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THE EUROPEAN UNION

THE STABILITY AND GROWTH PACT

WITH EVIDENCE

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(Q) refers to a question in oral evidence;

(p) refers to a page of evidence.

THIRTEENTH REPORT

11 MARCH 2003

By the Select Committee appointed to consider European Union documents and other matters relating to the European Union.

ORDERED TO REPORT

THE STABILITY AND GROWTH PACT

COM (2002) 668 Final	Communication from the Commission to Council and the European Parliament: "Strengthening the co-ordination of budgetary policies", Brussels, 27.11.2002

PART 1: EXECUTIVE SUMMARY

In the European Union, the national budgets of the Member States are subject to the constraints of the Stability and Growth Pact. In particular, the Pact imposes tight limits on government deficits and debt However, the Pact has come in for heavy criticism over the past year, as several large Member States are breaching the rules of the Pact. The Pact is under immense strain and pressure; some people have even said that the Pact should be torn up and that completely new fiscal rules need to be established for the EU. In the hope of rescuing the Pact's credibility, the Commission proposed a series of reforms at the end of last year.

The European Heads of State and Government will discuss the Stability and Growth Pact and these possible reforms at the European Council meeting in Brussels on 20–21 March.

This report examines the reasons why the EU has a Stability and Growth Pact and asks how it should be reformed. We analyse each of the Commission's proposals and assess their likely effects.

The Committee recommends:

- The target of budgets 'close to balance or in surplus' should be measured in terms of the cyclically-adjusted budget balance. Member States with a low level of underlying debt should be allowed "a small deviation" from the target.
- The Council should not treat the 3 % of GDP ceiling on deficits as an absolute limit. The decision to implement sanctions should take account of the underlying economic situation, including the Member State's position in the economic cycle and possibly its level of debt.
- The Commission should have the power to issue early warnings directly to Member States.

The Committee advocates a flexible interpretation of the Pact. This would provide additional flexibility for those countries (particularly Germany and Portugal) that currently need it. Our recommendations could also be used to allow greater short-term flexibility to low-debt countries with sound public finances (such as the UK) and so provide an incentive for highly indebted countries (such as Greece and Italy) to reduce their level of debt. As such, our recommendations should restore credibility to the Pact and help Member States to maintain sound public finances. We conclude that the Commission proposals can be used as a good basis to achieve the necessary flexibility for the Stability and Growth Pact, as they can be read as offering sound guidelines for Member States to follow. However, interpreted differently, they could be used to add a new set of extra rules to the Pact. Such an interpretation of the Commission proposals would move the Pact in the wrong direction, by making it more rigid. We therefore call on the Government to ensure that the Commission's proposals are interpreted in the flexible way proposed by the Committee.

PART 2: INTRODUCTION

What is the Stability and Growth Pact?

1. The Stability and Growth Pact sets out rules for the European Union, establishing a framework within which Member States have agreed to coordinate their fiscal policies. For whilst monetary policy in the euro area has been unified and is now conducted by the European Central Bank (ECB), fiscal policy remains a matter for national governments. The fiscal policies of the Member States are, however, subject to the constraints of the Stability and Growth Pact (SGP). This comprehensive surveillance procedure, which involves monitoring the national budgets across the European Union (EU), is aimed at ensuring the fiscal discipline of the Member States. Whether or not a Member State has adopted the euro, "Member States are free to structure the expenditure and the revenue side of their budgets according to their own national preferences" (Q 267). "But, subject to that, Member States have agreed a framework [in the Stability and Growth Pact] for the coordination of fiscal policy, with a view to maintaining sound public finances" (p. 44). In particular, the Pact imposes tight limits on government deficits.

2. The SGP, which was adopted at the Amsterdam European Council in June 1997, complements and strengthens the provisions of the EC Treaty on budgetary discipline. To understand the Pact, therefore, it is sensible to examine first the relevant EC Treaty provisions on economic policy.

THE EC TREATY AND EXCESSIVE DEFICITS

3. Under Article 99 of the EC Treaty Member States agree to "regard their economic policies as a matter of common concern" and accordingly to "coordinate them within the Council". Of particular importance in this regard is the Excessive Deficit Procedure (EDP), which is set out in Article 104 of the EC Treaty.

Box 1

Economic and Monetary Union (EMU)

The Delors Report in 1989 envisaged a three-stage transition to full Economic and Monetary Union (EMU). The EC Treaty, as revised in Maastricht, set out a timetable for the transition to the final stage—Stage Three—of EMU.

Stage Three of EMU started on 1 January 1999, when the exchange rates of participating currencies were locked together and these currencies became denominations of the single currency, the euro. Euro notes and coins followed three years later, on 1 January 2002, and gradually replaced participating national currencies.

Responsibility for determining monetary policy for those countries participating in Stage Three passed to the Governing Council of the European System of Central Banks, which consists of members of the Executive Board of the European Central Bank, plus governors of participating Member States' national central banks.

12 EU countries have now adopted the euro: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. The other three EU countries have not adopted the euro and remain at Stage Two of EMU: Denmark, Sweden and the United Kingdom.

4. Member States in Stage Three of Economic and Monetary Union (EMU) "shall avoid excessive government deficits", as defined in Article 104 and Protocol No 20 on the EDP, which is annexed to the EC Treaty. Member States, like the UK, that are in the Second Stage of EMU "shall endeavour to avoid excessive deficits", rather than be obliged to "avoid excessive deficits" (Article 116(4) of the EC Treaty). As part of the EDP, all EU Member States must submit Excessive Deficit returns to the European Commission on 1 March and 1 September each year.[1]

5. The Commission examines these returns and thereby monitors Member States' compliance with the Pact's rules on budgetary discipline and makes judgments on the existence or otherwise of excessive deficits. In accordance with Article 104(2), the Commission uses two criteria for this task:

[1] In line with Council Regulation (EC) No 3605/93, of 22 November 1993, on the application of the Protocol on the EDP.

(a) Whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds 3 %. Deficits above this limit will be considered excessive except when temporary and due to exceptional circumstances.

(b) Whether the ratio of government debt to GDP exceeds 60 %, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

6. As with any numerical threshold, the figures have a certain degree of arbitrariness. The figure for the debt ratio was slightly above the EU average when the Treaty was negotiated, while the deficit reference value was below, though it had been met in the late 1980s. If the Commission believes that a Member State has exceeded, or is at risk of exceeding, the values for government deficit or government debt, it should prepare a report as the first stage in the EDP, which can eventually lead to sanctions in the form of fines. To understand properly the EDP as it now functions, it is necessary to examine the Stability and Growth Pact, which clarifies how the EDP works.

THE LEGAL ELEMENTS OF THE STABILITY AND GROWTH PACT

7. The Stability and Growth Pact entered into force on 1 January 1999 with the transition to Stage Three of EMU. The Pact consists of three elements: a Resolution of the European Council and two Regulations.

- The first Regulation (No 1466/97) focuses on the prevention of excessive deficits;[2]
- the second Regulation (No 1467/97) focuses on deterrence, by clarifying how the EDP is to be implemented against Member States with excessive deficits;[3] and
- the Resolution provides guidance to the Member States, the Commission and the Council on the application and implementation of the Pact.[4]

The Amsterdam Resolution

8. In the European Council Resolution, agreed at Amsterdam on 17 June 1997, the European Heads of State and Government decided to go beyond the provisions of the EC Treaty. They committed themselves to the medium-term target of achieving budgets that are 'close to balance or in surplus'. The idea was that attaining such a position would give the Member States a safety margin which would allow them to deal with cyclical fluctuations, while always keeping the government deficit below the reference value of 3 % of GDP.

Regulation on surveillance and co-ordination.

9. Council Regulation (EC) No 1466/97 embodies the preventive elements of the Pact. The Regulation aims to prevent at an early stage the emergence of an excessive deficit. To this end, it establishes two key preventative measures:

- regular surveillance of Member States' respect of budgetary commitments; and
- early warnings in the event of non-respect of budgetary targets.

10. The main tools of multilateral surveillance are the Member States' annual stability or convergence programmes. The Regulation defines the contents of these programmes and sets out rules for their submission, examination and monitoring. In these programmes, Member States set out their short- and medium-term budgetary strategies to reach and sustain budget positions that are 'close to balance or in surplus'. As well as this adjustment path towards meeting the medium-term budgetary objective of the SGP, Member States also submit the expected path of the general government debt ratio.[5] The Member States submit their programmes to the Commission at the end of each calendar year. The Commission then assesses them, and, on the basis of the Commission's recommendation, the Council delivers an opinion.

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[2] Council Regulation 1466/97 [1997] OJ L209/1 (on the strengthening of the surveillance and co-ordination of budgetary policies).

[3] Council Regulation 1467/97 [1997] OJ L209/6 (on speeding up and clarifying the implementation of the excessive deficit procedure).

[4] Resolution of the European Council on the Stability and Growth Pact, Amsterdam, 17 June 1997, OJ C 236, 02/08/1997, pp. 0001–0002.

[5] Member States in Stage Three of EMU submit stability programmes; Member States outside the Eurozone submit convergence programmes. In contrast to stability programmes, the convergence programmes also deal with monetary policy and aim at achieving sustained convergence.

11. In the event of a significant divergence of the budgetary position of a Member States from the medium-term budgetary objective, or the adjustment path towards it, the second preventive measure can be activated. This is referred to as the early-warning mechanism; it involves the Council, on the basis of a Commission recommendation, addressing an early warning to the Member State, urging corrective action. In this early warning, the Council would recommend particular actions to rectify the budgetary slippage. The Commission explains the early-warning mechanism as follows:

> "The purpose of the early warning is to send a signal to the Member State concerned that the budgetary targets, which had been endorsed by the Council, have not been adhered to. It also gives the Member States sufficient time to take corrective measures if appropriate so as to avoid budget deficits approaching the 3 % of GDP reference value. As such, it is an important signalling device on the need for enhanced vigilance. The Pact foresees a clear sequencing of events, with an early warning being issued prior to recourse being made to the dissuasive elements of the SGP, namely the excessive deficit procedure."[6]

Regulation on the excessive deficit procedure

12. Council Regulation (EC) No 1467/97 is considered to represent the dissuasive side of the SGP, because it provides a detailed clarification and a speeding up of the sanction mechanisms, building on the EDP as set out in Article 104 of the EC Treaty. The purpose of the Regulation is thereby to deter excessive deficits and, if they occur, to further their prompt correction, by means of a set of rules for the application of Article 104.

13. Once the deficit of a Member State goes above 3 % of GDP, the Council must judge that the country has an excessive deficit, unless the breach is due to exceptional circumstances, is temporary and the deficit remains close to the reference value. The Regulation spells out (Article 2(2) and (3)) what is meant by "exceptional and temporary" in Article 104, which defines when the 3 % limit may be exceeded. The Commission has to apply tighter rules than the Council for qualifying a deficit over the reference value as exceptional:

- As a rule, a deficit is automatically considered exceptional by the Commission if output fell by at least 2 % of GDP in the year in question.
- In addition to considering a deficit exceptional if output fell by at least 2 %, the Council may consider a deficit to be exceptional if output fell by 0.75–2 %.

14. As can be seen, the Council has some discretionary room in deciding whether a deficit owing to a severe economic downturn is exceptional and hence not excessive. Where an excessive deficit is judged by the Council to exist, the Member State concerned is required to take measures that aim at bringing deficits below the 3 % of GDP reference value. A repeated failure to take corrective measures could eventually lead to the imposition of sanctions, which ultimately take the form of fines.

15. The Regulation specifies the rules on sanctions, together with guidance on their application, and sets deadlines for implementing the different steps in the procedure. It sets a deadline for decisions on sanctions and requires, as a rule, a non-interest-bearing deposit from the Member States concerned, which is to be converted into a fine if, two years later, the excessive deficit still persists.

16. When there is progress in correcting the excessive deficit, sanctions can be abrogated. However, the request for a deposit will be lifted only once the Council concludes that the excessive deficit had been corrected. Fines will not be reimbursed.

NON-LEGAL ELEMENTS SURROUNDING THE STABILITY AND GROWTH PACT

Code of Conduct

17. The principle of co-ordinating national budgets through the Pact continues to be an evolving process. The core legal texts set out above are complemented by a series of declarations,[7] which are not legally binding but which nonetheless exert a powerful influence over the interpretation of the Pact. This evolution of non-legal instruments around the Pact is demonstrated by the 'Code of Conduct on the content and format of stability and convergence programmes', which was first added in October 1998, and then revised by the Economic and Financial Committee (EFC) in June 2001. This latest version of the Code of Conduct was adopted by the Ecofin Council on 10 July 2001.

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[6] *Public Finances in EMU—2002*, *European Economy* No.3, 2002, pp.45–46.

[7] For example, the Heads of State or Government reconfirmed their commitment to the Stability and Growth Pact once again at their informal meeting in Ghent on 19 October 2001.

18. The guidelines set out in the Code constitute a code of good practice and a checklist to be used by Member States in preparing stability or convergence programmes. The new code encompasses a set of standardised tables. It also suggests that the annual updates are all submitted in the autumn, within a period of one and a half months. The aim of the guidelines is to facilitate the evaluation of the programmes by the Commission and Council. The Code explicitly states that the guidelines "are indicative and may be developed further over time, building upon the best practice emerging."[8]

The target date for achieving a balanced budget

19. There have been other important developments around the Pact. For example, in the Amsterdam Resolution, the Member States committed themselves to the medium-term target of achieving budgets that are 'close to balance or in surplus'. Yet neither the Resolution nor any of the other legal instruments of the Pact specifies the date by which Member States must achieve this target of a balanced budget. Nonetheless, various attempts have been made to define the target:

- the 1999 Broad Economic Policy Guidelines (BEPGs) urged Member States "to achieve budgetary positions of close to balance or in surplus by the end of 2002";
- the 2000 BEPGs brought this date forward, proposing that Member States should "meet a budgetary position of close to balance or in surplus earlier than envisaged in the updated stability and convergence programmes and, as a rule, in 2001";
- the 2001 BEPGs maintained the revised date, recommending that Member States "meet, as a rule and in keeping with last year's commitment, budgetary positions of close to balance or in surplus in 2001".

20. Eight of the twelve Eurozone countries achieved the objective by 2001. The other four EMU countries (France, Germany, Italy and Portugal) have, in the Commission's words, "been struggling ever since."[9] Consequently, the target date has been postponed repeatedly. The 2002 BEPGs stated that the medium-term target of budgets 'close to balance or in surplus' was to be achieved by 2004 at the latest for Germany, France, and Portugal, and by 2003 for Italy because of its high level of debt.[10] During the Barcelona Summit, in March 2002, all the EU Heads of State and Government reaffirmed their commitment to reaching or maintaining the target by 2004.[11]

21. In September 2002, the President of the Commission and Commissioner Solbes said that the deadlines for reaching a balanced-budget could "no longer be a moving target, since this not only undermines the credibility of the prevention arm of the SGP but it also reduces the room of manoeuvre of the countries concerned." They called on the Member States to commit to "a strict and enforceable adjustment path including an agreement on in any case a swift return below the 3 % threshold, and a minimum required rate of structural adjustment of 0.5 % of GDP." Yet, whilst calling on Member States not to move the target date again, the Commissioners recognised that their suggested adjustment path "would imply that close-to-balance would be reached [by the Member States] in 2006 at the latest." (*op cit.*) At the Eurogroup meeting on 7 October 2002, the Member States agreed to pursue the Commission's suggested continuous adjustment path for the underlying balance.[12] Consequently, it would appear that the medium-term target has been moved back once again.

[8] Annex to Council press release 262 of 10 July 2001, 10240/01.

[9] 'Budgetary Challenges in the euro area', Communication of Commissioner Solbes in agreement with President Prodi, SEC(2002) 1009/6, Brussels, 25 September 2002.

