correction

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[2] "Government is defined in the Protocol as "general government, that is central government, regional or local government and social security funds, to the exclusion of commercial operations, as defined in the European System of Integrated Economic Accounts". Further information is given in the "detailed rules and definitions" adopted under Treaty Article 104c(14): i.e. Regulation EC 3605/93 of 22.11.93 (*OJ L332 of 31.12.93).*

[3] *This is calculated on the basis of the actual borrowing necessary* on the capital markets - that is, the Public Sector Borrowing Requirement (PSBR) - rather than the statistical difference between public expenditure and public revenue, since the latter are defined in slightly different ways in different countries.

Once an excessive deficit is established, increasing pressure can be brought to bear on the offending Member State.

- The Council can first make a confidential recommendation for action.

- If this does not have the desired result, the recommendation can be made public.

- The next step is an explicit demand from the Council that the deficit be reduced within a specified time-limit.

- Continued failure to comply would trigger one or several possible sanctions:

    - the Member State might be required to "*publish additional information, to be specified by the Council, before issuing bonds and securities*";

    - the European Investment Bank might be "*invited...to reconsider its lending policy*";

    - the Member State might be required to "*make a non-interest-bearing deposit of an appropriate size with the Community*";

    - finally, fines might be imposed.

The Treaty provides that all the operative decisions on these measures are to be taken by the Council of Finance Ministers (ECOFIN), normally by a majority of two-thirds of the weighted votes of its Members, *excluding* the offending Member State. The only reference to the European Parliament is the short provision that "*the President of the Council shall inform the European Parliament of the decisions taken*".

BACKGROUND: GENESIS OF THE PACT

In 1995 the German Finance Minister, Theo Waigel, put forward detailed proposals for strengthening substantially the excessive deficits procedure. Should a Member State overshoot the target deficit level - which, he suggested, might be reduced from 3% to 1% of GDP - a non-interest-bearing deposit would become automatic and obligatory (under Article 104c, paragraph 11, such a deposit is only an option, and is subject to a decision by the Council). The deposit would be refundable when the deficit fell below the target figure. If this did not happen within a specified time, no refund would take place - i.e. it would become a fine.[4]

In June 1996, ECOFIN formally decided[5] that the procedures of Article 104c indeed needed to be strengthened, notably by setting "tight deadlines" for the various steps in the procedure, and by "establishing a presumption" that sanctions would follow the persistence of an excessive deficit. The Commission itself began work on a proposal of its own, which was presented to, and broadly approved by, an informal ECOFIN in Dublin on 21/22 September 1996.

The Commission's formal proposals were published on the 16th October 1996, and took the form of a Communication[6], together with two draft Regulations.

- The first of these covered the *"strengthening of the surveillance and coordination of budgetary positions"*.
- The second dealt with "*speeding up and clarifying the implementation of the excessive deficit procedure*".

These proposals were broadly supported by the European Parliament in November 1996[7]. ECOFIN reported[8] to the Dublin Summit of December 1996 that virtually all the details of the Pact - now to be called the "Stability and Growth Pact" - had been agreed.

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[4] See paper by Martin Weber for the European Parliament's Monetary Union Task Force *(Briefing no.18, PE 166.309)*

[5] See the Progress Report by the Council to the European Council in Florence: "Preparations for Stage 3 of Economic and Monetary Union *(UEM 15, Brussels 4th June, 1996)*

[6] "Stability Pact for ensuring budgetary discipline in stage three of EMU" *(COM(96)496, 16.10.96).*

[7] Parliament gave a "first reading" to the draft Regulation on "multilateral surveillance", to which the cooperation procedure applies, and an opinion on the draft Regulation concerning "excessive deficits". For details, see later under "THE OPINIONS OF THE EUROPEAN PARLIAMENT".

[8] See *Report by the Ecofin Council to the European Council,* annexed to the *Presidency Conclusions* to the Dublin European Council, 13 and 14 December 1996.

