An evaluation of the Stability and Growth Pact’s implementation in 1999-2004

-What does history tell us?
Table of Contents

LIST OF TABLES AND FIGURES.................................................................................................................. 4

EXECUTIVE SUMMARY ............................................................................................................................. 5

INTRODUCTION ........................................................................................................................................... 6

1. FROM THE MAASTRICHT TREATY TO THE STABILITY AND GROWTH PACT ...... 8
   1.1 MAASTRICHT TREATY BUDGETARY RULES FOR COUNTRIES FORMING THE EMU ........... 8
   1.2 THEORETICAL ECONOMIC RATIONALE FOR RULES CONSTRAINING THE FISCAL POLICY ....... 11
   1.3 LEGAL AND ECONOMIC CONSTRUCTION OF THE STABILITY AND GROWTH Pact (SGP) ....... 15
      1.3.1 THE HISTORY OF SGP .............................................................................................................. 15
      1.3.2 LEGAL CONSTRUCTION OF THE STABILITY AND GROWTH Pact .......................................... 18
      1.3.3 BROAD ECONOMIC POLICY GUIDELINES AND STABILITY/CONVERGENCE PROGRAMMES ...... 23
   1.4 TENSIONS AND POTENTIAL WEAKNESSES OF THE SGP .......................................................... 24
      1.4.1 ASYMMETRIC CONSTRUCTION OF THE SGP ........................................................................... 25
      1.4.2 ACTUAL VS. CYCLICALLY ADJUSTED BUDGET BALANCES ..................................................... 25
      1.4.3 CREDIBILITY AND ENFORCEABILITY OF THE Pact ................................................................. 27
      1.4.4 THE CHOICE OF THE FISCAL POLICY UNDER SGP – COORDINATION Game ....................... 28
      1.4.5 SGP - POTENTIAL PROBLEMS IN THE FUTURE ........................................................................ 31

2. SGP IMPLEMENTATION IN THE PERIOD 1999 - 2004 ................................................................. 33
   2.1 ECONOMIC SITUATION IN THE FIRST YEARS OF THE EMU .................................................... 33
   2.2 A BRIEF ANALYSIS OF ECONOMIC PERFORMANCE OF INDIVIDUAL MS IN 1999-2003 ......... 35
   2.3 EDP IMPLEMENTATION AGAINST PORTUGAL, GERMANY AND FRANCE ............................ 42
   2.4 EDP IN THE YEAR 2004 AND PROSPECTS FOR THE FUTURE ................................................... 48

3. SITUATION OF THE NEW EU MEMBER STATES IN THE LIGHT OF THE STABILITY AND GROWTH Pact ............................................................................................................. 52
   3.1 INTRODUCTION ............................................................................................................................ 52
   3.2 THE LEGAL SITUATION OF ACCESSION COUNTRIES UNDER THE SGP .............................. 54
   3.3 SITUATION OF PUBLIC FINANCE IN ACCESSION COUNTRIES ................................................... 55
   3.4 CLOSER LOOK AT THE SITUATION OF POLAND .............................................................................. 58
      3.4.1 STRUCTURAL PROBLEMS ...................................................................................................... 58
      3.4.2 PUBLIC FINANCE SITUATION AND PROSPECTS FOR THE FUTURE ........................................... 60
   3.5 LESSONS TO BE DRAWN BY THE NEW MEMBER STATES................................................................. 63

4. SGP – PROBLEMS AND PROSPECTS .......................................................................................... 65
   4.1 PROBLEMS EXPERIENCED WITH THE IMPLEMENTATION OF THE Pact .............................. 66
      4.1.1 BAD QUALITY OF STATISTICAL DATA ....................................................................................... 66
List of Tables and Figures

Table 1: Fiscal consolidation in the EU – 1993 – 1998 ................................................................. 9
Table 2: GDP per capita in PPS at current market prices in the years 1999-2001 for six EU countries ... 31
Table 3: General government consolidated gross debt in per cent of GDP ........................................ 35
Table 4: Actual and cyclically adjusted budget balances in EU (1999-2004) as per cent of GDP .......... 36
Table 5: Annual (2001-2000) change in the total government expenditures and revenues as % GDP .......... 39
Table 6: Discrepancies of statistical data on budget deficit in Greece in 2000-2003 .................................. 49
Table 7: Unit labour costs in manufacturing in 8 accession countries .................................................. 52
Table 8: Public finance in accession countries in 2002 and 2003 ........................................................ 55
Table 9: The comparison of Hungarian and Commission’s forecast on budget deficit (%GDP) ............. 57
Table 10: Demographic forecast for Poland 2002-2050 ..................................................................... 59
Table 11: Forecast for Social Security Sector 2002-2050, base scenario .............................................. 59
Table 12: GDP growth and budget deficit in Poland 2000-2006 (in percent GDP) ......................... 61
Table 13: Structure of general government sector expenditures 2003 – 2007 (in per cent) .................. 61
Table 14: Estimated effect of the Hausner Plan on general government sector in 2005-2007 ................. 63
Table 15: Debt levels in some EU countries in 1998-2004 (in % of GDP) ........................................... 70
Table 16: Gross fixed capital formation (general government) in some EU countries in 2000-2004 (% of GDP) ................................................................. 74

