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EDITORIAL COMMENTS

Whither the Stability and Growth Pact?

On 25 November 2003, to the great irritation of a number of Member States, the French and the Germans prevailed upon a majority of the other governments to decline to adopt certain decisions within the Council. These were decisions recommended by the Commission under Article 104(8) and (9) EC, and – had they been adopted – would have ordered France and Germany to put an end to their excessive deficits situations by 2005 at the latest, and to achieve in 2004 an annual reduction in the cyclically adjusted deficit equal to 1 per cent of GDP in France and 0.8 per cent in Germany. Neither France nor Germany had taken adequate measures to reduce their deficit in response to the Council's previous recommendations. The decisions recommended by the Commission could not be adopted because the requisite qualified majority was not achieved.[1] However, on the same day, the Council adopted, in respect of each of these two States, essentially identical conclusions, stating that it had decided to hold the excessive deficit procedure in abeyance, and addressed recommendations to them for correcting the excessive deficit in the light of the earlier commitments made by each of them. On 27 January 2004, the Commission brought an action before the Court of Justice challenging both the failure of the Council to adopt the instruments contained in the Commission's recommendations and the legality of the decisions taken by the Council instead. The Court of Justice reacted speedily. On 13 July 2004, it handed down a judgment which annulled the conclusions of the Council in which the latter had held the excessive deficit procedure against these countries in abeyance and had modified the recommendations previously made by it to each of these countries for correction of their excessive deficit.[2] However, the action seeking annulment of the Council's failure to adopt the measures set forth in the Commission's recommendations was declared inadmissible.

1. According to Art. 104(13) when taking decisions under (*inter alia*) paras. 7–9, the Council shall act on a recommendation from the Commission by a majority of two-thirds of the votes of its members weighted in accordance with Art. 205(2), excluding the votes of the representative of the Member State concerned.
2. Case C-27/04, *Commission* v. *Council*, judgment of 13 July 2004, nyr.

There are no indications that the Court's decision will actually have an effect on French or German fiscal policy or that in future situations the Council will feel that it is under a legal obligation to adopt decisions recommended by the Commission giving notice to a Member State that it *must* take specific measures for deficit reduction under Article 104(9). The judgment of the Court will be the subject of closer scrutiny in an annotation soon to appear in this Review.

Meanwhile, the Commission has conceded that the strict rules concerning fiscal discipline prescribed by the Treaty and the Stability and Growth Pact have lost credibility and that the system is in need of reform. For that purpose, on 3 September 2004, it presented to the Council and the European Parliament a Communication in which it makes proposals for a more flexible pact and more refined rules which basically will allow countries suffering from low growth to escape disciplinary action under the Pact.[3] The Council has now had a first informal discussion about these proposals. It is too early to tell, however, whether the much maligned Pact can be revamped and regain its credibility. The important question is now whether the rule-based system of controlling budgetary policies and preventing excessive deficits can be expected to operate in a more satisfactory manner if its rules are made less strict or if more flexible interpretations are placed on its terms, along the lines suggested by the Commission. Clearly, the combination of strict rules and toothless enforcement has little to commend it and does not endear the EMU to the European public. It remains to be seen, however, whether relaxation of strict ceilings for budgetary deficits and debt positions or allowing Member States more flexible and generous periods within which to comply with the rules and decisions addressing their situation, can be expected to improve the system. Presumably, an upswing in economic activity and an end to a fairly long period of sluggish growth in most Member States offers better prospects for improved fiscal discipline than a refinement of the clauses in the Pact.

It is difficult to disagree with the view, which has informed the Stability Pact, that EMU cannot survive without the imposition of considerable restraints on Member States' fiscal policies and in particular on their budgetary and debt positions. Indeed, the choice made in the European Union for an EMU in which monetary policy is completely taken out of Member States' jurisdiction, but where economic policy-making is decentralized, clearly implies that macro-economic policies are to be subject to measures of

3. Communication from the Commission to the Council and the European Parliament on Strengthening economic governance and clarifying the implementation of the Stability and growth Pact, 3 Sept. 2004, COM(2004)581 final.

coordination and in particular that constraints will have to be placed on the budgetary autonomy of Member States. The main argument for this proposition is that policy measures by one country belonging to an integrated common market are likely to have important repercussions on economic developments in other Member States. The cooperative approach is necessary to prevent a situation where lack of coordination may result in measures cancelling out each other's effects or otherwise remaining largely ineffective.

