

FRAMEWORK FOR FISCAL POLICIES

The framework for fiscal policies of EU Member States is primarily intended to monitor and supervise the deficits and debts of each Member State. The aim is to achieve balanced budgetary positions over the economic cycle. The Commission is the institution responsible for the monitoring. The crisis has shown the current legal framework to be insufficient and reform discussions on economic governance are ongoing.

LEGAL BASIS

- Articles 3, 120 to 144, 219 and 282 to 284 TFEU
- Protocols on the excessive deficit procedure, annexed to the TFEU, and on the convergence criteria referred to in Article 121, annexed to the TFEU

OBJECTIVES

The purpose of the framework for fiscal policies of the Member States is to fulfil the Treaty objective of securing sound public finances in the context of deeper economic integration, in particular within economic and monetary union (EMU). Rules outlining a common framework for national fiscal policies were introduced into EU law in the Treaty of Maastricht as an essential element of the preparations for the completion of EMU. Although national sovereignty in the field of fiscal policy was maintained, the autonomy of Member States was reduced by the Stability and Growth Pact (SGP).

1. Fiscal prerequisites in a monetary union

At the start of the third stage of EMU in 1999 (*5.1), and with the introduction of the euro, there were doubts as to whether a single currency could survive without some elements of common fiscal policy, such as fiscal stabilisation mechanisms, or even common (federal) taxes; at least the theory of monetary union seemed to suggest that it could not. For a long time, this debate was muted, as the first 10 years of the euro coincided with years of moderate economic growth, unprecedented financial globalisation and ample liquidity, which seemed to make the question obsolete. In a monetary union with fiscal policy independence, a common framework for fiscal policies can be justified so as to prevent free-riding. This problem arises when one participant can act knowing he will not be suffering the (full) consequences of his actions as others will bear the cost. In EMU this might be the case if an individual Member State were to choose to run high budget deficits and accumulate debt, expecting to escape the full cost of this course of action in the form of higher interest rates. In the absence of a monetary union, a country with such imprudent policies would be subjected to a higher cost of borrowing whereas in a monetary union, the impact on the whole is more muted. Given the experience of a drift towards ever-higher debt levels, the Member States have opted for a framework of rules-based fiscal policy.

ACHIEVEMENTS

A. Framework

1. Convergence criteria

The convergence criteria define the framework for fiscal policies for EU Member States before their entry into EMU, and they therefore continue to apply to those Member States that have not yet adopted the euro. For the first 11 Member States that entered the third stage of EMU in 1999, along with Greece (which was able to join at the beginning of 2001) and all other countries that have since adopted the euro, the original criteria are no longer applicable. The fiscal policy framework applicable to them, however, draws heavily on the convergence criteria and includes reporting procedures and sanctions. Council Regulation (EC) No 3605/93 on the application of the protocol on the excessive deficit procedure remains applicable.

2. The Stability and Growth Pact

The Stability and Growth Pact consists of:

- Resolutions of the Amsterdam European Council of June 1997 on stability, growth and employment;
- Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions, and the surveillance and coordination of economic policies, as amended by Council Regulation (EC) No 1055/2005 of 27 June 2005; and
- Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, as amended by Council Regulation (EC) No 1056/2005 of 27 June 2005.

These set out how the Treaty rules — in particular the excessive deficit procedure — should be implemented. The pact is applicable to all Member States, both those that have already adopted the euro and those still in the waiting room (Sweden, the Czech Republic, Latvia, Lithuania, Hungary and Poland) or opting out (Denmark and the United Kingdom). With regard to the soundness of budgetary positions, the rules are the same as the convergence criteria. They limit the deficit in general government finances to 3 % of GDP in any year; and the public debt-to-GDP ratio to 60 %. Additionally, the section on medium-term budgetary objectives in Council Regulation (EC) No 1466/1997 requires general government finances to be close to balance or in surplus in the medium term. This, combined with the nominal deficit limit of 3 % of GDP which is independent of the cyclical position of the economy, means that in times of strong growth, public finances should be in surplus if deficits are to be permitted during downturns. A balanced position in the medium term permits the use of ‘automatic stabilisers’ to offset the negative effects felt during downturns, where lower growth reduces tax revenues and higher unemployment raises public expenditure. Council Regulations (EC) Nos 1055/2005 and 1056/2005 amended the original regulations in a reform of the Stability and Growth Pact. As a number of Member States were experiencing difficulties in respecting the rules of the pact, the reform essentially increased its flexibility. Most notably, since 2005, the pact has paid greater attention to debt developments and the implementation of structural policies,