[10] http://europa.eu.int/comm/economy_finance/publications/european_economy/2002/ee402en.pdf

[11] The Presidency Conclusions of the Barcelona Council (15 and 16 March 2002) stated: "Member States will maintain or respect the medium term budgetary objective of close to balance or in surplus by 2004 at the latest."

[12] The full text of the relevant Eurogroup press release is available online at: http://www.ypetho.gr/eurogroup/

Box 2

The Stability and Growth Pact and the United Kingdom

The United Kingdom has signed up to the Stability and Growth Pact and is subject to its rules. If the United Kingdom budgetary position were to significantly diverge from the medium-term target or if the UK were to run an excessive deficit, it would be censured by the Commission and in the Council, as Director General Regling made quite clear to us (Q 280). This censure could involve various different stages. If, as part of the monitoring and surveillance process outlined in Regulation 1466/97, the Council, on the basis of a Commission recommendation, judged that the United Kingdom budgetary position significantly diverged from the medium-term target, the Council could address an 'early warning' recommendation to the UK Government to take the necessary adjustment measures to prevent the occurrence of an excessive deficit. If the divergence persisted or worsened, the Council would make a recommendation to take prompt corrective measures. In the event of the Council finding that the UK had an excessive deficit under Regulation 1467/97, the Council would make a recommendation to the UK with a view to bringing the situation to an end within a given period. As a Member State that is not a member of the Eurozone, however, the United Kingdom could not be sanctioned for running an excessive deficit or for any other budgetary position that did not comply with the rules of the Pact.

SUMMARY

22. The above sections demonstrate that the Stability and Growth Pact is firmly based on legal texts (the EC Treaty and the Regulations), which have been supplemented by various declarations and guidelines (Council conclusions, the Code of Conduct, the BEPGs) that are not themselves legally binding but are normative in effect. We return below (paragraphs 155–57) to this distinction, between what are often called 'hard' laws and 'soft' laws.

23. There are many ways in which the Stability and Growth Pact could be changed. These include, at one end of the spectrum, amendments to the Treaty and, at the other, a new set of guidelines. Generally speaking, some of our witnesses advocated radical surgery for the Pact, which would involve changes to the Treaty and the Regulations; other witnesses called for more subtle amendments, which could be achieved within the current rules, by, for instance, the Ecofin Council revising the Code of Conduct or the European Council issuing a new statement on the Pact via the Presidency conclusions to the March 2003 European Council in Brussels.

24. On 27 November 2002, the Commission issued a Communication that proposed developing further the interpretation of the SGP.[13] The Communication was generally welcomed,[14] perhaps because all but one of the Commission's proposals focus on changing the way in which certain provisions of the Stability and Growth Pact are interpreted, without changing the formal, legal rules of the Pact, as set out in the Treaty and the two Regulations (QQ 2, 263–64).

25. We did not limit the scope of our inquiry; we gave full consideration to all of the proposals to change the Stability and Growth Pact that we heard, regardless of how they might be effected. It is clear that many changes to the interpretation and implementation of the SGP can be achieved without changing the legal framework of the Pact. Nonetheless, 2003 offers a unique window of opportunity for considering all of the various ways in which the legal aspects of Pact might also be changed, as the Convention on the Future of Europe is currently considering changes to the European Treaties ahead of the next Inter-Governmental Conference, which is expected to produce a new constitutional Treaty for the EU.

Why do we need a Pact?

26. The Committee heard four main reasons why a Stability and Growth Pact is needed. First, the overarching reason is that the performance and management of national economies in the EU are a matter of common interest for the Community. Secondly, an important macroeconomic manifestation of the common interest is that the effects of public borrowing by one economy in the Eurozone may

[13] 'Strengthening the co-ordination of budgetary policies', Communication from the Commission to the Council and the European Parliament (ECFIN/581/02-EN REV 3), 27 November 2002.

[14] In their Explanatory Memorandum to Parliament on 16 December 2002 about the Commission's Communication, the Government called the Commission's proposals "a useful contribution to the debate on the reform of the SGP." Wim Duisenberg, the President of the European Central Bank, said that the ECB considered the Communication "a good starting-point for rebuilding confidence in the budgetary policy framework." (Testimony before the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 3 December 2002). The TUC expressed "broad support" for the proposals (Q 213).

spill over onto other members of the Eurozone, and, consequently, there may be what is known as a 'free-rider' problem. Thirdly, in extreme circumstances, a heavily-indebted member of the Eurozone might default on its debt, imposing costs on all Eurozone members. Fourthly, low public debt would better enable Member States to prepare for the increasing public pension obligations to ageing populations. These four reasons are set out in more detail below.

1. Economies in the EU are a matter of common interest

27. Wim Duisenberg, President of the ECB, has said that sound public finances "are in the interests of all Member States."[15] As can be seen from the box below, however, the EC Treaty goes further than this; the Member States have agreed that the economic decisions of one Member State are of interest to all the Member States. The Treaty makes clear that the economies of the Member States are "a matter of common concern" and that consequently they require co-ordination.

Box 3

THE EC TREATY

Part One: Principles, Article 4(1)

the activities of the Member States and the Community shall include […] the adoption of an economic policy which is based on the close co-ordination of Member States' economic policies

Article 4(3)

[…] activities of the Member States and the Community shall entail compliance with the following guiding principles: stable prices, sound public finances and monetary conditions and a sustainable balance of payments.

Part Three: Community policies

Title VII: Economic and monetary policies,

Chapter 1: Economic policy, Article 99(1)

Member States shall regard their economic policies as a matter of common concern and shall co-ordinate them within the Council.

28. A number of witnesses, such as Professor Buiter, emphasised that although fiscal policy in the EU was controlled at the national level, how such policies were managed was nonetheless a matter of common concern; these witnesses deduced from that position that some set of rules that were centrally monitored and possibly enforced was desirable (Q 2). For example, the TUC considered that macro-economic policy decisions in one economy had "knock-on impacts on others, increasing the potential benefits of effective policy co-ordination and the potential costs of member states pursuing beggar my neighbour policies." (pp. 58, 109)

29. The Directorate-General for Economic and Financial Affairs in the European Commission said that "the key objective of policy coordination is to take account of spillovers of national policies. […] Co-ordination is needed to take account of direct cross-border spillovers of national policies on neighbouring countries."[16]

30. The Stability and Growth Pact is one way in which the Member States aim to achieve the economic co-ordination referred to in the Treaty. Professor Fitz Gerald explained how the transition to Stage Three of EMU "changed the operating environment for all member economies by creating new channels through which the actions of individual Members States could adversely affect the citizens of other members. It is this possibility of negative externalities for the union from fiscal policy in individual members (or a group of members) that required the addition of new rules for coordinating fiscal policy, leading to the agreement on the SGP." (p. 93) The introduction of the euro has led to a new structure of policy making for countries in the Eurozone. A single monetary policy and interest rate responds to Eurozone-wide economic developments, while fiscal policy remains at the national level to deal with asymmetric shocks within the Eurozone and country-specific developments. UNICE and the Commission emphasised the importance of tightly co-ordinated fiscal policies as a consequence of a unified monetary policy in the Eurozone (p. 69; Q 253). The ECB was obviously a

[15] Testimony before the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 3 December 2002.

[16] 'Co-ordination of economic policies in the EU: a presentation of key features of the main procedrues', *Euro Papers*, No 45.

strong advocate of the position that the EU economies were a matter of common concern. Mr Solans, Member of the Governing Council and of the Executive Board of the ECB, considered the Stability and Growth Pact as a "public good, indispensable in an economic and monetary union in which there are national fiscal policies."[17] Witnesses reported two particular potential problems that had given justification to fiscal policies being co-ordinated through the Stability and Growth Pact.

2. THE FREE-RIDER PROBLEM

31. One rationale for the Pact was to prevent members of the Eurozone accumulating excessive debts and deficits, the economic costs of which the Eurozone as a whole would have to bear.

32. As mentioned above, all countries in the Eurozone share a common interest rate on their debt. Therefore, to the extent that higher public borrowing leads to a higher interest rate on public debt, the higher rate is paid by all Member States, not just the member whose borrowing increases. At the same time, the increase in interest rates occasioned by the borrowing of a single Eurozone member, being spread across all members of the Eurozone, is smaller than it would be if that State were not inside the Eurozone, but instead had an independent currency and its own exchange rate and monetary policy. The concern when establishing the Eurozone was that, because the financing costs would appear to be lower, Member States would face smaller market disincentives to public borrowing and so would run larger deficits. As a consequence, total EU government debt would increase, and the interest rate paid on it would in fact be higher. In the words of Professor Begg, the outcome of one country over borrowing would be "adverse for the fiscally virtuous as well as the sinners." (p. 24)[18]

33. Two further arguments link higher public borrowing to higher interest rates. The first is that higher public deficits lead to higher demand for goods and services, and thus greater inflationary pressure. In order to keep inflation on target, the ECB then responds by setting higher interest rates, in effect penalising those Member States that had pursued sensible policies. The second argument is that higher levels of public debt—arising from the accumulation of past deficits—may lead to greater pressure on the ECB to accommodate inflationary pressures, in order to erode the real value of these debts. Financial market anticipations of higher future inflation raise the required yield on government bonds.

34. Apart from the burden that higher interest rates impose on government finances, they also discourage private sector investment and reduce the growth rate of potential output. Consequently, the SGP was intended to produce an advantageous policy mix for the Euro zone. It was intended to lead to a combination of tight fiscal policy and less tight monetary policy to promote medium-term economic growth.

35. In order to tackle this 'the free-rider problem', Member States decided that rules were needed to co-ordinate and restrict Member States' fiscal policies. Otherwise all Member States could be worse off in the end with higher interest rates, and possibly with higher inflation also. Many witnesses cited the free-rider problem as one of the main reasons behind the creation of the Stability and Growth Pact (pp. 58, 93, 107, 109, 110) and the Commission confirmed that this was the case, stressing that every country in the Eurozone still had "an obligation to watch out" for what its deficit situation meant for other countries in the monetary union and for the ECB (QQ 267, 276).

36. However, Mr Crook saw "no evidence" to support the view that the over-borrowing of one country could drive up the interest rate for other Member States. He found that to be a "completely unconvincing" rationale for the Pact. He said that the Commission was "wrong about this." There was "no evidence" to suggest that there was "an EU-wide interest rate penalty for the over-borrowing of a single country" (QQ 139, 143). Professor Fitz Gerald also argued that in practice this problem was likely to be relatively unimportant (p. 96), and the TUC said that, since the formation of the euro, concern with the free-rider problem had "faded" (p. 58), but it was still a "potential problem" that would always remain in a situation where there was a single currency and countries borrowed against a common interest rate (QQ 215–17).

3. THE DEFAULT PROBLEM

37. The second major reason for the Stability and Growth Pact, to which witnesses referred, was to prevent the problem of governments becoming very heavily indebted and then defaulting on their debt.

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[17] Speech 'Macroeconomic stability and growth in the European Monetary Union', delivered at The Economist Conference: Portugal and the European Union, Lisbon, 16 December 2002.

[18] UNICE pointed out that this scenario reflects the 'prisoner's dilemma' in Game theory: "By damaging the other players, one 'free rider' profits more from a situation than he would profit by being cooperative" (q 13).

38. We have seen that many witnesses suggested that being a part of the Eurozone could give Member States incentives for excessive borrowing, the effects of which would 'spill over' onto other Member States. An extreme manifestation of these spill-over effects, which featured prominently in our evidence, was that if a government chronically over-borrowed, in due course it might face problems in meeting interest payments on existing debt, and being able to refinance maturing debt, resulting in default. Professor Goodhart argued that the risks of default were further increased in the Eurozone, because Member States would not be able to monetise their debt when default threatened, as they could have done when they had their own monies (p. 97).

39. Government default within the Eurozone would threaten the stability of the financial system of the country in question and the effects would possibly spread more widely. This raises the possibility that the ECB would have to bail out the financial system of some or possibly all Eurozone members, in order to prevent systemic collapse; and witnesses agreed that bailout would impose costs on all Eurozone members. The so-called 'no-bail out' clause (Article 103) of the EC Treaty is supposed to prevent the ECB being forced to bail out an insolvent Member State and to ensure that Member States are not liable for the commitments of other Member States. But some witnesses questioned whether, in this crisis situation, the ECB would be able to resist the pressures to monetise the defaulting country's debt. These witnesses, such as Mr Crook, thought that it was "difficult to imagine the ECB would be able to stand entirely aside […] the political pressure for some pooling of the cost of the default would be very hard to resist" (Q 139). For Professor Begg, the ECB's credibility rested in part on its ability to resist these pressures; but if the central bank's credibility was damaged, then "the whole Euro area (indeed EU)" would be "the loser" (p. 24).

40. For Mr Crook, the default problem offered a "persuasive rationale" for some measures to increase the fiscal discipline of Member States (Q 139; p. 94). The TUC argued though that the danger of bail-outs in the Eurozone appeared to have receded (p. 58).

4.THE ECONOMIC CONSQUENCES OF DEMOGRAPHIC CHANGES IN THE EU

41. When the Pact was agreed in 1997 it was in part to avert the two problems above. It is now necessary to append a third problem, which was not widely envisaged at the outset of EMU, but which adds a further rationale for Member States to control their debt and deficits through the Pact. Abiding by the rules of the Pact will help all EU Member States to deal with the economic effects of their ageing populations.

42. UNICE pointed out that one benefit of the SGP was that it prepared national budgets for "the threatening time bomb of an ageing population" (p. 69; Q 238). The TUC also mentioned the need to keep down the level of debt in the EU, in order to anticipate the burden on public finances of an ageing population (p. 61). For the President of the ECB, this was "the basic long-term justification of the Stability and Growth Pact." He held that sticking to the Pact would "over time, maybe decades, create the room in budgets to cope with the costs of the ageing of the population which are expected to rise over a 30-year period by something in the neighbourhood of 5 to 6 % [of] GDP." (*op.cit.*)

Why not leave it to market discipline to ensure the sustainability of public finances?

43. There is general agreement that the four problems summarized above provide some justification for the EU Member States co-ordinating their fiscal policies. Where there is less agreement, is over the extent to which such co-ordination is necessary.

44. At one end of the spectrum of thought on fiscal co-ordination, some people, such as Professor Fitz Gerald, suggested that, with the integration of the EU economy, "there may be a need to extend co-ordination of policy in this area." The European Economic and Social Committee (EESC) went further, considering that there was "a strong need" for a more coordinated economic policy across the EU (CES 361/2002, p.12).

45. At the other end of the spectrum, it was proposed that there should be no attempt to achieve such formal co-ordination; instead, it should be left to market discipline to ensure the sustainability of Member States' finances. Mr Crook argued that the markets automatically applied a special risk premium to the interest rates in countries that face a risk of insolvency. This premium would have the effect of the market applying a sanction on the individual country that was over borrowing. As such, this regime would more directly affect the Member States that over borrowed. Mr Crook therefore claimed that a Pact was not needed, for the disincentive to a Member States increasing its level of debt was supplied by the market, and in a way that only discriminated against the country with an excessive deficit. Indeed, Mr Crook would prefer it if there were no regime at all to the current Pact, which he saw as positively damaging (Q 139). We noted that there have been some indications that the market does exert an influence on Member States: on 15 January 2003 the rating agency Standard & Poor

lowered the outlook on Italy's AA debt rating from stable to negative, and another rating agency, Fitch, said that even the AAA rating for Germany could not be taken for granted (*Financial Times*, 13 December 2002, p.23).