Figure 1: Fiscal policy choice as a coordination game ................................................................. 30
Figure 2: GDP growth and budget balances for EU-15/Eurozone in 1999-2004 ................................. 33
Figure 3: Euro exchange rate against USD and GBP between 1998-2003 (annual average) ............ 34
Figure 4: GDP growth in EU (1999-2004) – annual percentage change of GDP .............................. 38
Figure 5: Fiscal policy stance and growth in the EU in 2002 .......................................................... 40
Figure 6: Fiscal stance and cyclical conditions in Eurozone, 1999-2005 ........................................... 65
Figure 7: Overview of the main academic proposals on the reform of the SGP ................................. 75
Executive Summary

The Eurozone aggregated budgetary positions worsened from a balance in 2000 to a significant deficit of 2.7%GDP in 2004. This, although caused by a lower than expected economic growth, revoked the discussion on the EU fiscal rules, mainly on the executive part, i.e. the Stability and Growth Pact. While it is commonly agreed that there exists a need of rules ensuring fiscal prudence within the EMU, more and more discussion is devoted to the SGP design. This stems from the fact that in some cases the Pact did not create an sufficient incentive to pursue necessary consolidation. Furthermore, when the main creators of the Pact, namely France and Germany, became subject to the Excessive Deficit Procedure, the Council failed to reach a consensus to endorse the Commission’s recommendations. This, in practice weakened the provisions of the SGP and its credibility.

This paper presents the history of the SGP creation, touching upon the main insights from the prevailing economic theory. Then, an overall evaluation of the Pact’s implementation is conducted with a special focus on the available empirical evidence. It is argued that the SGP numerical rules might be overly simplistic and their mechanistic application might be unjustifiable from the economic point of view. Therefore it is claimed that some adjustments are necessary in order to remedy the Pact’s weaknesses and enhance its rationale. On the other hand, such changes should not in any case endanger the rule of equal treatment.

A short insight is made into the situation of the accession countries, that did not participate in the SGP creation, but are obliged to respect its requirements. In this respect it is also argued that a more country-specific approach might be to the benefit of all the parties. The same as in the case of the Eurozone states, the situation of the new Member States confirms the need for strengthening the focus on long-term sustainability of public finance.

Finally, the main shortcomings and weaknesses of the SGP following from its construction and experience of implementation are summarized. Having in mind the current degree of political integration it is more plausible that the reform of the Pact will be conducted in the form of incremental improvements rather than a grand redesign. Therefore, latest proposals suggested by the European Commission are listed and explained.
Introduction

The creation of a monetary union was a milestone in the history of the European integration. The Euro has been present in the European countries since 1999. Before starting the third stage of the EMU creation, some of the prospect members, especially Germany and France, demanded for a special safety net which would assure sound public finances across the Eurozone. This stemmed from the fact that from the theoretical point of view, fiscal irresponsibility may result in adverse consequences on the stability of the monetary union. Moreover large and persistent deficits lead to debt accumulation which may endanger economic sustainability in the long run.

Traditionally, the attitudes towards desired levels of public debt and budget deficit among Member States were very diverse. Therefore, the Maastricht Treaty contains general rules on the budgetary discipline and establishes a surveillance mechanism. Those rules were clarified and made more operational by the Stability and Growth Pact (SGP) adopted by the European Council in Amsterdam in June 1997. The aim of the Pact was to create a transparent and efficient framework for monitoring the budgetary situation in the Member States and preventing them from running into excessive deficits. Quantitative restrictions are accompanied by strengthened monitoring procedures and special procedure applied to Member States suffering from an excessive deficit - Excessive Deficit Procedure (EDP).

Since the introduction of the SGP, it was a source of fierce discussion both in academic and political circles. Some specialists doubt in the desirability of the Pact while others support its existence, but are doubtful about its enforceability. The economic rationale for creating fiscal restrictions in the monetary union is only briefly touched upon and it is out of the paper’s scope to examine its desirability in details.

The main objective is to argue that the Pact in its current form is ill-designed for ensuring sound budgetary positions throughout the economic cycle. Apart from describing its main theoretical shortcomings, e.g. asymmetric construction or overly simplistic approach to numerical targets, it is argued that the problems with its implementation result from a very limited account of a country-specific situation. Consequently, uniform application of the rules may lack economic rationale and become a burden for the Member States hampering economic growth and the pursuance of necessary structural reforms. This is especially the case of accession countries, which are characterized by significantly different economic structure.
from the old Member States. Furthermore, the legal analysis and empirical experience shows that the *Pact* contains some weaknesses which might jeopardize its enforceability and as a consequence undermine its credibility. The remainder of the paper is structured as follows.