and also allows for a more differentiated country-specific assessment in the medium-term objectives. It also allows for more leeway in the enforcement of the excessive deficit procedure (see point 3 below). Indeed, immediately after its introduction, the reform was criticised for having gone too far in catering to the special needs of some Member States struggling with high budgetary deficits. Following the crisis, a reform of the decision-making framework was proposed and is under consideration in the EP and Council. The legislative package proposed by the Commission on 29 September 2010 contains the most comprehensive reinforcement of economic governance in the EU and the euro area since the launch of EMU. Broader and enhanced surveillance of fiscal policies (COM(2010) 522 and COM(2010) 526 final) and macroeconomic imbalances (COM(2010) 527 final) is foreseen, enforcement is to be enhanced (COM(2010) 524 and COM(2010) 525 final) and reforms in national fiscal frameworks are introduced (COM(2010) 523).

B. Enforcement

The procedures for guaranteeing that objectives are met are based on multilateral surveillance, comprising regular reporting and recommendations for corrective action, if commonly agreed targets are not met. Pecuniary sanctions are possible if the binding deficit limit is exceeded. However, it is the generally accepted opinion that the enforcement mechanisms have failed to sufficiently contain the fiscal profligacy of some Member States, and the reform of the SGP is under way.

1. Stability and convergence programmes

For the purposes of multilateral surveillance, all Member States are required to submit medium-term programmes to the Council and the Commission with regard to their budgetary position and the economic outlook on which they base their budget plans, as part of the preventive arm of the pact. These programmes are called stability programmes for the EMU Member States and convergence programmes for those outside EMU. They must cover a period of 3 years following the year of submission, as well as the year prior to submission and the current year. The programmes must be updated annually. Updates are typically submitted in the autumn; which in most Member States coincides with the presentation of the following year's budget proposal to the national parliament. The new 'European semester for economic policy coordination' should integrate all revised and new surveillance processes into a comprehensive and effective economic policy framework.

a. Content

The programmes must provide information on:

- how the medium-term objective of close to balance or in-surplus is to be achieved, as well as on the expected development path of the government debt ratio;
- the main assumptions about economic developments on which the programme is based, and measures of budgetary and other economic policy carried out to achieve the objectives set out in the programme.

b. Assessment

The programmes are assessed by the Commission and the Economic and Financial Committee. On the basis of these assessments, the Council examines whether:

- based on the medium-term objectives set out in the programme, an excessive deficit is likely to be avoided;
- the measures taken or proposed are sufficient to achieve a medium-term objective of a balanced budget;
- the underlying economic assumptions are realistic;
- the programme is consistent with the recommendations addressed to the Member State in the broad economic policy guidelines (*5.4).

The Council delivers an opinion on each programme acting on the recommendation of the Commission and after having consulted the Economic and Financial Committee.

2. Early warning

a. Failure to respect the balanced-budget requirement

If the Council finds that the development of a Member State's public finances diverges significantly from the objective of a balanced position in the medium term or from the path towards such a position, it must issue an early warning to the Member State concerned. The early warning is given as a Council recommendation to make the policy adjustments that are necessary.

b. Failure to implement the broad economic policy guidelines (BEPGs)

The Council can also give an early warning if it considers, following a Commission recommendation, that a Member State has not implemented in its stability or convergence programme the recommendations addressed to it in the BEPGs.