In principle there are two types of solution to the problem of mismatched economic policies in an EMU. The first would be to leave budgetary policies of individual Member States essentially to the discretion of their authorities and to rely on peer pressure to obtain a sufficient degree of coordination. The other approach would be to intervene at the source of the distortionary policies, by imposing more or less strict limits on the scope of Member States' freedom to determine budgetary policy unilaterally.

Most federal States have tended to discard the second solution. Countries like the United States, Switzerland and Canada impose few constraints on the budgetary policies of subfederal governments. As was shown in a study by A. Lamfalussy[4] submitted to the Delors Committee in 1989, there is little or no evidence of large or persistent differences in the fiscal behaviour of the regional governments relative to their federal counterparts in the period between 1970 and 1988. No country in that period, with the possible exception of Australia, appears to have experienced serious problems with medium-term control over spending and deficits of subnational entities. Growth of net lending or expenditure of regional authorities had not markedly been out of step with that of the respective central governments. This situation does not seem to have changed during the 1990s.

However, the situation in the fledgling European EMU is sufficiently different from that in most federal States to render indispensable the inclusion in the Treaty and secondary legislation of severe restrictions on Member States' fiscal policies. One of the reasons for this is that in true federations the central government commonly is as large as the regional governments and is in charge of macro-economic stabilization. By contrast, the European Union's budget is insignificant (a mere 2% of the Union's GDP) and lacks the scope and the flexibility for it to be used as an instrument for genuine redistributional transfers between Member States, let alone for counter-cyclical fiscal policies.

4. "Macro-coordination of fiscal policies in an economic and monetary union in Europe" in Report on EMU in the European Community, Luxembourg, 1989, pp. 91–127.

The result presents us with an awkward dilemma: the European Union, which itself does not have a budget of sufficient size or the fiscal means to conduct stabilization policies, must rely on national level measures of stabilization. The Member States, on the other hand, while remaining in charge of such policies, must be prevented from behaving irresponsibly. Constraints are therefore necessary, but if they are too strict they cripple Member States' room for manoeuvre and may make the pursuit of the stabilization goal an unattainable objective, both at the national level and at that of the Union. But then again, without appropriate constraints imposed on them by binding rules and procedures, Member States might be tempted to run excessive deficits. If deficits are to be financed by borrowing – monetary financing is strictly out of bounds in an EMU –, this might result in a situation where the borrowing requirements of one country could absorb a disproportionate share of Union savings. This in turn could lead to an increase in the level of interest rates throughout the Union and to "crowding out" effects on private investment in countries where otherwise the interest rate would have been lower. Such a chain of events could ultimately result in higher inflation throughout the area, pressures for a more accommodating monetary policy (some form of bailing-out) and possibly depreciation of the common currency.

Strict constraints to impose fiscal rectitude would not be required if market forces could be relied on to enforce budgetary discipline. However, it is unwise to expect the market mechanism to iron out significant differences in fiscal behaviour between the several Member States or to prevent them from incurring sizable budget deficits. Financial markets will not sufficiently impose fiscal discipline. They tend to throw good money after bad for some time, and then react violently, precipitating a crisis and bankrupting banks and other financial institutions. Under such circumstances it will be difficult to ensure strict compliance with the no-bailout clauses. It seems rather improbable that monetary authorities will be able to resist pressure to monetize (part of) the debt. This type of scenario has led one commentator to describe the fiscal constraints embodied in the excessive deficit procedure as an insurance scheme against the risk that European institutions would some day be compelled to monetize some State's out-of-control debts.[5]

How strict should constraints be?