DETAILS OF THE PACT

Formally, the Stability and Growth Pact will consist of:

- the **two draft Regulations**, introduced through the provisions of Treaty Articles 103(5) and 104c(14). In the case of the "multilateral surveillance" regulation the Council acts by weighted majority voting, and the European Parliament is involved through the "cooperation procedure" (Article 189c). In that of the deficit procedure, Council must decide by unanimity, and Parliament is only able to give an "opinion".

- a **European Council Resolution** enshrining "*the solemn political commitment of the Commission, the Council and the Member States to the strict and timely application of the pact*".

The "reference value" for budget deficits remains at 3% of GDP; but this is "*to be seen as an upper limit in normal circumstances*". National budgetary policies should "*create room for manoeuvre in adapting to exceptional and cyclical disturbances*", while avoiding excessive deficits. Hence the medium-term budgetary objective is to be "*close to balance or surplus*": effectively a balanced budget over the economic cycle.

The Commission sees the Pact as a "twin-track strategy", providing

- a "*preventive, early-warning system*" for identifying and correcting budgetary slippages before they breach the 3% threshold; and

- a "*dissuasive set of rules*" to deter Member States from incurring, or failing to correct, an excessive deficit.

Early warning

The first element of this strategy is a strengthening, in the first Regulation, of the "multilateral surveillance" procedure provided for in Article 103 of the Treaty. While those Member States not yet within the Euro area would continue to produce "convergence programmes", each Member State participating fully in Stage 3 of EMU would present three-year, rolling "**stability programmes**". These would contain:

- ♦ an "*objective and an adjustment path*" for budget surpluses/deficits, and forecasts of the government debt ratio;

- ♦ the main official forecasts for growth, unemployment, inflation and "*other important economic variables*";

- ♦ a description of the budgetary measures being taken; and

- "*a commitment to take additional measures when necessary to prevent slippage from targets*".

The first stability programme would have to be submitted before the start of EMU Stage 3 on January 1st 1999. After that, the programmes would be updated annually, and be submitted "*not later than two months after the presentation of annual budget proposals by a Member State government to its national parliament*".

The Council would then have two months (as would also be the case for the convergence programmes of those Member States still outside the Euro area) to examine a programme, and, if necessary, to recommend adjustments. The programme would also be examined by the Monetary Committee (which will have become the Economic and Financial Committee at the beginning of 1999). The procedures for confidential, but if necessary public, recommendations would then continue as provided would then continue as provided for under Treaty Article 103.

Deadlines

The second Regulation makes precise the deadlines in the excessive deficit procedure.

- The Economic and Finance Council (ECOFIN) would have *three months* following the submission of budget figures by a Member State to decide whether an "excessive deficit" existed (Article 104c(6)), and to issue a recommendation (Article 104c(7)). Council would initially base its judgement on the "official public decisions" by the national government concerned. It would reserve the right to reconsider if these decisions were not enacted by the national legislatures within a specified time limit.

- If ECOFIN decided after *another four months* that no effective action had been taken by the member State in question, it could make the recommendation public.

- Failing action by the offending Member State within *one month*, ECOFIN could then issue a notice for the Member State to take deficit-reduction measures.

- If *within another two months* no satisfactory measures had been taken by the Member State, ECOFIN would, "as a rule, decide to impose sanctions".

The *total time* between the reporting date for budgetary figures and any decision to impose sanctions would have to be *less than ten months.*

Table 1: Stability and Growth Pact deadlines

March	A	May	J	J	A	September	October	N	December	2 yrs. later
Member States reports fiscal data*		"Excessive deficit" established by Council and recommendation made				Recommendation may be made public. Member States report fiscal data*	Possible notice of "specific measures" by ECOFIN		Measures implented. If not, non-interest-bearing deposit to be made'	Excessive deficit to be eliminated. Otherwise deposit paid into Comunity Budget

* Member States are required to submit data in March and September of every year.