3. Excessive deficit procedure (EDP)

a. Concept

The purpose of the procedure is to ensure that excessive deficits are promptly corrected: it constitutes the corrective arm of the pact, and as such is also meant as a deterrent. In normal circumstances, a general government deficit exceeding the reference value of 3 % of gross domestic product (GDP) at market prices is considered excessive. This deficit limit is not applicable in a severe recession. Before the reform of the pact in June 2005, a severe recession was defined as an annual drop in real GDP of at least 2%; since this reform, a negative rate of GDP growth or a prolonged period of low growth now suffices. The EDP may also be set aside in 'exceptional' circumstances, and the scope of these circumstances was increased in the June 2005 reform (now called 'relevant factors').

b. Implementation

The Commission is responsible for monitoring the Member States' budgetary positions and debt levels. For this purpose, the Member States report their planned and actual government deficits and debt levels to the Commission twice a year (by

1 March and 1 September). If the Commission detects a deficit that is or risks becoming excessive, it must draw up a report. Based on a Commission recommendation, the Council then decides whether an excessive deficit exists: if this is the case, the Council makes a recommendation to the relevant Member State establishing a deadline of 6 months for effective corrective action to be taken. If the Member State does not take adequate measures, the Council may require it, at the latest 10 months after the reporting of the data indicating the existence of an excessive deficit, to make a non-interest bearing deposit. However, the Council may extend this period by 1 additional year. The payable deposit comprises a fixed component equal to 0.2 % of GDP and a variable component linked to the size of the deficit. Each subsequent year, the Council may decide to intensify the sanctions by requiring an additional deposit; though the annual amount of deposits may not exceed the upper limit of 0.5 % of GDP. As a rule, a deposit is converted into a fine if, in the view of the Council, the excessive deficit has not been corrected after 2 years.

c. Practice

Since the beginning of the third stage of EMU, the Commission has prepared a number of reports under the excessive deficit procedure. For example, in September 2002, it concluded that Portugal's deficit of 4.1 % of GDP in 2001 was excessive. In November 2002, the Commission reached the same conclusion concerning Germany's projected deficit for 2002. In April 2003, the French deficit of 3.1 % in 2002 was found to be excessive. In all cases, the Council subsequently adopted a decision on the existence of an excessive deficit and a recommendation with a view to bringing an end to the situation. During the crisis, especially in 2009 and 2010, most Member States of the Union were in breach of the criteria of the SGP. In practice, however, the financial sanctions foreseen in the EDP have never been applied.

C. Financial and economic crisis of 2008–11

The situation of public finances in the EU Member States is worrying. In 2009, the average government deficit stood at 6.3 % of GDP for the euro area and 6.8 % for the EU. Government debt stood at 79.2 % and 74.0 %, respectively. Public finance crises have been experienced in Greece and Ireland, and speculations about Portugal, Spain, Italy and Belgium continue to raise concerns. This situation is to a great extent induced by large private-sector leverage which constitutes a contingent liability for the public sector; inasmuch as the state would have to bail out the banking sector, the debts of a substantial part of which remain unresolved. As a result, economic governance in general and fiscal governance in particular are in the process of being restructured. This involves the following elements:

- (i) addressing imbalances through stronger macroeconomic surveillance, including alert and sanction mechanisms; (ii) strengthening national fiscal frameworks by specifying minimum requirements for domestic fiscal frameworks, and notably moving from annual to multiannual budgetary planning; and (iii) strengthening the Stability and Growth Pact, in particular by focusing on the issue of debt dynamic next to deficits;
- the European semester for economic policy and coordination will provide a European input to national policy decisions, leading to more effective ex ante policy coordination; this also applies to the structural reforms and the growth-enhancing elements of the Europe 2020 strategy;

- the proposed creation of the European Stability Mechanism (ESM) as a permanent crisis resolution mechanism to respond to threats to the systemic stability of the euro area (*5.3).

THE ROLE OF THE EUROPEAN PARLIAMENT

The EP is an equal co-legislator regarding setting detailed rules for multilateral surveillance, including the Stability and Growth Pact. It is consulted on secondary legislation implementing the excessive deficit procedure. In several resolutions the EP has reiterated its view that it and the national parliaments should be more closely associated in the policy coordination processes, which have a significant impact on national fiscal policy.

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