46. However, UNICE pointed out that such moves, which might eventually prevent a Member States from becoming insolvent, were not enough for the stability of the Eurozone: a country could "accumulate deficits and debt a long time before actually facing insolvency." (q13) Therefore, leaving the market to regulate on Member States' debt would do nothing to counter the threat of a country 'free riding'. The TUC agreed that it was "very important" to have such a Pact, or the free-rider problem would not be addressed and "some countries could bask in the financial rectitude of others and act irresponsibly" (Q 214). Furthermore, abolishing the Pact could prove an incentive for individual EU governments to adopt divergent approaches, which would lead to difficulties for the ECB. The Government concluded that leaving the markets to regulate the debt of Member States was not "the right way to go." (Q 194) The Commission agreed that it was "wrong" to think that the markets could "take care of everything." Even if the market could exercise an influence on the level of Member States' debt, it was the deficit levels that were important for the conduct of monetary policy and so affected the ECB and the consequent policy mix. It was therefore "important to have a co-ordination mechanism." Moreover, the Commission rejected the argument that the market could exert pressure on governments to control their debt and implement sound fiscal policies. This was because, as an effect of monetary union, the interest rate spreads had "come down tremendously". Where previously the spreads might have gone up by between 100 and 500 percentage points in reaction to fiscal policies that the market saw as profligate or unsustainable, today in the Eurozone the spreads were "down to below 50 basis points," which was "not surprising" because of the absence in the Eurozone of exchange rate risk that would need to be reflected in the interest rate spreads (QQ 253, 255, 271–72).

47. However, the fact that spreads are low currently merely indicates that there is currently no differential default risk between different Member States. That may reflect a market belief that any Eurozone member that did default on its debt would be bailed out by the ECB and, effectively, by other members of the Eurozone. Or the low spreads may simply reflect a current absence of default risk. They need not necessarily indicate that if one country were to experience an increase in default risk its interest rate would not rise relative to the rest.

48. Another argument against leaving the markets to regulate the debt of the Member States was that the markets liked the sense of certainty and stability that the Pact provided. Professor Zank argued that the current pact, by limiting deficits and debt, reassured financial markets, by communicating to them Member States' commitment to fiscal probity (p. 110). UNICE warned that the size of Member States' budget deficits was "a factor directly influencing" market confidence. A "strong SGP" sent "a signal to the markets that no excessive budget deficits" would emerge in the Euro-area "thus also providing room for manoeuvre for the ECB". For the sake of "keeping the confidence of market participants, the EU should refrain from any watering down of the deficit criteria"[19] (q2; 12; p. 69). If the EU announced that the Pact was dead this would probably have a seismic effect on the markets. Mr Crook contended that the markets regarded the Stability and Growth Pact "as dead already, to all intents and purposes […] the markets will take the view that not much has changed if the EU simply acknowledged that the Pact was defunct" (Q 142). Professor Persaud, however, produced compelling evidence to refute this claim. He demonstrated that the market was concerned about the free-rider problem and that it would appear that the Stability Pact had "served its purpose in reassuring the markets on this point." He added that the market appeared to be "particularly concerned" about attempts to make the Pact looser when the limits were being threatened, because this smacked of "moving the goal posts to where the ball is and the markets do not like that."[20]

49. **The Committee supports the co-ordination of national fiscal policies across the EU with a view to maintaining sound public finances. Market discipline alone cannot be guaranteed to ensure the sustainability of public finances. Consequently, the Committee considers that a co-ordinating pact or other method of co-ordination between the Member States is necessary to deal with the 'free rider' problem and the risk of default. Such a pact can help Member States to control their debt and deficits, which should also contribute to their preparations for the economic effects of ageing populations, while providing stability for the ECB and the market. It is extremely important that Member States are free to structure the expenditure and the revenue side of their budgets according to their own national preferences. This is not in question**

[19] The European Parliament Committee on Economic and Monetary Affairs also considered that the SGP played "an important role" in "creating European economic confidence" (A5-0161/2002, p.6).

[20] 'Is it Really Stupid? The markets perspective on the Stability & Growth Pact and prospects for its reform', Avinash Persaud and Michael Metcalfe, State Street, January 2003.

in any of the discussions on the Stability and Growth Pact, which deals only with levels of government debt and deficit.

Problems affecting the operation of the SGP

50. Before examining how to change the SGP, we must first analyse how it has performed since it came into force at the start of 1999. These first four years have seen the Pact face various challenges, which are briefly summarised below.[21]

THE GLOBAL ECONOMIC SLOWDOWN

51. Apart from Germany, all EU countries had a positive output gap in 2001 following several years of higher-than-potential growth. In spite of the positive output gaps, however, a number of euro-area countries loosened their stance in 2001 (particularly Ireland, but also Finland, Germany, Greece, Holland, Luxembourg and Portugal), with some of these countries making large tax reductions (Germany, Holland and Ireland).[22] Given the level of the output gap, the fiscal stance in these countries appeared to be pro-cyclical. This lack of fiscal consolidation in 2000 when economic growth was buoyant proved to be short-sighted and was to contribute to the constraints facing high-deficit countries during the subsequent economic slowdown.

52. 2001 saw the sharpest slowdown in world growth for close to thirty years (with the rate of GDP growth falling from 4.7 % to 2.2 %). Moreover, at the same time, world trade declined from a growth rate of 12 % to a position of almost no growth at all. These global slowdowns were due to a range of factors, including: the rise in oil prices, the economic effects of the terrorist attacks of September 11th 2001, corporate accounting scandals and rapid falls on the stock markets.

53. 2001 thus proved to be the most challenging period for fiscal policy since the launch of EMU. One of the consequences of this was that the budget deficit for the euro area reached 1.3 % of GDP in 2001, up from 0.7 % in 2000; this represented the first reversal in the process of budgetary consolidation since 1993.[23] The estimated cyclically-adjusted budget deficit for the euro area increased slightly to 1.5 % of GDP, up from 1.3 % of GDP in 2000.

54. In 2002, output growth in the euro area was on average 0.75 % (after 1.4 % in 2001). Thus, for the second consecutive year, it was significantly below potential (or trend) growth, so that the output gap—a measure of the under-utilisation of resources—moved from positive in 2001 to negative in 2002. The political situation in the Middle East and the threat of war with Iraq have since created further uncertainty, posing a further risk to the economic outlook in Europe.

THE INCREASING FINANCIAL IMPACT OF AGEING POPULATIONS IN THE EU

55. The demographic changes in the EU over the coming decades are expected to place a large strain on European public finances. The ageing populations across Member States will have a considerable budgetary impact, which may, in turn, have serious repercussions for Member States' adherence to the Stability and Growth Pact. According to the Commission:

> "Public spending is projected to rise by between 4 % and 8 % of GDP in the coming four decades, although much higher increases are projected in several Member States. Increases in public spending due to ageing population will start as of 2010 in some countries as the baby-boom generation enter into retirement, and the steepest rise will occur between 2020 and 2035 in most Member States." (*Public Finances in EMU—2002*, *European Economy* No.3, 2002, p.5)

56. The Commission has called on all Member States to achieve and sustain the medium-term target of budgets 'close to balance or in surplus', in order to meet these costs by lowering the future interest burden on debt. Furthermore, those countries most affected by the economic impact of ageing populations should run budget surpluses up to 2010 and beyond so as to achieve a large reduction in public-debt levels prior to taking hold. According to the Commission's calculations, six Member States (Germany, Spain, Greece, France, Austria and Portugal), that is, half of the Eurozone membership, risk budgetary imbalances that would breach the Stability and Growth Pact, based on their current policies. Two further countries (Belgium and Italy) with high levels of public debt will

[21] All figures are taken from the Commission document *Public Finances in EMU—2002*, *European Economy* No.3, 2002.

[22] For a short discussion of what happened in reaction to this fiscal loosening by the Irish Government, see below paragraph 98.

[23] The official deficit figures for 2002 were not available at time of going to print.

need to maintain high primary surpluses over the very long term to cope with the budgetary impact of their ageing populations.

57. The Commission explains that the ageing population is projected to have "only a minimal impact on public spending in the UK. This largely stems from the strategy of limiting the role of the State to providing a minimum flat-rate pension (that is indexed to prices), while ensuring a legislative and fiscal framework that enables individuals to save for their own retirement income." (*ibid*., p.35)

THE COUNCIL DID NOT SEND 'EARLY WARNINGS' TO GERMANY OR PORTUGAL

58. These problems were thrown into sharp focus when, early in 2002, the Commission judged that the budget deficits of two Member States were in danger of breaching the 3 % of GDP reference value. Germany and Portugal had missed the deficit targets for 2001 set down in their 2000 stability programmes by a wide margin of over 1 % of GDP. The Commission considered that there was a clear risk of the countries' deficits approaching the 3 % reference value in 2002.[24] In line with the Treaty, the Commission therefore recommended that the Council issue early warnings to the two Member States. This was the first time that these preventive elements of the SGP had been activated.

59. However, Germany and Portugal were not issued with early warnings. Following a discussion in the Eurogroup, political agreement was reached at the Ecofin Council not to endorse the Commission recommendation for early warnings. The reason given by the Council for not issuing early warnings was that both Germany and Portugal had provided firm political commitments which "effectively responded" to the Commission's concerns.[25]

60. The Council's unexpected decision not to issue the early warnings caused a great deal of unease; questions were asked about the Member States' commitment to the rule-based approach outlined in the SGP. The Committee on Economic and Monetary Affairs of the European Parliament was concerned over the fact that this approach had, "on the one hand, cast doubts on [the Pact's] credibility and, on the other hand, might lead to inequalities in its application." That Committee even saw it necessary to draw Member States' attention to the 2001 code of conduct, which differed from the 1998 code in requiring, *inter alia*, "equality of treatment among Member States". The Committee said that, following the recommendation sent to Ireland for an economic policy inconsistent with the BEPGs, the Council itself seemed to have "ignored completely" this equality in the decisions over Germany and Portugal.[26] The Commission reported that there was a "widespread perception in the public opinion" that the rules could be "manipulated or disregarded."[27] This perception was reinforced when, later in the year, the deficits of both Germany and Portugal did exceed the 3 % reference value, in line with the Commission's predictions.

MEMBER STATES ARE BREAKING THE RULES OF THE SGP

An excessive deficit in Portugal

61. In September 2002, the Portuguese Government, which had come into office in April 2002, substantially revised the deficit data submitted by the previous Portuguese authorities in February 2002. The new Government notified the Commission that the government deficit in Portugal had increased from 2.4 % in 1999 to 4.1 % of GDP in 2001. Consequently, the Ecofin Council on 5 November 2002 decided that an excessive deficit existed in Portugal in 2001. The Council's Opinion said that part of the deficit increase in 2001 "was due to the rectification of government accounts, the other part to deviations of budget execution from targets planned."[28] The Portuguese government declared its firm commitment to a new deficit target of 2.8 % of GDP for 2002; whether Portugal achieves this target will not be known until the Council considers Portugal's stability programme for 2002 on 7 March 2003.

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[24] For a full justification of why the Commission decided to recommend early warnings for Germany and Portugal, see *Public Finances in EMU—2002*, *European Economy* No.3, 2002, Part II.

[25] Both countries stated their willingness to implement their new stability programme updates in full so as to avoid a breach of the 3 % of GDP reference value, to resume the process of budgetary consolidation and to reach their medium-term targets of balanced budgets in 2004 (see Council press release 28 of 12 February 2002, 6108/02).

[26] A5-0145/2002, pp.7–8.

[27] *Public Finances in EMU—2002*, *European Economy* No.3, 2002, p.52.

[28] Council press release 333 of 5 November 2002, 13490/02.

An excessive deficit in Germany

62. The German stability programme for 2002 to 2006 said that the government deficit in 2002 was 3.75 % of GDP. Consequently, the Ecofin Council on 21 January 2003 decided that an excessive deficit existed in Germany in 2002. The Council therefore sent a Recommendation to Germany with a view to bringing an end to the excessive government deficit. The Council noted that the rise in Germany's nominal deficit from 2.7 % in 2001 to 3.75 % in 2002 could "only partially be explained" by the unexpected slowdown in growth and that there had once again been "expenditure overruns in the health sector which contributed to a deterioration of the underlying balance." The stability programme said that Germany aimed to reduce the deficit in 2003 to 2.75 %; the Council judged that this forecast was based on an optimistic growth rate of 1.5 % in 2003 and considered that there was "a non-negligible risk" that the general government deficit in 2003 might again exceed the 3 % of GDP reference value. In underlying terms, the government accounts were predicted to be close to balance by 2006. The Council established a deadline of 21 May 2003 for the German Government to take measures that would bring the deficit below 3 % as planned.[29]

A risk of an excessive deficit in France

63. The Ecofin Council on 21 January 2003 decided to send an early warning to France with a view to preventing an excessive deficit occurring. The Council noted that France's nominal deficit had risen from 1.4 % in 2001 to 2.8 % in 2002 and judged that "a large part of the slippage" in 2002 was due to a deterioration in the underlying balance. France's stability programme for 2003 to 2006 projected that the general government deficit would fall to 2.6 % of GDP in 2003, based on a predicted increase in real GDP of 2.5 % in 2003; the Council considered this forecast to be optimistic and concluded that there was a danger that French government deficit would breach the reference value in 2003.

64. The macroeconomic projections of France's stability programme were based on two scenarios: a 'cautious' scenario, with real GDP growth at 2.5 % a year over the period, and a 'favourable' scenario, where real GDP growth would reach 3 % per year. The Council was concerned that France would only achieve the medium-term objective—of a budget close to balance by 2006—under the favourable scenario. (*ibid.*)

Member States with debt above the 60 % reference value

65. The EC Treaty requires the ratio of government debt to GDP to be below the 60 % reference value, "unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace." According to the 2001 stability programmes, the gross debt-to-GDP ratio in the euro area is set to fall to 63 % of GDP in 2004. According to these projections, 12 Member States will be below the 60 % of GDP ceiling by that time. The three other countries, however, will remain a long way off this reference value. Belgium is predicting its debt level will be 88.6 % in 2005; Greece predicts a level of 90 % of GDP in 2004; Italy predicts its debt will still be at 95 % of GDP in 2005. The Pact, however, does not explain how the Excessive Deficit Procedure is to be applied when the public debt criterion is violated (the Commission is now planning to change this, see below paragraphs 116–26).

WHO IS TO BLAME?

66. Broadly speaking, there are two opposing interpretations of these problems: either the problems are the result of the budgetary actions of the Member States; or the problems are to do with the rules of the SGP.

The problems are the result of Member States' budgetary actions

67. The Commission firmly backed the former interpretation; it claimed that the Member States were responsible for their budgetary decisions and so for the consequent breaches of the rules of the SGP. The Commission stated that it was clear that in 2001 budget deficits increased "due to tax cuts that were not fully offset by expenditure reductions and the operation of automatic stabilisers in the cyclical downturn."[30] Many of our witnesses supported this position. Professor Buiter, for instance, said that there was "no reason" why France and Germany should be in the budgetary position that they found themselves at the end of 2002. Their excessive deficits were due to the fact that they had not run tighter budgets during the period of higher growth: "If they had done so, they would now not be in that position." (Q 9; p. 109) UNICE agreed that, in contrast to most EU Member States, "the governments

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[29] Council press release 15 of 21 January 2003, 5506/03.

[30] Communication form the Commission 'The euro are in the world economy—developments in the first three years', COM(2002) 332 final, 19 June 2002.

of several large Member States applied the Pact selectively and did not conduct prudent fiscal policies during the times of high economic growth." (p. 69)

68. Mr Solans, Member of the Governing Council and of the Executive Board of the ECB, said that it was important to be clear that "normally, behind the non-fulfilment of the SGP there is a case of bad public administration, either past or present." (*op. cit.*) Wim Duisenberg concurred that the current fiscal problems had arisen not because the rules were "inflexible," but because countries had "not honoured their commitments to make progress in fiscal consolidation, particularly during good times." He added that it was now "high time" for those countries with deficits approaching or exceeding 3 % of GDP to "honour their commitment to respect the rules". He was concerned by "a certain laxity in living up to the solemn pledges and commitments" that many countries had made (*op cit.*). French Bank BNP Paribas agreed that the problem was not so much with the Pact, rather it was with the "willingness of the countries to honour their commitments." (*Ecoflash*, 27 November 2002, #02–530)

The problems are with rules of the SGP

69. Alternatively, the fact that several Member States are in breach of the Pact could be interpreted as being the fault the rules of the SGP, that is, that the rules of the Pact are badly conceived and 'inflexible'. The Committee heard complaints against the medium-term target and the reference values for deficit and debt in the Pact, how they are interpreted, the fact that they are measured in nominal rather than cyclically-adjusted terms, the uniform way in which the rules are applied to the different Member States, and the enforcement procedures and sanctions. The Commission's Communication aims to address some of these criticisms. We took seriously all of the criticisms of our witnesses. Each of the criticisms, together with the relevant Commission proposal wherever possible, is examined in Part Three below. We reserve our conclusions until we have considered all the sides of the arguments.