Penalties

The second purpose of this Regulation is to quantify the deposits and fines provided for in Treaty Article 104c, and to make them obligatory. The non-interest-bearing deposits provided for under Article 104c(11) would consist of two elements:

- a fixed sum equal to 0.2% of GDP; and

- a supplement equal to 0.1% of GDP for every percentage point by which the budget deficit exceeded the 3% reference level.

These provisions would, however, be subject to two qualifications:

- There would be an *upper limit* of 0.5% of GDP; and
- If the excessive deficit were due to non-compliance with the *government debt criterion* (the 60% of GDP reference value), only the *fixed sum* would be due.

If the deficit persisted two years later:

- the deposit would become a fine, and be paid into the Community Budget[9];
- a new non-interest-bearing deposit would have to be made; and

- some of the other measures outlined in Article 104c(11) might also be imposed.

The Noordwijk ECOFIN of April 5th 1997 decided that a fine up to 0.5% of GDP could be levied for *each year* during which the excessive deficit persisted. However, after the first year the 0.2% fixed sum would no longer apply: i.e. a 4% deficit would incur a 0.3% of GDP penalty in the first year (0.2% + 0.1%); but only 0.1% of GDP in the second.

“Exceptional and temporary”

The second draft Regulation also provides for possible derogations from this procedure if an excessive budget deficit is the result of "exceptional and temporary" circumstances. What these might be was the main item clarified at the Dublin ECOFIN and Council. In the text of the draft Regulation, the Commission gave its opinion that the term could be "clarified to a degree”. A deficit could be defined as exceptional and temporary:

> “*when resulting from an unusual event outside the control of the relevant Member State and which has a major impact on the financial position of the general government, or when*

[9] It was decided at the Noordwijk ECOFIN of April 5th that fines would accrue only to countries participating in EMU Stage 3, and not to the European Community as a whole.

resulting from a severe economic downturn, in particular in the case of significant negative annual real growth".[10]

The main problem that faced the Council was quantifying the term "significant". The outcome is a two-tier system, to be incorporated in the European Council Resolution.

- "As a rule" an economic downturn will be considered exceptional only if there is "*an annual fall of real GDP of at least 2%".*

- A Member State will also be able to request that a *less than 2%* fall of real GDP be considered exceptional "*in the light of further supporting evidence, in particular on":*

    - *"the abruptness of the downturn",* or

    - *"the accumulated loss of output relative to past trends*".

- However, the Resolution will also "*contain an undertaking by the Member States*" not to invoke this special request procedure "*unless they are in severe recession*".

- "*In evaluating whether the economic downturn is severe, the Member State will as a rule take as a reference-point an annual fall in real GDP of at least 0.75%".*

Effectively, the Council Resolution would therefore allow scope for *any* fall in national GDP to be considered "exceptional", though with increasingly stringent conditions the lower the fall:

Table 2: "Exceptional" falls in GDP - definitions

Fall in GDP	Circumstances in which it may considered "exceptional"
-2% or worse	"as a rule"
0.75% - 2%	"severe recession" established in the light of supporting
	evidence on abruptness and accumulated loss of output.
0 - 0.75%	exceptionally, a reference point lower than 0.75% applied
	(0.75% is considered the reference point "as a rule")

[10] Draft Regulation, Article 1(2).

POSSIBLE EFFECTS

Now that most of the statistical details of the Stability and Growth Pact are known, it is possible to evaluate its potential effectiveness in preserving fiscal discipline. It is instructive to see, for example, how it might have operated in the past.

One element would have been the extent to which "exceptional circumstances" would have exempted Member States from the "excessive deficits" procedure.