Lawyers are not in a position to give guidance on this question and even economists are seldom in agreement. As G.B. Shaw has said, "if all econo-

5. C.Wyplosz, "EMU: Why and how it might happen" in (1997) *Journal of Economic Perspectives*, 3–22 at 15.

mists were laid end to end, they would not reach a conclusion".[6] The code word here seems to be "sustainability" of the government financial position. The Maastricht approach has defined fiscal policy sustainability in terms of quantitative limits. Economists have criticized this method as arbitrary, unsophisticated and at best naïve.[7] So, if today there is profound disagreement over the wisdom of a numerical straitjacket of 3 per cent for the deficit and 60 per cent for the aggregate debt position of a country, this is nothing new. Neither is it new to point out that the criteria have never been adhered to very strictly. It is common knowledge that some Member States could only participate in the third stage of EMU by way of a combination of creative accounting devices and recourse to the escape clauses that were built into Article 104 of the Treaty. The latter provision in combination with Article 121 enables the Council to judge that a Member State has achieved a government budgetary position without an excessive deficit because, although the deficit was in excess of 3 per cent of GDP, the deficit has either declined substantially and continuously and has come close to the reference value or, alternately the excess over the reference value was only exceptional and temporary. In relation to the government debt position, the apparent strictness of the reference value (60% of GDP) was mitigated by the clause that a debt position would also be acceptable if the ratio to GDP were sufficiently diminishing and approaching the reference value at a satisfactory pace. The record of many member Euro-zone States in this regard is far from impressive.

So, if the Commission puts forward certain proposals and seeks to develop a set of criteria, guidelines, procedures and, generally speaking, more sophisticated methods for ascertaining to what degree a deficit or debt position is incompatible with long term sustainability of government finances and with the Union's overall sound money policy, it may be sensible to study these ideas with care. It is reassuring that the Commission takes pains to reaffirm that the Treaty provisions including the reference value for government deficit and debt of 3 and 60 per cent of GDP will remain the anchor of the system. It is noteworthy that it wishes not only to give rigorous attention to developments in budgetary deficits but that it seeks also to place a greater focus on the sustainability of countries' public debt position. Therefore the concept of debt reduction at a "satisfactory pace" should be clarified. Furthermore, the Commission suggests bringing under the criterion of "excep-

6. Quoted by K. Dickson, *Elusive Union: The process of economic and monetary union in Europe* (Longman 1994), at p. 231

7. See e.g. Buiter, Corsetti and Roubini, "Excessive deficits : Sense and Nonsense in the Treaty of Maastricht", 16 *Economic Policy*, April 1993, 57–100

tional and temporary circumstances" (under which deficits exceeding the 3% reference value can be regarded as not-excessive) also the situation that a Member State experiences a period of slow but positive growth. Under the current framework a period of economic hardship can only be regarded as "exceptional" if there is a severe economic downturn, defined as a period where there is an annual fall of real GDP of at least 2 per cent.[8] Other refinements include allowing for more country-specific elements in determining the pace at which an excessive deficit must be corrected. This now appears necessary because countries may find themselves in different phases of the economic cycle and a one-size-fits all approach is not an appropriate method for countering asymmetric economic developments. It would also be worthwhile, although the Commission does not elaborate this point, to contemplate changes in the sanctions system of the Treaty. Rather than imposing sanctions (for instance in the form of non-interest bearing deposits or fines (Art. 104(1)) when a Member State has incurred an excessive deficit or exceeds the reference value for government debt, it may be preferable to penalize countries for not reducing a deficit or debt in times of economic prosperity. Otherwise the system risks encouraging measures that, far from contributing to stabilization of the economy, are pro-cyclical rather than counter-cyclical.

It may be hoped that the discussions in the Council will not undermine the character of the Stability Pact surveillance system as a rule-based system in which discretionary elements do not play a dominant role. At the same time, the Court's judgment in Case C-27/04 has shown that in the area of economic policy-making, enforcement of respect for the rules of the game cannot readily be achieved through judicial involvement.

8. Art. 2 of Council Regulation 1467/97 of 7 July 1997, O.J. 1997, L 209/6, on speeding up and clarifying the implementation of the Excessive Deficit Procedure.