PART 3: CRITICISMS OF THE STABILITY AND GROWTH PACT

Criticism 1: The SGP does not take account of underlying economic conditions

70. In their stability and convergence programmes, Member States stated their budget targets in actual or nominal terms. However, our witnesses unanimously agreed that, in assessing compliance with budgetary commitments, it was necessary to consider the effects of the economic cycle on the budget position.[31] They argued that countries' fiscal balances should vary between the years in accordance with their cyclical position. This would allow the automatic stabilisers to operate fully and so help to smooth the fluctuations in the economy in the face of varying levels of demand.

Box 4

Automatic Stabilisers

The Government explain the role of the automatic stabilisers as follows:

"Several features of the taxation and spending regime help to stabilise the economy over the economic cycle. As the economy strengthens, incomes tend to rise, resulting in higher income and corporation tax receipts. At the same time, lower unemployment rates reduce social security spending. As the economy weakens, the opposite effects occur. This means that government borrowing tends to fall when growth is relatively high, and rises when growth is relatively low. These 'automatic' effects help to reduce volatility in output over the cycle, by boosting aggregate demand when the economy is below trend, and reducing aggregate demand when the economy is above trend."

Source: *HM Treasury, Sustainability for the Long Term: Convergence Programme for the United Kingdom*, submitted in line with the Stability and Growth Pact, December 2002

71. The Commission has continually stressed that the norm for budgetary behaviour in the EU should be that of relying on automatic stabilisers. The Commission has also implicitly recognised that this model may only function without a fear of Member States breaching the 3 % deficit criterion once they have attained their medium-term targets of budgets 'close to balance or in surplus'. The medium-term targets are set so as to provide a safety margin for Member States during cyclical developments:

> "If countries abide by the SGP's fiscal philosophy, they will choose a broadly balanced budget in structural terms and let automatic stabilisers play freely over the cycle. […] Meeting these [medium-term] targets will allow all Member States to let automatic stabilisers operate freely during future cyclical downturns. […] By attaining this budgetary target, countries have sufficient room for the automatic stabilisers to operate freely during normal cyclical downturn without breaching the 3 % of GDP reference value."[32]

72. Under the Pact, the 3% of GDP reference value has become a hard ceiling to be breached only in exceptional circumstances and for a limited period of time. In order to create sufficient room for manoeuvre within this limit, however, a rapid transition to broadly balanced budgets in structural terms is required.

The Commission's proposal

73. In order to take account of underlying economic conditions, the Commission proposed establishing budgetary objectives that take account of the cycle. In its Communication, the Commission suggested that this development would involve "setting the requirement that budgets be 'close to balance or in surplus' in terms of the cyclically-adjusted or underlying budget balance, not the current value." (*op. cit.*)

74. In the words of French Bank BNP Paribas, however, this represented "more a change in emphasis [in the Pact] rather than of content" (*op. cit.*). The Amsterdam Resolution already stressed that achieving a balanced budget was a medium-term objective, and this was widely interpreted as meaning that the underlying, structural budget position should be in balance, rather than the current or nominal value.[33] Professor Buiter certainly interpreted the medium-term target in this way (Q 9); as indeed had the Commission itself. The Commission spelt out this understanding of the 'close to

[31] The cycle is generally taken to be the period between the point where the output gap is zero and when the output gap returns to zero.

[32] *Public Finances in EMU—2002*, *European Economy* No.3, 2002, pp.3, 9, 45.

[33] See, for instance, 'EMU Fiscal Rules: A New Answer to an Old Question?', Balassone and Franco, in *Fiscal Rules*, Banca d'Italia, Rome, 2001.

balance or surplus' rule in its own publications, saying quite clearly, for example, that "the cyclical adjustment of budget balances is used when evaluating […] the respect of the 'close to balance or in surplus' target of the Stability and Growth Pact."[34] However, as noted in last year's report from the European Economic Advisory Group,[35] the Stability and Growth Pact did not state explicitly that the medium-term target refers to the cyclically-adjusted balance. For our witnesses, however, the medium-term target was not the major issue; they were more concerned about how the 3 % limit should be calculated.

Should the excessive deficit criterion be recast in cyclically-adjusted terms?

75. Some witnesses argued that the 3 % figure was rigid in circumstances where the automatic stabilisers operated in a recession. They were concerned that, in a situation of subdued growth, a quick transition to a balanced underlying budget would require pro-cyclical policies that might worsen the cyclical conditions. These witnesses claimed that the current problems, where certain Member States—particularly France, Germany and Portugal—were breaking the terms of the Pact, came from the difficulties that these countries were experiencing in coping with a cyclical slowdown before having reached their targets of underlying budgets close-to-balance. Mr Crook argued that, as these countries could not let their deficits rise naturally with their automatic stabilisers for fear of being sanctioned under the excessive deficit procedure, they were being obliged, to varying degrees, to tighten fiscal policy in the teeth of a recession. This situation was something that he described as "very, very bad policy." Mr Walton agreed that in Germany, at a time when the economy was weak, the Government was being forced to tighten fiscal policy "quite sharply". He said that it would seem "much more sensible" to allow Germany that "extra bit of flexibility" to reduce its deficits more slowly. Professor Begg agreed that, in "a recession or a slowdown", it made no sense to compel a country to reduce its deficit rapidly, because that was "just going to aggravate the problem" that was causing the downturn. In order to tackle this transition problem, these witnesses suggested that the 3% limit should be removed or at least recast in cyclically-adjusted terms (QQ 42, 118–19, 144).

76. The Commission recognised that this was a criticism that had been levelled at the Pact (Q 253), but it was completely against such amendments. The Commission said that any change in the 3% reference value, even moving from a nominal 3% limit to a cyclically-adjusted limit, would require a change in the Treaty. So, first of all, it was against amending the deficit criterion for this legal reason. But it was also against such a change on economic grounds, arguing that the Pact provided enough room for the Member States to let their automatic stabilisers to work so that the 3 % nominal ceiling was never breached. It was also concerned that if the 3 % ceiling were expressed in cyclically-adjusted rather than nominal terms, and if countries took advantage of that change, then "countries would run significantly higher deficits over time". This increase in the Member States' deficits would mean that the problems mentioned above in the introduction—free riders, countries with a high level of debt defaulting of that debt, and ageing populations—"would be no nearer a solution." Director General Regling said that

> "the effect would be higher deficits everywhere, debt levels would not come down as quickly as otherwise, or they could even go up, because in the end, it would mean if countries wanted to take full advantage of such a rule, that they would run a 3 per cent deficit over the cycle on average, so that would be a significant weakening of the Pact, it would mean you would not need a Pact any longer, because it would not be a constraint on public finance." (Q 255)

77. The Commission and the Government also pointed out that the 3 % ceiling was not an absolute, because, in exceptional circumstances—such as natural disasters or the collapse of the banking system—Member States could let their deficits go above 3 per cent (QQ 177, 257).[36]

Problems with cyclical measurements

78. While many witnesses agreed that greater use of cyclically-adjusted measures was conceptually a good thing, there were some strong reservations about how they could be implemented in practice, because of the difficulties of agreeing upon how they should be measured and disagreement over methodologies for working them out. Professor Sibert, for example, was concerned that introducing cyclical measurements would introduce "endless scope for squabbling over the proper methodology. (p. 110) Any attempt to actually punish a deviation [would] lead to interminable arguing about calculations and measurements." Professor Fitz Gerald and Dr Scott agreed that whilst cyclical measurements appeared in theory to be "a sensible way to proceed", in practice, "most cyclical

[34] *Public Finances in EMU—2002*, *European Economy* No.3, 2002, p.2.

[35] *Report on the European Economy 2002*, European Economic Advisory Group at CESifo, Munich.

[36] For details of the exceptional circumstances under which this is possible, see above, paragraph 13.

adjusted deficit series do not convince as a reliable adjustment." Given this problem, they thought that it was "undesirable to place too much weight on them or use them to construct the deficit targets." (pp. 96, 108) Other witnesses said that whilst there would be difficulties over implementation, these were not "insuperable difficulties"; what were needed were "firm accountancy standards or analytic procedures." (pp. 26, 62) Mr Weale suggested that such an approach could be achieved if a technical, independent, apolitical body was established to judge what constituted the cycle (Q 76).

79. For the Commission, these concerns over the question of methodology were not a problem, as last year it developed with the Council an agreed method to calculate cyclically-adjusted budget balances. The principle tool for assessing underlying budget positions would be "the common methodology to measure cyclically-adjusted budget balances which [had] been agreed by Member States and the Commission." This common methodology was proposed by the advisory Economic Policy Committee, who had set up a Sub-Committee that had carried out an inquiry into the question of how it was best to calculate such figures. The resultant proposal had been agreed and adopted by the Commission and Ecofin.[37]

80. **It should be made explicit that the medium-term target of budgets 'close to balance or in surplus' is to be measured in terms of the cyclically-adjusted budget balance. The common methodology agreed and adopted by the Commission and Ecofin should be used to calculate the underlying budget balances for this target; this means that an extra body of experts is not needed to calculate the cycle.**

81. **Conversely, the Commission should continue to use the nominal ratio when monitoring Member States' compliance with the deficit criterion as part of the surveillance procedure. The actual 3% deficit-to-GDP ratio should continue to be treated by the Commission as a trigger. Early warnings should be sent to Member States whose nominal deficits approach this figure.**[38]

82. **However, when deciding how the Pact is to be enforced, the Council should not treat the actual 3 % figure by as an absolute limit, never to be breached. The 3 % reference value is a precise figure that sets a clear benchmark against which peer pressure can be applied within the Council. But the Council's enforcement of the deficit criterion should nonetheless involve a degree of flexibility. The Council's decision whether or not to implement the excessive deficit procedure, once a country has breached the 3 % reference value, should take account of the underlying economic situation, including the Member State's position in the economic cycle and possibly its level of debt.**[39]

83. **This flexible interpretation of the Pact, which we believe could be achieved without changing the Treaty, should help to tackle the problems that countries still in transition towards lower underlying deficits face in the event of a cyclical downturn.**[40] **As such, it would help countries that have high underlying deficits but which are taking appropriate steps to reduce them gradually. This proposal would thereby provide additional flexibility for those countries that need it. It could also be used to allow greater short-term flexibility to low-debt countries with sound public finances and so provide an incentive for countries to reduce their level of debt.**[41]

84. **It is also important to recognise that the current difficulties experienced by France, Germany and Portugal demonstrate that the Pact functions asymmetrically over the economic cycle—these countries did not previously make use of better cyclical conditions to reduce their structural deficits. This is a problem that needs to be addressed (see below, paragraphs 92–103).**

[37] Council press release 198 of 12 July 2002, 10668/02; *Public Finances in EMU—2002*, *European Economy* No.3, 2002, pp.54–61.

[38] We discuss the early-warning system below, see paragraphs 132–45.

[39] We see the distinction outlined in these two paragraphs between the surveillance process, conducted by the Commission, and the enforcement process, administered by the Council, as fundamental. We return to this division below (see Part Four).

[40] Despite supporting the introduction of this additional flexibility into the enforcement of the Stability and Growth Pact, the Committee does not believe that fiscal policy is an effective way of stimulating sustainable growth (see below, paragraphs 104–15).

[41] This could help to address the criticism that the Pact's incentive structure is asymmetrical, as the SGP punishes fiscal indiscipline but does not recognise or reward those countries who have achieved sound public finances. On the importance of providing Member States with an incentive to place a greater emphasis on their level of debt, see below, paragraph 141.

Criticism 2: Too many countries have underlying budget balances that exceed the 'close to balance or in surplus' requirement.

85. In its Communication, the Commission proposed establishing a general principle requiring countries with underlying deficits exceeding the 'close to balance or in surplus' rule to improve these deficits by 0.5% of GDP each year until they reach the medium-term target. Furthermore, the rate of improvement in the underlying budget position should be higher in countries with high deficits or debt. The Commission also envisaged a more ambitious rate of annual improvement in underlying budget positions in periods of favourable growth conditions.

86. A number of witnesses questioned the thinking behind this figure of 0.5 % of GDP. Mr Walton, for example, said bluntly that there was "no particular economic rationale" for the proposal. These witnesses were concerned that the figure was arbitrary and inflexible. Furthermore, the inflexibility of adding to the SGP another figure that was not contingent on the circumstances of the particular country would inevitably mean that some countries would follow "sub-optimal policies". For example, in a period of recession, improving the underlying budget was bound to imply fiscal tightening, which could reduce aggregate demand and worsen unemployment (Q 38; pp. 10, 108, 62).

87. Other witnesses, however, defended the proposed rule as both justified and achievable. Both the Commission and UNICE stated that achieving a 0.5% of GDP improvement in a country's underlying deficit was "more than feasible"; this was demonstrated by the fact that it had been achieved by many countries in the past.[42] Although the Commission's Communication did not include the possibility of exceptions to this rule in difficult economic circumstances, Director General Regling conceded that, if there were "a real crisis situation, a recession", the rule might need to be revisited (QQ 238, 278; q6).

88. As mentioned above (paragraph 21), this proposal—that countries with underlying deficits exceeding the 'close to balance or in surplus' rule should improve these deficits by 0.5% of GDP each year until they reach the medium-term target—was not new to the Commission's Communication of November 2002; it had already appeared in the Communication of Commissioners Prodi and Solbes in September 2002. Moreover, it had already been agreed by the Eurozone countries. At the Eurogroup meeting on 7 October 2002, the Eurozone Member States concurred with the Commission that those countries which had not yet reached the medium-term objective, needed "to pursue continuous adjustment of the underlying balance by at least 0.5% of GDP per year."[43] Why then should the Commission suggest this proposal anew? It could be so that the principle applies to all EU Member States and not just those in the Eurozone. Also, the Commission could want the principle to be more clearly established as a rule that is both "strict and enforceable" (SEC(2002) 1009/6).

89. **The Committee accepts that the 'close to balance or in surplus' requirement is a sound medium-term objective; it can act both as a useful guideline for Member States and as an effective benchmark for peer pressure. Member States should be encouraged to achieve this aim as soon as it is economically sensible for them to do so, because it will give them sufficient room to allow the automatic stabilisers to work fully across the cycle (see above, paragraphs 70–76). Some flexibility in enforcing how Member States attain this target may be required, however.**

90. **The Commission's proposal that Member States should set an adjustment path towards the medium-term target of budgets 'close to balance or in surplus' of 0.5 % GDP per year should not be treated by the Council as an enforceable rule, any breach of which would activate the excessive deficit procedure. Such a proposal would reinforce and tighten the conditions of the Pact, rather than allowing the Council to interpret it flexibly. It would increase the complication of the Pact and could lead to the Commission having to intervene more often, since the more complicated the rules become, the greater the danger that the Member States will transgress them. This would have as a consequence that the rules' credibility would be undermined. Furthermore, strictly enforcing a proposed adjustment path that is not country-specific could require Member States in a downturn to adopt pro-cyclical policies that might worsen the cyclical conditions (see above, paragraph 75).**

91. **Nonetheless, the Commission's proposal does have the advantage that, even if its economic logic is questionable, it is easy to monitor. For this reason, the figure of 0.5 % could act as an effective benchmark around which peer pressure could be mobilised in the Council. The Commission proposal is a sensible one if it is treated as a guideline for the Member States; it should not be interpreted as a rule.**

[42] Wim Duisenberg also supported this new rule. He said that the proposal gave him reason "to express some confidence in the future" (*op cit.*).