Table 3: Number of "exceptional" years, 1970-96

	Annual GDP fall of	
	more than 2%	*0.75% - 2%*
Austria	0	0
Ireland	0	0
Netherlands	0	0
Spain	0	1
denmark	0	2
France	0	2
Belgium	0	3
Germany	0	3
Luxembourg	1	0
Greece	1	1
Italy	1	1
Portugal	1	2
Sweden	1	3
Finland	2	1
UK	2	2
Total	**9**	**21**

Source: "Economist" December 21st. 1996, & OECD

Estimates have also been made of the extent to which Member States would have incurred financial penalties as a result of failing to eliminate "excessive deficits". Taking into account only the 2% threshold for "exceptional circumstances", and the timetables laid down in the draft Regulation, Germany, France, Italy and the UK would all have incurred financial penalties over the last 25 years.

Table 4: years in which penalties would have been payable

Germany	1975/76	1981/82				
France			1992/93	1993/94	1994/95	1995/96
Italy	all years!					
UK	1973/74	1975/76	1977/78	1979/80	1992/93	1994/95
	1974/75	1976/77	1978/79	1983/84	1993/94	1995/96

Source: The Times, Friday December 6th., 1996

The UK would only have escaped penalties for 1980-81 and 1991-92 because its GDP fell in 1980 and in 1991 by more than 2%. The cumulative fines would have come to 1.9% of GDP for France ($25 billion); 4% of GDP for the UK ($41 billion); and 12% of GDP for Italy ($122 billion).

THE OPINIONS OF THE EUROPEAN PARLIAMENT

The European Parliament voted on the draft Stability and Growth Pact Regulations on 28th. November 1996[11]. The report by Mr. Ephthymios **CHRISTODOULOU** proposed a substantial number of amendments to both, reflecting the general approach of Parliament to the Pact as a whole.

In the case of the Regulation on the **strengthening of the surveillance and coordination of budgetary positions,** Parliament's vote constituted a first reading. Council's "common position" will in due course return to Parliament, when those amendments not already accepted may be re-affirmed by an absolute majority.

In the case of the Regulation on **speeding up and clarifying the implementation of the excessive deficit procedure** Parliament's vote is its final say on the matter.

Parliament's amendments to *both* Regulations emphasise a number of points.

- Strict adherence to the provisions of the Treaty requiring Parliament to be informed of action taken by the Council.

- The importance of taking into account, when assessing national budget deficits, the level of public investment (as required by the Treaty); and to ensure that budgetary policy is set to allow adequate public investment.

- The importance of factors other than limits on budget deficits and debt: in particular, the effects of fiscal policy on demand, economic growth and employment.

- A requirement that the "modalities and provisions" of the Regulations should be regularly reviewed by the Council, after consulting the Parliament, the first review to take place in 2001.

In addition, specific amendments were adopted in the case of the **first Regulation** concerning:

- Maintenance following the start of EMU Stage 3 of the Cohesion Fund.

In the case of the **second Regulation** Parliament also called for:

- Inclusion among the "exceptional circumstances" of "unusual events linked to safeguarding the territorial sovereignty of a Member State".

- The exclusion from consideration as public expenditure, in assessing budget deficits, of any deposit or fines payable under the Pact.

[11] See Minutes of the session PE 254.432

At the same November 1996 session, Parliament also adopted a resolution based on a report by Mr. Alman **METTEN**, concerning the 1996 convergence decision by the Council taken under Article 109j(2) of the Treaty. This particularly emphasises the possibilities for a flexible interpretation of the 3% and 60% reference values, and

> *"Calls on the EMI Council, the Commission, the Ecofin Council and the Council meeting in the composition of the Heads of State or Government to make full use of the assessment margin incorporated in Article 104c(12) of the EC Treaty and to respect the same interpretation of the assessment margins for the stability pact."*

The resolution also recommends that, where Ecofin has decided that excessive deficits *do* exist,

> *"the excessive deficit decisions should be abrogated as soon as possible, i.e. as soon as the excessive deficits in the Member States concerned have been corrected and no longer exist, in accordance with Art. 104c(12) of the Treaty."*