[43] The full text of the Eurogroup press release is available online at http://www.ypetho.gr/eurogroup/

Criticism 3: The SGP does not function symmetrically across the cycle.

92. Our witnesses unanimously agreed that one of the Pact's main weaknesses was that it did not work symmetrically over the economic cycle. The rules provided insufficient incentives for fiscal restraint during periods of high growth by not rewarding such policies enough. The risk of fines for breaking the deficit rule in a down turn would not influence government behaviour in economic good times, since at that time the next recession could seem a long way off and might even occur under another government.[44] Indeed, some said that the Pact encouraged pro-cyclical fiscal policies as the rules put pressure on governments to engage in fiscal tightening in an economic downturn but did not oblige them to pursue counter-cyclical policies in times of economic boom (see, for example, p. 108; QQ 42, 118, 144, 189).

93. The problems of the last two years, and particularly the difficulties that Germany and France were experiencing in meeting the deficit rule, were said to have their roots in the missed opportunities of the high-growth period of 1998–2000. The Communication noted that a "failure to pursue budgetary consolidation in 1999 and 2000 when growth conditions were favourable led to a deterioration in underlying budget positions and inadequate room for the automatic stabilisers to operate in the subsequent economic slowdown" (*op. cit*.). The implication, with which our witnesses agreed, is that had the Pact worked symmetrically across the cycle and obliged these countries to apply counter-cyclical fiscal policies in 1999 and 2000, their deficits would not have risen so much subsequently (p. 69; QQ 9, 78, 189, 253).

94. As indicated in the previous paragraph, the Commission was aware of this weakness in the SGP. It recognised that preventing structural budget balances from deteriorating during upturns was one of the most important challenges for the Pact. The Commission "wanted to eliminate this asymmetry" (Q 253), and the Communication proposed that Member States should not implement expansionary, pro-cyclical policies in the good times but should run surpluses instead (*op. cit*.). The vast majority of witnesses welcomed this "measure of providence", which would represent a move to "a more 'symmetric' approach" (see, for example, pp. 62, 70). Professor Buiter thought that the SGP should send a clear instruction to countries: "make hay while the sun shines, do not wait for winter" (Q 18).

95. As with the other proposals examined so far, the proposition that the SGP should operate symmetrically across the cycle is not a new idea in itself. Indeed it is already implicit in the Pact, since it is an integral part of the policy of using automatic stabilisers to dampen the business cycle (see above paragraphs 70–71). This point was clarified in the Presidency Conclusions of the Barcelona European Council (15–16 March 2002), which stated: "Automatic stabilisers should be allowed to play symmetrically, provided the 3% of GDP limit is not breached in downturns. This means, in particular, that in expansionary phases growth dividends should be fully reaped. Member States could make use of discretionary fiscal policy only if they have created the necessary room for manoeuvre".[45]

96. As Director General Regling said, deficits could help a country to stabilise during an economic downturn, and the medium-term target of the Pact was designed to allow this. Professor Buiter confirmed that, "in principle, the Pact does not rule out the operation of the automatic stabilisers" (Q 9), but experience has shown that governments do not tend to take a long-term view of fiscal policy.

97. Where the Commission's proposal is new, perhaps, is the question of how Member States should be prevented from inappropriately loosening their fiscal policies in good times. In the Communication, the Commission stressed that there were "inadequate surveillance and enforcement mechanisms to deal with unwarranted pro-cyclical loosening of the fiscal stance" and said that "effective enforcement procedures" were required (*op. cit*.). The Government agreed and underlined the "need to have credible ways of enforcing" any policy designed to prevent fiscal loosening during a boom (Q 189).

98. The consideration that enforcement mechanisms in this area needed to be strengthened was probably a conclusion drawn from what happened with Ireland when it was judged to have acted in a pro-cyclical manner during an economic up-turn. In 2001, Ireland was censured by the Council for not running a large enough budget surplus during its period of boom, when real GDP growth was above 10 %.[46] The Council addressed a recommendation to Ireland because it was not following the

[44] Report on the European Economy, European Economic Advisory Group at CESifo, Munich.

[45] Press release 100/1/02 REV 1.

[46] The Ecofin Council of 12 February 2001, in accordance with Article 99(4) of the EC Treaty, addressed a recommendation to Ireland concerning the inconsistency of its stability programme with the BEPGs agreed by the Council on 19 June 2000. The Council judged that the Irish budget for 2001 was "expansionary and pro-cyclical" and would "aggravate overheating and inflationary pressures and widen the positive output gap" (Council press release 35 of 12 February 2001, 5696/01).

guidance laid out in the BEPGs. However, the BEPGs provide guidelines rather than enforceable rules for Member States, and therefore there is no sanction that can be applied against a Member State not doing something that is stipulated in the BEPG. The Irish government disagreed with the decision to issue the recommendation, and the Irish Minister for Finance, Charlie McCreary, refused publicly to countenance the measures advocated by the Council in the recommendation.

99. In reaction to these events with Ireland and the expansionary budgetary actions of France and Germany when growth was high, the Commission Communication proposed penalising those countries that fail to cut deficits during economic upturns under the Stability and Growth Pact. The Communication stated that "an inappropriate pro-cyclical loosening of the budget in good times should be viewed as a violation of budgetary requirements at EU level, and should lead to an appropriate and timely response through the use of instruments provided by the Treaty" (*op. cit.*).

100. It is not clear exactly how this proposal should be interpreted, as the Treaty provides a variety of instruments to ensure budgetary discipline, from the sort of recommendation sent to Ireland in accordance with the BEPGs to the fines that can be imposed under the excessive deficit procedure. Mr Crook thought that the situation with Ireland showed that tougher enforcement measures were needed. He wanted to see "a rule" to oblige governments to run surpluses in booms. He said:

> "I think that would be an improvement, on balance. I do say it with a heavy heart, because it complicates the regime and that is a bad thing; but, on balance, I think that would be desirable […] what is missing is something analogous to the excessive debt criterion that kicks in with a penalty. A dressing down is easy to bear when you have Ireland's growth rate and Ireland's budget surplus in unadjusted terms. I do not think a dressing down from the Commission imposes much of an embarrassment for the government in those circumstances." (QQ 161–62)

101. Mr Walton, on the other hand, was concerned that, if the Commission imposed too many conditions on the way that governments behaved, this would be bound to end in failure, as there would be too many breaches of the rules, ending up with too many censures which in the end would become quite meaningless (Q 72). Mr Weale therefore suggested that the Commission should say to a Member State acting pro-cyclically during a boom: "Are you sure you have got enough leeway to cope with a downturn given these are the rules of the Pact?" (Q 78)

102. **It is important to tackle the fact that the Pact works asymmetrically across the economic cycle. Furthermore, it would be in the long-term interests of the Member States if pressure could be brought to prevent them from acting pro-cyclically in times of boom. The Committee does not, however, consider that applying the sanction of the excessive deficit procedure in good times would be the most effective way of achieving these twin objectives. The Committee shares the concern that the rules of the Pact should not be complicated. The number of situations that lead to the formal sanctions of the excessive deficit procedure being invoked should not be extended, or these measures will lose their force. The Stability and Growth Pact should not be interpreted so as to include formal sanctions for Member States pursuing pro-cyclical actions in good times.**

103. **Instead, the Member States should commit themselves to running fiscal policies that function symmetrically across the economic cycle.[47] In addition, the BEPGs and the Council Opinions on the stability and convergence programmes should provide additional explicit guidance on how such policies are to operate, together with more consistent instructions from the Council to Member States on how to implement these policies. The guidelines should be enforced by the Council through a strengthened process of peer review. To facilitate the Council's work, a timely surveillance procedure is needed, which would include sending an early warning to the Member State concerned during the period of boom, warning it that if it continues to act pro-cyclically, then it runs a high risk of subsequently running an excessive deficit. To be effective, this warning needs to be followed by firm peer pressure within the Council.**

[47] This commitment should be part of a new Resolution of the European Council and of a revised Code of Conduct (see below, paragraph 162).

Criticism 4: The SGP restricts Growth.

104. The Stability and Growth Pact has come under heavy criticism that its rules do not sufficiently encourage growth and that it is therefore a constraint on Member States implementing the Lisbon agenda for the EU to become the most competitive and dynamic knowledge-based economy in the world. The TUC explained that a "key problem" had been that the Pact had put "too much emphasis on stability and not enough on growth" (p. 62). In its Communication, the Commission admitted that that one area where the SGP had "struggled" was in developing a framework for "assuring the long-term sustainability of public finances while supporting structural reforms that are designed to enhance employment and growth potential" (*op. cit.*).

105. Mr Crook said short-term growth had been constrained by the Pact. This is because, when a country was in an economic downturn, an increase in its budget deficit (achieved either through more spending or lower taxes) might have given aggregate demand a short-term boost. Mr Crook also considered that the Pact created a "deflationary bias" in the longer term (Q 144).

106. The Commission did not accept, however, that sustainable growth could be stimulated through deficits. Director General Regling said that to argue that increasing deficits automatically lead to more growth was "a very dubious proposition." He cited the recent examples of Japan, Germany and Portugal as evidence of this and argued that experience showed "quite clearly" that a government could not stimulate sustainable growth through increasing deficits (Q 258). Mr Weale agreed that, on a trend basis, high government borrowing did not help economies to grow faster; he concluded that the Pact was not proving to be a particular constraint on growth or the economy, as did Professor Begg (QQ 55, 78, 106, 116). Whilst questioning whether the Pact might have "a bias against growth", Mr Walton firmly agreed that fiscal policy was not "a particularly good instrument for affecting the long-term growth rate of the economy (Q 55).

107. The Commission further argued that it was "too simplistic an approach" to claim that because according to the Pact deficits should be reduced, this meant less growth. Not every fiscal consolidation necessarily led to less growth; it always depended on the circumstances. If consolidation was done mainly through cutting expenditures and not through raising revenue, then under those circumstances the growth impact was much more favourable (Q 277). Indeed, the Commission considered that, in the medium term, the Pact encouraged growth. The restriction on public borrowing was intended to ensure that the 'policy mix' in the Euro zone was a tight fiscal policy (i.e., budget balances 'close to balance or in surplus' in the medium term) combined with a less tight monetary policy, that would lead to price stability at low interest rates which would encourage private investment, and thus growth.[48]

108. The Commission also pointed out that increasing the potential growth rate in Europe would require structural reforms; an increase in growth could not be achieved simply through macro-economic policies. The role of the SGP was to co-ordinate fiscal policy; it was the Broad Economic Policy Guidelines that went beyond budgetary issues to deal with the full range of economic policies—including labour markets, product market reform, research and development, education and training systems. The Commission concluded that whilst the Stability and Growth Pact was "very important […] it should not be overburdened with these other considerations" (QQ 258, 274).

109. Witnesses agreed that there was a limit as to how much fiscal rules at the EU level could achieve on their own. They reinforced the Commission's point that Europe's slow growth was not due to the SGP but rather to structural deficiencies, such as market rigidities, that held down productivity and employment growth (QQ 51, 99, 221–22, 244; UNICE q7). This view—that the weak economic performance of the EU was not due to the SGP—was shared by the Greek Minister for Economic Affairs and Finance, who was currently chaired the Ecofin Council.[49] The Government also maintained that changing the interpretation of the Pact could not compensate for structural reforms.[50]

110. The Commission's Communication said that, if possible, the Stability and Growth Pact should "cater for the inter-temporal budgetary impact of large structural reforms (such as productive investment or tax reforms) that raise employment or growth potential in line with the Lisbon strategy

[48] The Commission has long been concerned that deficit spending by governments could 'crowd out' private investment. Conversely, it considers that the SGP is pro-growth, as it 'crowds in' private investment (see, for example, *Public Finances in EMU—2000*, European Economy No.3, 2000, p.33). The point that the Pact was "conducive to private investment" was reiterated in the Communication (*op. cit.*).

[49] See his address to the congress of "Economic Policy and the New Sources of Growth in Europe", 08 February 2003, available online at http://www.eu2003.gr/en/articles/2003/2/7/1847/index.asp .

[50] Evidence of Dr MacShane, MP, to this Committee on 21 January 2003 (published in our 8th Report, Session 2002–03, HL 54: *Evidence by the Greek Ambassador on the Greek Presidency and by the Minister for Europe, Foreign and Commonwealth Office, on the Copenhagen European Council*, Q 33). This was also the view of Wim Duisenberg, President of the ECB (*op. cit.*).

and/or which in the long-term improve the underlying public finances positions." For this reason, the Commission proposed tolerating "a small deviation" from the 'close to balance or in surplus' requirement for Member States with an underlying debt of less than the 60 % of GDP reference value who have already made substantial progress towards the 'close to balance or in surplus' requirement. An adequate safety margin would also have to be provided at all times to prevent nominal deficits from breaching the 3 % of GDP reference value (*op. cit.*).

111. Professor Begg's analysis was that, despite the proposals, stability remained the focus, "with little concession to growth imperatives such as the acknowledged need to accelerate and support structural reforms" (p. 26). He concluded that the Commission's proposals on growth were "far too half-hearted" because they did not "allow for the possibility that a Member State could sustain public investment over several years justified on the golden rule principle" (Q 120). In its Communication, however, the Commission was sceptical about deficit-financed public investment:

> "Investment in physical (infrastructures), human (education, training) and knowledge (R&D, innovation) capital, if well designed, can improve long run output and growth potential, above all through their beneficial impact effect on productivity and employment. However, if higher productive public spending is financed though a rise in taxes or increased deficits and consequently higher public debt, private investment may be crowded out thus offsetting any potential beneficial effect on growth and employment." (*op. cit.*)

112. The TUC said that the Commission's proposal would make the Pact more supportive of growth and employment; it was "a timely and sensible initiative" (p. 63). UNICE also welcomed this proposal "in principle", as long as it was closely monitored. Together with Mr Crook, UNICE was concerned that the proposal inevitably involved problems of definition. Mr Crook cautioned that it was "the easiest thing in the world" to define vast parts of public accounts as public investment. He considered that defining public investment for the purposes of framing fiscal discipline was "virtually impossible" (QQ 164–66). UNICE was also worried about policy makers "selling" new public expenditures as public investments. Consequently, UNICE said the proposal should not be extended: "Any further loosening of budget consolidation would have adverse effects by letting deficits get out of control and thus hampering the long term growth potential of the GDP" (q7).

113. The Commission, however, said that it was not an issue of classifying some types of expenditure as better than others. In any case, it was very clear about the particular policy initiatives, such as pension reform, that it would accept as having long-term benefits for the economy.[51] The Commission said that, in fact, the issue when considering whether to allow the proposed deviation was the public finance situation in the Member State. Director General Regling explained this as follows:

> "Italy would not be allowed, according to our proposal, to deviate from the balanced budget rule, and the UK would be allowed to deviate from the balanced budget rule, but it is because the underlying fiscal situation is so much better in the UK, not because certain expenditures are now more important in the budget as such. Italy also has public investment, but they have such high debt levels and such an ageing and pension problem that they should run a balanced budget; it is good for their economy. It is really a question of how you look at the problem: it is not the question of good versus bad expenditures; it is more where the public finance situation is." (QQ 260–61)

114. **Whilst it may be true that a rigid implementation of the Pact restricts short-term growth, we accept the argument that fiscal policy is not a good instrument for affecting the sustainable long-term growth rate of the economy. We conclude that the current slow rate of growth in Europe is not due to the Stability and Growth Pact but is more a consequence of some Member States' failure to implement structural reforms. A much broader range of economic policy issues than those relevant to the SGP will be needed to stimulate growth across the EU.**[52]

115. **We welcome the Commission's proposal to relax slightly the 'close to balance or in surplus' rule in certain circumstances. We agree that Member States with a low level of underlying debt should be allowed "a small deviation" from the medium-term target of a budget that is 'close to balance or in surplus' in order to invest in physical and human capital. We support the fact that only countries with a low level of underlying debt will benefit from this**

[51] Elsewhere, the Commission has recognised "the conceptual difficulty in defining what 'quality' actually means" (*Public Finances—2002*, *European Economy* No.3, 2002, p.95). Yet, in its Communication, the Commission has settled on a definition, saying that a certain composition of public expenditure "could be considered as 'high quality' if it makes a positive contribution to the goals of the Lisbon strategy, i.e. making the Union the most dynamic, competitive, knowledge-based economy, enjoying full employment, strengthened economic and social cohesion and environmental sustainability." (*op. cit.*)

[52] This was recognised by the Government in their recent White Paper *Meeting the Challenge: Economic Reform in Europe*, February 2003.

additional flexibility, as this places a greater emphasis on debt and signals a move towards a more country-specific interpretation of the Pact. As such, this proposal provides an incentive to countries to lower their debt levels, which helps to address the criticism that the Pact's incentive structure is asymmetrical.[53] We believe that the Government should also welcome this move to a more country-specific interpretation of the Pact as it would allow them to target the UK national priorities of public investment in physical and human capital (Q 74).[54]

Criticism 5: The SGP does not put enough emphasis on debt and the sustainability of public finances.

116. It was generally accepted by the Commission and our witnesses that underlying debt was the key factor to the sustainability of public finances. In particular, they were concerned about the situation where the interest burden on a country's debt could become so high that a government might default on its debt obligations, especially in light of the consequences of the predicted demographic changes.[55]

117. The debt criterion, cited in Article 104(2) of the EC Treaty, states that if the government debt to GDP ratio exceeds 60 % it should diminish at "a satisfactory pace". Originally, this debt criterion was interpreted very loosely by the Commission, so that even Belgium and Italy, with ratios over 120 % of GDP, qualified for Stage Three of EMU. The Commission justified this decision on the grounds that the two countries' debt levels were declining because of primary surpluses.[56] The European Monetary Institute noted, however, that even if these surpluses were maintained over the long term, Belgium and Italian debt levels could remain above the 60 % reference value for as long as 15 to 20 years.[57]

118. Since the Helsinki European Council in December 1999, there had been continued calls for greater emphasis on medium to longer-term sustainability of public finances. The Stockholm Council in March 2001, which noted with particular concern unfunded future public liabilities, instructed the Ecofin Council "regularly" to review "the long-term sustainability of public finances in the context of both the BEPGs and the SGP." In the light of these instructions, the Commission carried out its first systematic assessment of the sustainability of public finances on the basis of the 2001 stability and convergence programmes. Subsequently, the Barcelona European Council, in March 2002, asked the Commission and the Council to continue to examine the long-term sustainability of public finances as part of the annual surveillance exercise, "particularly in the light of the budgetary challenges of ageing".

119. Nonetheless, the Commission still recognised that the "framework of the SGP, with its focus on national account definitions of government deficits and debt," did not provide "a complete picture of the financial positions of governments, especially as regards the long-term implication of budgetary policies."[58] Many witnesses asserted that this was because, when assessing Member States' compliance with the SGP, the Commission still had not paid sufficient attention to the debt criterion. Italy and Greece, with debt ratios in 2002 of well over 100 %, caused most concern, particularly as they had made very little progress to reduce their debt levels towards the 60 % of GDP reference value since the implementation of the Pact in 1999 (pp. 95, 108; QQ 50, 116, 134–40).[59]

120. In its Communication, the Commission acknowledged that this situation had created a difficulty in implementing the Pact. The Commission proposed that "greater weight must be attached to government debt ratios in the budgetary surveillance process" and that the SGP requirement for

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[53] Witnesses, such as Dr Scott (p. 108), pointed out that the SGP did not provide Member States with any incentive for good fiscal behaviour; it focused only on punishing bad fiscal actions.

[54] The Government said: "It is also important for the legitimacy of the arrangements that governments are able to target their national priorities. In the United Kingdom's case, for example, it is clear that we have a need for significant public investment to catch up for a prolonged period of under-investment. Given the fact that we have very low and sustainable debt levels, we believe there is a very strong case for enabling us to accommodate that public investment." (Q 175) This is exactly what the Commission's proposal seeks to achieve.

[55] The European Economic and Social Committee (EESC) also considered that "an increasing interest" in the objective of Member States having debt-to-GDP ratios below 60% was "necessary" as the demographic changes would "among other things require that the interest burden be as small as possible." (CES 361/2002, p.2) These concerns, which were shared by our witnesses, refer to the default problem and the pensions problem that are explained above (see paragraphs 37–42).

[56] *Convergence Report 1998*, Brussels, March 1998.

[57] *Convergence Report*, Frankfurt am Main, March 1998.

[58] *Public Finances—2002*, *European Economy* No.3, 2002, p.62.

[59] cf. Council Opinions of 21 January 2003 on the updated Stability Programme presented by Italy (5320/03) and on the updated Stability Programme presented by Greece (5318/03). The 2001 stability and convergence programmes for Portugal and Sweden recorded slight increases in debt levels, although both countries' debt-to-GDP ratio remained below the 60 % reference value.

debt/GDP ratios above 60 % to fall towards that level at a "satisfactory pace" should be put into practice. The Commission suggested that this could be achieved in a number of ways. First, countries with debt levels well above the 60 % reference value should be obliged to outline a detailed strategy in their stability and convergence programmes for reducing their debt level to below 60 %. This proposal includes activating the excessive deficits procedure for countries whose debt does not fall fast enough. Secondly, as part of the Commission's analysis of each country's stability and convergence programme, the sustainability of public finances should be assessed more closely with firm conclusions on whether the country's budgetary policies were sufficient to meet future liabilities such as pensions (*op. cit.*). The Commission suggested that this development could strengthen the credibility of the 'no bail-out' clause in the Treaty.[60]

121. The Commission recognised that it needed to clarify what would constitute a "satisfactory pace" of underlying debt reduction towards 60 % of GDP. The Communication proposed that an appropriate pace of debt reduction would result from compliance with the 'close to balance or in surplus' deficit requirement, but it did not provide more specific details about how this would be applied (*op. cit.*). Under these conditions, and assuming optimistic growth rates, it was estimated that it would still take those Member States with debt-to-GDP ratios of more than 100 % around 10 years to get down to the reference value of 60 % of GDP (Q 50).

122. Professor Begg explained that picking an appropriate pace for debt reduction was not easy, because it should "be fast enough so that it is not some very distant *manana* and slow enough so that it is not disruptive to the particular Member State" (Q 117). There was general agreement among our witnesses that the Commission should not develop another numerical target that did not take account of the circumstances of the particular country, such as stipulating there had always to be a 3 % reduction per annum by all Member States, for instance. Rather, the Council should, where necessary, set out with each Member State a specific "credible trajectory towards getting debt down"; this type of country-specific approach could be adaptable and provide flexibility for changes in economic circumstances, where necessary. This method could be based on the annual stability and convergence programmes, as the Commission proposed. Witnesses said that it was important that flexible interpretation should be possible, because for a Member State during a recession to continue reducing its underlying debt ratio would only aggravate the problems, resulting in a further slow-down and making it more difficult to consolidate finances (p. 109; QQ 117, 118). Mr Crook agreed that the pace of adjustment to the lower debt ratio ought to be very sensitive to the country's economic environment (Q 173). As Professor Begg pointed out, however, it was in the interest of the Member States themselves to reduce their underlying debt:

> "Even Greece, with 100 % is still paying 4 % of GDP on average for debt financing, if it is paying slightly above the ECB interest rate, and that is a very heavy burden on Greek tax payers or a very heavy loss to mounting public expenditure" (Q 117).

123. Mr Crook suggested that if the Commission focused sufficiently on the debt criterion, it would be possible to abandon the deficit criterion in the Pact (Q 136). Yet, although the Commission accepted that greater emphasis should be placed on underlying debt, it did not accept that this should mean a weakening of the deficit criterion. Director General Regling told the Committee: "Debt is very important and we will try to take it more into account now than we used to in the past, but the deficit is important for the conduct of monetary policy" (Q 255). Although Mr Crook argued for debt to be the headline criterion of a revised SGP (Q 137), the majority of our witnesses agreed that it should not totally replace the existing deficit focus of the Pact (e.g. Q 49).

124. **Taking into consideration underlying debt levels as well as budget deficits provides a more coherent basis for analysing the sustainability of Member States' public finances. We therefore welcome the Commission's proposal to focus more on debt. Furthermore, we agree with the Commission that focusing on debt should not detract from the need for Member States to keep their deficits under control, for the two elements are clearly connected, as a country running high deficits will accumulate a high level of debt.**

125. **The stability and convergence programmes of Member States with particularly high debt ratios should contain a clear commitment to an agreed trajectory of reducing debt. In the light of these commitments, the Council opinions on the stability and growth programmes should include guidelines for reducing debt. If necessary, these guidelines should be enforced through a strong process of peer pressure after an early warning sent by the Commission direct to the Member State.**

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[60] *Public Finances in EMU—2002*, *European Economy* No.3, 2002, p.62. For a discussion of the issue of bail outs, see above, paragraphs 37–40.

126. **Whilst we are in favour of those Member States with high levels of underlying debt working out a plan for reducing their debt, we would not wish to see these governments penalised for not being able to meet their plans in the event of an economic downturn. The Commission should not stipulate a uniform rate of date reduction that does not take account of the circumstances of each particular country. The plans for debt reduction should not be the same for all countries irrespective of their starting point or expected future growth rate; they should offer Member States discretion to respond to changed economic circumstances. Therefore, we do not accept the Commission proposal that a failure on the part of a Member State to achieve the established pace of debt reduction should lead to sanctions. As we have already stated (see above, paragraphs 90 and 102), we do not wish to see an extension of the number of situations that lead to the formal sanction of the excessive deficit procedure.**

Criticism 6: The SGP's rigid rules do not allow for differences between countries.

127. A recurring theme among the five criticisms of the SGP examined above was that the Pact did not sufficiently recognise the differences between the circumstances of Member States when reviewing their budgetary policies. Dr Scott, for example, complained that the Pact's rigid rules allowed no discrimination "between countries who should be allowed flexibility and those who need to reform" (p. 107). He considered it important to discriminate between governments who had been adversely affected by unforeseen shocks and needed to be flexible in their response and governments who had been pursuing excessive deficits relative to their long run plans (p. 108). This was illustrated by the fact that the excessive deficit procedure had been launched against Germany for coming perilously close to the 3 % deficit ceiling, despite the fact that its underlying debt position was healthy. Italy, on the other hand, had not been cautioned for failing to bring down its debt from a very high level of over 100 % of GDP. Both countries had large future pension liabilities looming, but Germany's lower level of debt meant that at present it was in a better position to meet these than Italy. Another reason given to demonstrate the desirability of country-specific targets was that the demographic profiles of the different Member States were very different and would lead to very different demands on their pension systems. Sweden had already opted voluntarily for a 2 % surplus and was discussing a 2.2 % to 2.75 % surplus for their medium-term target, because they recognised that they would have a significant pension burden in the future.

128. In order to avoid such anomalies, a number of our witnesses wanted the Pact to adopt customised, country-specific targets. Professor Sibert was adamant that, unlike the uniform, 'one size fits all' approach of the SGP as currently designed, "sensible budgetary policies ought to vary across countries and across time". This would involve scrapping the 3 % and 60 % reference values for deficits and debt, which were applied uniformly between Member States, and instead setting different targets for debt and deficit for each Member State according to its economic circumstances (p. 108, 110; QQ 104, 109, 140).

129. The Commission and UNICE, however, argued against any such move. The BEPGs already contained country-specific targets, and they did so in their recommendations not only on fiscal policy, but also for labour markets, product markets and education systems. In addition to the BEPGs, however, it was important to have a rule-based framework for fiscal policy, in order to guard against the problems outlined above in our introduction (see Part Two). A further danger was that changing the targets in the Pact would fudge the issues. The beauty of the SGP was its simplicity. A shift to customised targets would make it less clear which Member States were following sensible economic policies and which were not. The process of surveillance would become a lot more complex, and discipline would become harder to enforce. Along with UNICE and the Commission, the TUC therefore concluded that the need for simple, clear, easily enforceable rules was "overwhelming" (Q 214). UNICE also raised the concern that the introduction of country-specific targets would lead to horse trading and Member States conducting deals with one another within the Council over each other's targets. This would be extremely damaging; fiscal policy "must not become subject to political bargaining" (q3).

130. Director General Regling also pointed out the proposals in its Communication already had the aim of introducing a degree of flexibility into the Pact. The Commission was proposing that countries with low levels of government debt should be allowed a small deviation from the medium-term balanced budget rule. It was also proposing that, until they reached the medium-term target, heavily-indebted countries would have to improve their underlying deficits by more than the 0.5 % of GDP each year that the Commission proposed stipulating for other Member States. These two changes would bring some country-specific targets into the SGP, making it more customised (Q 275).

Box 5

Accession Countries

Some witnesses pointed out that one rationale for having customised targets was the enlargement of the Union in 2004 (QQ 104, 109). A number of the accession countries had made considerable efforts to control their fiscal policies, but all the medium-sized and large countries already had what Professor Buiter described as “worryingly large” fiscal imbalances (Q 29). He explained that these countries were going to be “very, very hard pressed to keep their fiscal house in order.” For a number of these countries, the reality of having to cope with deficits above 6 % would come home, regardless of the Pact. If the Pact were to be enforced at all tightly on them, it would be “the most severe fiscal impact faced since the transition began.” (Q 30)

As soon as they joined the EU, the accession countries would formally become subject to the rule requiring Member States to have budgets ‘close to balance or in surplus’ in the medium term. To make the transition from a deficit of around 6 % to close to balance—even if it was in the medium term—would be “wrenching, especially with the additional demands of the environmental and infrastructure fields coming on top of current spending needs and given the fact that the net transfer from Brussels, while mitigating the problem, will not eliminate it; it will not finance the full required increase in expenditures.” Consequently, these countries were going to be under “very severe” fiscal pressure. Most of them, with the exception of one or two of the Baltic States, had continental western European levels of public spending-to-GDP ratios but with much lower levels of income per capita. These were much poorer countries supporting very ambitious welfare states. What is more, they would have to make the transition from a command to a market economy. They would need to upgrade their public infrastructures and prepare for the liberalisation effects which EU membership would entail.

The implied question behind these facts was how the SGP could take into account that the accession countries were undergoing tremendous structural and institutional changes without moving to customised targets.

In view of these future requirements, and the fact that, once they become EU members, the accession countries would be obliged to maintain budget deficits below 3 % of GDP, the Commission implemented a new initiative called the pre-accession fiscal surveillance procedure (PFSP) in spring 2001. This process was “designed to closely approximate the policy coordination and surveillance mechanisms of the EU while giving due regard to the accession priorities of the candidate countries.” (*Public Finances in EMU—2002*, *European Economy* No.3, 2002, p.133)

131. **As Professor Buiter said, the Commission faces the difficult task of creating rules that are “both simple and appropriate to a variety of circumstances” (Q 6). The Pact needs to be clear enough and simple enough to be monitored and enforced across all of the Member States, whilst providing individual Member States with the flexibility to react to their own economic circumstances. Some uniform, firm rules are required to avoid countries free riding or running up large debts on which they might default and to enable countries to deal with the economic effects of their ageing populations. But there is a possibility that the SGP rules could be interpreted and applied in a way that does not take sufficient account of the different circumstances of different countries, especially the accession countries. We agree with many of the Commission’s proposals for improving the interpretation of the Stability and Growth Pact. As we have made clear, however, we do not wish to see these proposals interpreted in an inflexible manner that takes no account of the particularities of each individual case. The crucial question is how the proposals are to be enforced, and it is to the issue of enforcement that we now turn.**

PART 4: SURVEILLANCE AND ENFORCEMENT

Surveillance—the early-warning mechanism

CRITICISM: THE PROCEDURES DO NOT WORK BECAUSE THE INSTITUTIONAL BALANCE IS TOO COMPLICATED

Background

132. As summarised in our introduction (see above, paragraphs 58–60), the Stability and Growth Pact came under severe strain last year when the Council did not endorse the Commission's recommendation to issue an early warning to Germany and Portugal. As explained above, this decision was widely interpreted as undermining the credibility of the Pact.

Box 6

The Early-Warning Mechanism: Regulation (EC) No 1466/97

- The Council monitors the implementation of stability and convergence programmes "with a view to identifying actual or expected 'significant divergences' of budget positions from the medium-term objective or the adjustment path towards it" (Article 6(1)). The Council's decisions are based on assessments made by the Commission and the Economic and Financial Committee.
- If, on the basis of these assessments, the Council identifies such a significant divergence, it sends a recommendation to the Member State concerned "with a view to giving an early warning in order to prevent the occurrence of an excessive deficit" (Article 6(2)).
- This Council adopts its recommendation "to take prompt corrective measures" by qualified majority (including the Member State concerned) on the basis of a Commission recommendation following the procedure outlined in Article 99(4) of the Treaty.
- The SGP does not define what constitutes a 'significant divergence' from budgetary targets or in any other way define the conditions under which the early-warning mechanism is to be activated.

133. If a country receives an early warning of an excessive deficit and following this warning the country's deficit does not rise above 3 %, that is the end of the procedure. There are no other steps unless the deficit goes up further and breaches the reference value, in which case the next procedure (i.e., the excessive deficit procedure) may be activated. The early-warning mechanism does not itself lead to the excessive deficit procedure (EDP) and the possibility of sanctions. The decision to implement the EDP is taken separately from any warning, and the EDP can be applied even if a warning has not been sent to the Member State, as was clearly shown in the cases of Germany and Portugal.

134. In theory, the early-warning mechanism outlined in the box represents a three-stage process:

1. the Commission assesses the situation and activates the early warning mechanism, by making a recommendation to the Council;
2. the Council takes a decision (after consulting the EPC and based on the Commission recommendation) whether or not a significant divergence from budgetary targets has occurred and whether to issue an early warning; and
3. the Member State concerned responds and announces appropriate policy measures.

135. The Commission, however, pointed out that these steps were re-ordered in the case of Germany and Portugal, where the Council effectively reversed steps 2 and 3, with the two Member States concerned announcing corrective action before the Council decided whether to issue an early warning (*Public Finances in EMU—2002*, *European Economy* No.3, 2002, p.51).

The Commission's proposal

136. The Commission proposed that it should be given the authority, without recourse to a Council vote, to issue an initial early warning directly to any Member State at risk of running an excessive deficit or significantly departing from the recommendations drawn up under the BEPGs.[61] The

[61] cf. COM(2002) 728 final/2, Brussels, 11 December 2002.

Commission suggested that this could lead to "more direct and timely signalling of budgetary problems". Such a proposal would greatly simplify the system.

137. The Commission further proposed that:

> "the Member State concerned should be excluded from any vote on issuing warnings. The Treaty already makes provision for such exclusion where the Council has to issue a formal notice to a Member State about correcting an excessive deficit—but this detail has been omitted from the voting arrangements on issuing warnings. By definition, the Member State concerned will generally be opposed to any such warning. Excluding it from the vote would therefore prevent a situation in which it was both judge and defendant." (*op. cit.*)

138. These proposals would require a change to the Treaty, which can only be achieved by unanimous agreement between the Member States. The Commission therefore submitted these proposals to the Convention on the Future of Europe, which is considering what Treaty changes are necessary to prepare for the enlargement of the EU in 2004. The conclusions of the Convention will be forwarded to the IGC that is scheduled to take place in the autumn.

Evidence

139. Many of our witnesses supported the Commission's proposal, saying the current arrangements were not working, because, as Professor Buiter put it, the Council did not have "the political capacity to deliver and enforce a judgment against a member country". There was a fear that political tradeoffs could be made in the Council. In the Council's system of peer review, Member States did not want to sit in judgement on a country that might be judging them subsequently. Therefore, the Pact should move to a system of Commission review. Sending an initial early warning to Member States was part of the surveillance and monitoring process, as such it was preventative-as indicated by being covered under Regulation No 1466/97.[62] These witnesses supported strengthening of the Commission's role in the surveillance process, because they saw the process of monitoring Member States' compliance with the Pact to be the proper role of the Commission, as the guardian of the Treaties. Furthermore, the decision to send an early warnings should be based wholly on facts; it was not a political decision (QQ 10, 16, 91; pp. 27, 70).

140. The Government, unsurprisingly, spoke out strongly against this proposal. They claimed that, although there had been problems when the issue of early warnings first arose, that is, with Germany and Portugal at the beginning of 2002, this was no longer the case; the Council was now functioning much more effectively. This was evidenced by the Council's decision to send an early warning to France (as decided at the Ecofin Council meeting on 21 January 2003, see above paragraphs 63–64). The Government also argued against the proposal on the grounds of national sovereignty. They said it was "much better for Member States together to decide what action [was] appropriate on the basis of strong evidence from the Commission" (Q 196).

141. The TUC was the only other witness to oppose this proposal, because, it said, the Commission did not have the political legitimacy to issue the warnings. The warnings would only be seen by Member States to have legitimacy if they came through the Council. If warnings came directly from the Commission, Member States would be less likely to pay such heed to them (Q 219).

142. To counter this problem of legitimacy, Begg suggested that the judgement of the Commission could be subject to an independent panel of experts, who would 'audit' the Commission's analyses. This body could take a purely analytic view of the budgetary position of the Member State and establish whether or not the Commission had judged correctly that there was a risk of an excessive deficit. If the panel found this to be the case, it would endorse the Commission's opinion, giving the decision more legitimacy (QQ 108, 110).

The Committee's Conclusions on surveillance

143. **It is important to avoid a perception in the public, the media and the markets that the rules of the Stability and Growth Pact can be ducked in challenging circumstances. As the Council's decision not to send early warnings to Germany and Portugal highlighted, the present arrangement for early warnings leaves too much room for political tradeoffs, which can severely undermine the credibility of the Pact. The early warning is a statement of fact, based on the technical monitoring by the Commission of the Member States' stability and convergence programmes. It is equivalent to a Commission Communication that provides a technical**

[62] For the distinction between the two Regulations that form the core of the Stability and Growth Pact and the corresponding distinction between the preventative side of the Pact, which involves surveillance and the early-warning procedure, and the deterrent side of the Pact, which involves sanctions and the excessive deficit procedure, see above, paragraphs 7–16.

analysis; it is not part of the enforcement procedure, as it does not entail the Member State being enjoined to follow a particular course of action or implement a particular policy.

144. **To ensure the credibility and proper functioning of the Stability and Growth Pact, situations such as the one last February—when the Council went against the Commission's recommendation and did not send early warnings to Germany and Portugal—must be avoided in the future. The Commission's proposal that it should be given the authority to issue early warnings directly to Member States without recourse to the Council provides an effective way of ensuring this. We therefore recommend that the Treaty be amended to grant the Commission this power. This proposal is in line with the monitoring and surveillance functions of the Commission. In a system where the Commission sends an initial early warning directly to Member States, the Council should retain the right to send a further warning itself. The Member State concerned, however, should be excluded from any Council vote on issuing warnings. This will require a further minor change to the Treaty.**

145. **The Committee agrees that the Commission's role should not be extended beyond the right to issue an early warning direct to a Member State. The Council should remain the final arbiter of all the enforcement procedures enshrined in the Pact. Only the Council should have the power to enforce sanctions through the excessive deficit procedure and to oblige Member States to take specific actions to remedy excessive deficits.**

Enforcement

146. The Committee heard that the enforcement measures available under the Stability and Growth Pact were inappropriate, unworkable and needed revision. We analysed the current sanction of fines and examined other possible forms of sanction. We heard a lot of evidence about the role and importance of peer pressure in enforcing the Pact. Finally, we considered whether its was appropriate for the SGP to rely on the 'hard law' of rules founded on legal regulations or whether it would be better for the Pact to comprise a set of 'soft law' measure, based around guidelines. These issues are examined below.

ARE FINES AN APPROPRIATE SANCTION FOR THE SGP?

Fines are perverse—they will only worsen the budgetary situation

147. Many witnesses agreed that the sanction of fines was an inappropriate way to enforce the SGP. Professor Sibert, for example, called them "a rather perverse punishment", as they would only serve to worsen the budgetary situation in the errant country (p. 110). It would be "counter-productive" to impose a financial burden on a country that was already running an excessive deficit (QQ 16, 171)

Fines will never be imposed—they are not politically credible

148. Furthermore, witnesses agreed that it was politically highly unlikely that Member States would vote for the enforcement of fines to be levied on a fellow Member State. Witnesses agreed that the Council would not actually impose fines on any EU country through the SGP. It was reported that there was also very little expectation in the markets that sanctions will be applied. As Professor Begg said, "the fines are the nuclear deterrents, they are not to be used." This view was supported by many other witnesses (p. 110; QQ 17, 38, 58, 63, 102, 112, 142). As the TUC explained:

> "The fines are really the nuclear option. If any country got to the point where the Commission was seriously thinking about imposing fines, then the system itself is in danger of breakdown; we would be facing a major political as well as an economic crisis." (Q 218)

149. Accepting this position, it was only a short step to say that unenforceable law was bad law, and so it would be a good thing to write fines out of the Pact. This was the position of Professor Begg and Mr Crook. Professor Begg said the fines were not there to be used, and so consequently "we might as well write them out of the system" because they were "a pointless and rather silly exercise" (QQ 112, 128, 152).

Reasons to maintain the possible sanction of fines

150. Witnesses gave three reasons to maintain fines in the SGP. First, UNICE maintained that fines had worked as an ultimate deterrent and were "the best means of deterrence between sovereign countries" (q17). UNICE agreed that the practical reality of such fines being imposed was very slim,

but that it would be "better to leave this ultimate threat, understanding that it will probably not happen". Secondly, removing them would send out the wrong signal about the Pact, indicating that budgetary discipline in the EU was being relaxed. Thirdly, it was argued that fines should not be abolished at this point, because we do not know what could replace them in the Pact (QQ 241–42, 245, 267).

ARE THERE ANY OTHER POSSIBLE SANCTIONS FOR THE SGP?

151. In response to the argument that fines had to be kept in the Stability and Growth Pact because no credible alternative had been found, the Committee explored other possible sanctions for the Pact. Professor Begg mentioned the possibility of a country losing it structural funds. But he discounted this option as it would operate just like a fine in effect, as it imposed a financial penalty on the errant country (Q 113). Professor Buiter referred to the possibility of the Member State losing its right to vote in the ECB. However, he did not accept this solution, as he thought it inappropriate, as it concerned a different institution (Q 16). He proposed instead that the Member State should lose its right to vote in the Ecofin Council. He suggested that this sanction was "more plausible and more effective than monetary sanctions or fines" (QQ 17, 35). Mr Crook was a keen supporter of this proposal. He said it was "a very good idea," because it would make the penalty a political one rather than an economic one. It would be

> "a humiliating thing for a government to have to bear; but in itself there is next to no economic damage and that is exactly how it should be. This regime should punish politicians who are pursuing unsound or even reckless fiscal policy. It should not punish citizens in their economies which the excessive deficits procedure does do." (Q 146)

152. Professor Sibert also wondered whether this would be a more suitable sanction (p. 110). The Committee noted that already, on the latter stages of the Stability and Growth Pact sanctions, Member States were not allowed to vote on their own case. However, what Professor Buiter was of a significantly different order, as it would involve taking away the Member State's right to vote on other items of legislation. Professor Begg countered that such a sanction would be "just petty" (Q 122).

THE ROLE AND IMPORTANCE OF PEER PRESSURE

153. Our witnesses unanimously agreed that peer pressure was the most important enforcement mechanism in the Stability and Growth Pact. The most appropriate way of enforcing the Pact was through building political consensus among all the Member States. The focus should not be on sanctions so much as on political processes which could change the political will of Member States whose fiscal policy risk breaching the terms of the Pact (QQ 45, 59, 102, 109, 127, 146, 167, 189, 196). Witnesses accepted that Member States could not be left to put pressure on one another. Peer pressure would not come about by itself but would need to be focused. For this to happen, it was necessary to put in place a credible framework, with bench marks and an effective surveillance process, so that comparisons could be made and peer pressure applied. Mr Crook, for example, pointed out that

> "if there is no number at all then there is no focus for peer pressure to begin. It seems to me that you need a bench mark of some kind for the process even to start […] a number to organise the discussion. If you do not have that then I think it is much harder to mobilise peer pressure, harder to organise opinion in a certain direction" (Q 170–72)

154. The question was: what would be the most effective framework within which peer pressure could operate?

WOULD IT BE BETTER TO HAVE 'SOFT' GUIDELINES RATHER THAN 'HARD' RULES?

155. If peer pressure was accepted as the only effective means of enforcing the SGP, as the official sanction of fines might never be used, some witnesses asked whether it would be better to move to a Pact that is based on 'soft' guidelines, rather than 'hard' rules. The distinction between hard and soft in this context is that hard rules have legal sanctions backing them, whereas the softer procedures are only proposals that can be advocated to the Member States. The BEPGs are an example of the 'softer' approach, as there is no sanction against not doing something in the Guidelines.

156. Professor Begg was the main proponent of this view; Mr Crook agreed with him. Professor Begg said that the rules did not make it any easier to enforce the Pact, so the emphasis should be put instead on offering guidelines to Member States. He suggested that this would allow the Commission to use other 'soft' tools, such as benchmarking, peer review, and league tables, which were ways in which pressure could be put on a Member State (Q 109).

157. In opposition to this, UNICE said the hard law element of the SGP was needed to avoid the free-rider problem (q 16). Others witnesses argued that the Pact (and they saw rules as an integral part of this) had been successful in getting Member States to pay close attention to their fiscal policy. By removing the rules, one risked allowing more profligate fiscal policies in the EU. The Commission also considered it important to keep the hard elements of the Pact, even though it hoped they would never have to be used (QQ 254, 267).

THE COMMITTEE'S CONCLUSIONS ON ENFORCEMENT

158. **The Stability and Growth Pact is, first and foremost, a political agreement. Its effectiveness depends on the willingness of countries to cooperate with the Commission and in the Council. The policy makers must accept and implement rigorously the principle of peer pressure. The success of the Pact depends upon the willingness of politicians to give and receive open and frank advice and to adjust policies when necessary.**

159. **Fines are a generally unsatisfactory penalty for the Stability and Growth Pact, because they would aggravate the budgetary problems that the Member State is supposed to be dealing with, and, in any case, they are unlikely to be used. We agree, however, that abolishing the threat of fines in the SGP would give the wrong signal to the public, the media and the markets that budgetary discipline in the EU was becoming less strict. Accepting that the sanction of fines is a 'nuclear deterrent' and unlikely to be enforced, we are content to leave this aspect of the SGP unchanged, in order to act as an ultimate deterrent and to be used as a measure of absolute last resort for the extreme case where a Member State completely disregards the rules.**

160. **Moreover, we did not find another penalty that could work and that would be more appropriate. We do not support Professor Buiter's proposal to deny Member States that break the rules of the Pact the right to vote in Ecofin. We do not consider that this a sanction that could be acceptable to the Member States or that could work in the real political world. Moreover, politicians in the Council vote for their national interest, therefore the proposal would not only affect the politicians, as intended, but it would affect the country as a whole, including the country's citizens. Nonetheless, we do not support the sanction of fines in normal circumstances, and, as we have made clear, we do not wish to see any extension in the use of the excessive deficit procedure.**

161. **We accept that peer pressure is the most effective enforcement mechanism currently available in the Stability and Growth Pact. The question is how the Pact can be shaped so that peer pressure does what is required so that the necessary level of fiscal coordination is achieved. We agree that peer pressure can be effective only if there are quantitative yardsticks against which it can be applied. The excessive deficit procedure is there as a measure of absolute last resort. Beyond this, it is essential to have a series of guidelines that make it easier to place the emphasis on policy coordination and peer review. These guidelines can work alongside the statutory, binding elements of the Pact.**

162. **In its Communication, the Commission proposed that Member States should reaffirm their political commitment to the SGP in a "Resolution to reinforce the co-ordination of budgetary policies" to be endorsed by the European Council at their meeting in Brussels in March 2003. We would support such a Resolution, as it could function as one of the necessary yardsticks against which peer pressure can be applied. The proposed Resolution, however, is not enough; it is time that the politician's words and commitments are backed up by firm actions. It is also necessary to update the Code of Conduct to incorporate the Commission's new proposals interpreted as guidelines.**

PART 5: SUMMARY OF KEY CONCLUSIONS

THE NEED FOR A STABILITY AND GROWTH PACT

163. The Committee supports the co-ordination of national fiscal policies across the EU with a view to maintaining sound public finances. Market discipline alone cannot be guaranteed to ensure the sustainability of public finances. A co-ordinating pact or other method of co-ordination between the Member States is necessary to deal with the 'free-rider' problem, the risk of default and to help Member States to prepare for the economic effects of ageing populations in the EU; such a method of coordination should also provide stability for the European Central Bank and the market (paragraph 49).

PROPOSALS TO REFORM THE INTERPRETATION OF THE SGP

164. It should be made explicit that the medium-term target of budgets 'close to balance or in surplus' is to be measured in terms of the cyclically-adjusted budget balance. The common methodology agreed and adopted by the Commission and Ecofin last year should be used to calculate the underlying budget balances for this target; this means that an extra body of experts is not needed to calculate the cycle (paragraph 80).

165. When monitoring Member States' compliance with the 3 % deficit criterion, the Commission should continue to use the actual deficit-to-GDP ratio. However, when deciding how the Pact is to be enforced, the Council should not treat the 3 % figure as an absolute limit, never to be breached. The Council's decision whether or not to implement the excessive deficit procedure, once a country has breached the 3 % reference value, should take account of the underlying economic situation, including the Member State's position in the economic cycle and possibly its level of debt (paragraphs 81–83).

166. The Commission's proposal that Member States should set an adjustment path towards the medium-term target of budgets 'close to balance or in surplus' of 0.5 % GDP per year should not be treated by the Council as an enforceable rule, any breach of which would activate the excessive deficit procedure (paragraphs 89-91).

167. It is important to tackle the fact that the Stability and Growth Pact works asymmetrically across the economic cycle. Furthermore, countries need to be encouraged not to act pro-cyclically in times of boom. The Committee does not, however, consider that the Commission's proposal to apply the sanction of the excessive deficit procedure in good times would be the most effective way of achieving these twin objectives. The Committee shares the concern that the rules of the Pact should not be complicated. The number of situations that lead to the formal sanctions of the excessive deficit procedure being invoked should not be extended, or these measures will lose their force (paragraphs 102–03).

168. Member States with a low level of underlying debt should be allowed "a small deviation" from the target of budgets 'close to balance or in surplus'. The Government, too, should welcome this move to a more country-specific interpretation of the Pact, as it would allow them to target the UK national priorities of public investment in physical and human capital (paragraph 115).

169. The Pact should focus more on debt. The stability and convergence programmes of Member States with particularly high debt ratios should contain a clear commitment to an agreed trajectory of reducing debt. In the light of these commitments, the Council opinions on the stability and growth programmes should include guidelines for reducing debt (paragraphs 124–26).

SURVEILLANCE OVER THE SGP

170. To ensure the credibility and proper functioning of the Stability and Growth Pact, situations such as the one last February – when the Council went against the Commission's recommendation and did not send early warnings to Germany and Portugal – must be avoided in the future. The Treaty should be amended to grant the Commission the power to issue early warnings directly to Member States without recourse to the Council. This proposal is in line with the monitoring and surveillance functions of the Commission (paragraphs 143–44).

ENFORCEMENT OF THE SGP

171. The Commission's role should not be extended beyond the right to issue an early warning direct to a Member State. The Council should remain the final arbiter of all the enforcement procedures enshrined in the Pact. Only the Council should have the power to enforce sanctions

through the excessive deficit procedure and to oblige Member States to take specific actions to remedy excessive deficits (paragraph 145).

172. Peer pressure is the most effective enforcement mechanism currently available in the Stability and Growth Pact. The sanction of fines is a 'nuclear deterrent' only to be used as a measure of absolute last resort (paragraphs 158–61).

OVERALL GENERAL CONCLUSION

173. Each of the Commission's proposals—to measure the medium-term target of budgets 'close to balance or in surplus', to encourage Member States to reduce their underlying deficits to achieve this objective, to encourage countries not to act pro-cyclically in times of boom, to allow Member States with a low level of debt to deviate from the 'close to balance or in surplus' target, to encourage highly-indebted countries to reduce their levels of debt—provides Member States with a useful aim and sound objective. However, they should be interpreted as guidelines rather than as rules. Interpreted in an inflexible way that takes no account of the particularities of each individual situation, they would increase the complication of the Pact. This could lead to more transgressions by the Member States and more interventions by the Commission and the Council, which could possibly threaten to undermine the credibility of the very rules that the proposals seek to strengthen. Interpreted in a way that is sensitive to the specific circumstances of each country, the proposals would introduce the necessary extra benchmarks against which the budgetary actions of Member States could be judged and around which peer pressure could be applied in the Council. Such an interpretation should encourage Member States to follow sensible fiscal policies, which could lead to greater stability and growth.

RECOMMENDATION

174. The Committee considers that the Stability and Growth Pact raises important questions to which the attention of the House should be drawn and makes this Report to the House for information/debate.

APPENDIX 1

Sub-Committee A (Economic and Financial Affairs, Trade and External Relations)

Members of the Sub-Committee

Lord Armstrong of Ilminster
Lord Geddes
Lord Hannay of Chiswick
Lord Jones
Lord Lamont of Lerwick
Lord Lea of Crondall
Lord Marlesford
Lord Radice (Chairman)
Lord Sharman
Lord Sheldon
Lord St John of Bletso
Lord Taverne

The Specialist Adviser was Professor John Driffill

Members of the Sub-Committee declared the following interests:

Lord Radice

Board Member, Britain in Europe
Board Member, European Movement
Chairman, British Association for Central and Eastern Europe

Lord Armstrong of Ilminster

Chairman, Forensic Investigative Associates plc
Chairman, Board of Governors, Royal Northern College of Music
Chancellor, University of Hull
Chairman, Leeds Castle Foundation
Chairman, Hestercombe Gardens Trust
Trustee, RVW Trust

Lord Geddes

Non-Executive Chairman:
Pacific Chartered Capital Management Limited
Pacific Chartered (Europe) Limited
Photo Corporation (UK) Limited
Trinity College London
Chrome Castle Limited

Non-Executive Director:

Portman Settled Estates Limited
Trinity College of Music

Lord Hannay of Chiswick

British Government Special Representative for Cyprus
Tangguh Independent Advisory Panel (for BP)
Member, Council of Britain in Europe
Non-Executive Director, Aegis Group
Non-Executive Director, Chime Communications
Pro-Chancellor, University of Birmingham
Director Salzburg Seminar
Member, International Advisory Board of EDHEC (French Business and Management Schools)
Member, Advisory board,Centre for European Reform
Member, Advisory board, European Foreign Affairs Review
Member, Advisory board, Prospect Magazine

Lord Lamont of Lerwick

Chairman, East European Food Fund
Director, Balli plc
Director, Banca Commerciala Robank SA
Director, Compagnie Internationale de Participations Bancaires et Financieres
Director, European Growth and Income Trust (managed by Aberdeen Asset Management)
Director, Jupiter Finance and Income Trust (Investment Trust)
Consultant, Fintrade
Consultant, Rotch Group
Vice-President, Bruges Group
Member, Business for Sterling

Chairman, Le Cercle
Director, British Iranian Chamber of Commerce
Director, British Romanian Chamber of Commerce
Vice Chairman, International Nuclear Safety Commission
Chairman of the Oil Club

Lord Lea of Crondall

Treasurer, Parliamentary Group on Macedonia
Treasurer, Parliamentary Group on the Federal Republic of Yugoslavia
Member, Central Arbitration Committee

Lord Marlesford

Adviser, Board of John Swire and Sons
Adviser, Mitsubishi Corporation (UK)plc
Adviser, Sit Investment Associates (Minneapolis)
Adviser, World View Incorporated (New York)
Non-Executive Director, Baring New Russia Fund Ltd
Independent National Director, Times Newspaper Holdings Ltd
Chairman Marlesford Parish Council
President, Suffolk ACRE (Action for Communities in Rural England)
President, Suffolk Preservation Society

Lord Sharman

Chairman and Shareholder, Aegis plc
Board Member, Britain in Europe
Director and Shareholder, B G International plc
Director, AEA Technology plc
Director, Reed Elsevier plc
Director, Youngs Brewery plc
Director and Shareholder, Phocis plc
Adviser (paid) KPMG

Lord Taverne

Director, Industrial Finance Group Ltd
Chairman, Monitoring Board, Axa Sun Life plc
Chairman, Advisory Board, Oxford Centre for Environment, Ethics and Society (OCEES)
Chairman of Trustees, Alcohol and Drug Addiction Prevention and Treatment (ADAPT) Ltd
Chairman of Trustees, Iran Aid Foundation
Trustee, The Health and Science Communication Trust

APPENDIX 2

List of Witnesses

The following witnesses gave evidence. Those marked ** gave both oral and written evidence; those marked * gave oral evidence only; those without an asterix gave written evidence only.

** Professor Iain Begg, London School of Economics and Political Science

* Professor Willem Buiter

Professor Jagjit Chadha, Clare College, Cambridge University

* Mr Clive Crook, the Economist

* European Commission

Professor John Fitz Gerald, The Economic and Social Research Institute

Professor Charles Goodhart, London School of Economics and Political Science

** HM Treasury

Professor Andrew Hughes-Hallett, Cardiff Business School and the Centre for Economic and Policy Research (CEPR)

* Professor Patrick Minford, Cardiff Business School

Dr Andrew Scott, The London Business School

Professor Anne Sibert, Birkbeck College

** Trades Union Congress (TUC)

* Mr David Walton, Goldman Sachs

* Mr Martin Weale CBE, National Institute of Economic and Social Research (NIESR)

** Union of Industrial and Employers' Confederations of Europe (UNICE)

Dr Wolfgang Zank, Aalborg University

APPENDIX 3

Glossary

Note: Terms defined elsewhere in the Glossary are shown in italics.

Automatic stabilisers: Various features of the tax and spending regime which react automatically to the economic cycle and reduce its fluctuations. For example, a downturn in government revenue and an increase in government expenditure automatically arise in a recession, thus cushioning the reduction in aggregate demand. As a result, the *budget balance* tends to improve in years of high growth and to deteriorate during economic slowdowns.

Bail out: See *'no-bail out' clause*.

Broad economic policy guidelines (BEPGs): Annual guidelines for the economic and budgetary policies of the Member States. Established under Article 99(2) of the EC Treaty, in the context of which Member States are required to conduct their economic policies. Since 1993, they have been adopted by Ecofin on the basis of a Commission recommendation.

Budget balance: The balance between total public expenditure and revenue in a specific year. A positive balance would indicate a surplus; a negative balance would indicate a deficit. In a balanced budget, a government's revenue is equal to its spending, so it has no need to borrow or lend. See also *cyclically-adjusted budget balance*.

Close-to-balance rule: A rule contained in the Stability and Growth Pact, according to which Member States should, over the medium term, achieve an overall *budget balance* that is close to balance or in surplus.

Convergence programmes: National medium-term budgetary and monetary strategies submitted annually by each of those Member States outside the *Eurozone* (i.e., those countries that have not yet adopted the euro). They must conform to the provisions of the Stability and Growth Pact and show the Member States' progress towards achieving sustained convergence. See also *stability programmes*. In contrast to stability programmes, the convergence programmes also deal with monetary policy.

Cyclical component of budget balance: That part of the change in the *budget balance* that follows automatically from the cyclical conditions of the economy, due to the reaction of public revenue and expenditure to changes in the output gap. See *automatic stabilisers*, and *cyclically-adjusted budget budget balance*.

Cyclically-adjusted budget balance: A government's actual *budget balance* adjusted for its *cyclical component*. The structural balance gives a measure of the underlying trend in the budget balance, when taking into account the automatic effect on the budget of the economic cycle. It is intended to give a better forecast of the future path of the deficit. It is also referred to as the *structural budget balance*.

ECB: European Central Bank

Ecofin: The Council of Ministers of the European Union responsible for Economic and Financial Affairs; it is made up of the economics and finance ministers of the Member States.

Economic Cycle: the period of time between the point where the output gap is zero and when the output gap returns to zero.

EFC: Economic and Financial Committee. In accordance with Article 114(2) of the EC Treaty, an Economic and Financial Committee was set up at the start of the Stage Three of *EMU*. For further information on the EFC, see the Council Decision of 21 December 1998 on the detailed provisions concerning the composition of the Economic and Financial Committee (98/743/EC), together with the Council Decision of 31 December 1998 adopting the Statutes of the Economic and Financial Committee (1999/8/EC).

EMU: Economic and Monetary Union

Eurogroup: The group of government finance ministers of the twelve Member States in the *eurozone*; they meet every time there is a meeting of *Ecofin*.

European Council: the European Council consists of the heads of state or government of the European Union.

Eurozone: Term used to refer collectively to those Member States which are participating in Stage Three of *EMU*, that is, who have adopted the euro.

Excessive deficit procedure (EDP): A procedure according to which the Commission and the Council (in line with Article 104 of the EC Treaty) monitor the development of national *budget balances* and public debt in order to assess the risk of an excessive deficit in each Member State. Its application was clarified in the Stability and Growth Pact (see Council Regulation (EC) No 1467/97). See also *stability programmes*.

GDP: Gross Domestic Product

Medium-term target: An alternative name for the *close-to-balance rule*.

'No-bail out' clause: Agreement (expressed in Article 103 of the EC Treaty) precluding collective liability for debt incurred by individual Member States.

Pact: Stability and Growth Pact.

Pro-cyclical fiscal policy: A fiscal stance which amplifies the economic cycle by increasing the government deficit during an economic upturn, or by decreasing it in a downturn. It can be contrasted with (discretionary) counter-cyclical policy which has the opposite effects. A neutral fiscal policy keeps the *cyclically-adjusted budget balance* unchanged over the *economic cycle* but lets the *automatic stabilisers* work.

SGP: Stability and Growth Pact

Stability programmes: National medium-term budgetary strategies submitted annually by Member States that have already adopted the euro (i.e., who are part of the *eur zone*). They must conform to the provisions of the Stability and Growth Pact, and set out plans for bringing the *cyclically-adjusted budget balance* towards the *medium-term target* of budget positions that are 'close to balance or in surplus'. As well as this adjustment path towards meeting the *medium-term target* of the *SGP*, Member States also submit the expected path of the general government debt ratio. Council Regulation (EC) No 1466/97 defines the contents of these programmes and sets out rules for their submission, examination and monitoring. The Member States submit their programmes to the Commission at the end of each calendar year. The Commission then assesses them, and, on the basis of the Commission's recommendation, the Council delivers an opinion. See also *convergence programmes*.

Structural budget balance: See *cyclically-adjusted budget balance*.

TUC: Trades Union Congress.

UNICE: Union of Industrial and Employers' Confederation of Europe