Firstly, the main theoretical arguments for the fiscal restrictions existence is presented. Next the history of the *Pact’s* creation is briefly described which is followed by the presentation of its legal construction. The review of the main qualifications to the SGP design concludes the first Chapter.

The second Chapter describes the first years of the *Pact’s* functioning. After having presented the economic upturn which took place in 1999-2000, a deeper analysis of the economic slowdown that occurred between 2001-2003 is conducted. Special attention is devoted to the budgetary balances of the EMU members, especially those being subject to the Excessive Deficit Procedure, e.g. Greece, Portugal, France, Germany. Projections on future implementation of the EDP is offered as a conclusion of the second Chapter.

In the third Chapter a closer look is devoted to the situation of the accession countries. A short analysis of the specific features of their economic structure is conducted. The presentation of their legal situation under the SGP follows. After having presented the recent budgetary developments in those countries, the case of Poland is brought forward with a special focus on current economic situation in the light of the latest Convergence Programme. Furthermore, the effects of the population ageing phenomenon, the need of extraordinary public investment in infrastructure, rapidly increasing public debt are shortly analyzed. The presentation and evaluation of the plan for economic reforms together with prospects for the future conclude the third Chapter.

The last Chapter summarizes the main shortcomings of the *Pact* taking due account of problems experienced with its implementation. After presenting an overview of academic proposals on reforming the SGP, the Commission’s proposals for the SGP gradual improvement are presented.
1. From the Maastricht Treaty to the Stability and Growth Pact

“Member States shall avoid excessive government deficits”

1.1 Maastricht Treaty budgetary rules for countries forming the EMU

The Economic and Monetary Union, which was created in 1999, is based on the legal rules as agreed by the European Council in Maastricht in 1992. EMU is a very exceptional framework as it combines centralized monetary policy conducted by the European Central Bank (ECB) with multiple fiscal policies pursued by the governments of EU Member States on the national level. The Delors report, which in essence became the roadmap for the creation of Economic and Monetary Union, underlined that requirements on budgetary discipline in Member States would be essential in order to preserve the stability and credibility of the new currency. A reflection of this suggestion may be found in Art. 4(3) of the Maastricht Treaty, which includes sound public finances into the list of Community guiding principles. Another sign of the importance of “healthy” budgetary stance can be found within the convergence criteria, which were the conditions that needed to be fulfilled by the candidates to become full participants in the EMU. The protocol annexed to the Treaty established numerical targets regarding the budget deficit and debt ratio in relation to the GDP. The former was set on 3% level, while the latter should not exceed 60%.

While analyzing the public finances in Member States in the period prior the creation of the EMU, one can notice that budgetary restrictions resulted in the improvement of budgetary situation in some Members States. Especially in those which had problems balancing their budgets and recorded a significant level of government debt (Table 1). The data reveals a considerable change towards the thresholds set in Maastricht Treaty, notably in Belgium, Greece, Ireland, Netherlands and Italy. Although none of those countries actually managed to fulfill the debt ratio requirement, they were all admitted to stage III of the EMU.

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1 Art. 104 (Ex Art. 104c) para.1of Treaty Establishing the European Community, hereafter referred to as Maastricht Treaty
3 More detailed rules in this respect are included in Art. 99 (Mutual Surveillance Procedure), Art. 103 (No-bail-out clause) and Art. 104 (Excessive Deficit Procedure)
4 The rationale of budgetary constraints will be explained in 1.2
5 It must be noted however that those numerical targets seem to be arbitrary and without sound economic reasoning, see De Grauwe, P., Economics of Monetary Union, Oxford, 2000, p. 134
creation\(^6\) (except for Greece, which had to wait until the year 2000). On the other hand Germany and France which traditionally were seen as good examples of sound fiscal policy, struggled to reduce their annual deficit ratio below the 3 per cent threshold, while letting the government debt rise dangerously close to the permitted level.

<table>
<thead>
<tr>
<th>Indicator</th>
<th>General government gross debt - Percentage of GDP</th>
<th>General government deficit (-) Percentage of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>137.9</td>
<td>135.9</td>
</tr>
<tr>
<td>Denmark</td>
<td>81.0</td>
<td>75.7</td>
</tr>
<tr>
<td>Germany</td>
<td>46.9</td>
<td>49.3</td>
</tr>
<tr>
<td>Greece</td>
<td>110.1</td>
<td>107.9</td>
</tr>
<tr>
<td>Spain</td>
<td>58.4</td>
<td>61.1</td>
</tr>
<tr>
<td>France</td>
<td>45.3</td>
<td>48.4</td>
</tr>
<tr>
<td>Ireland</td>
<td>95.1</td>
<td>89.6</td>
</tr>
<tr>
<td>Italy</td>
<td>118.7</td>
<td>124.8</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>6.8</td>
<td>6.3</td>
</tr>
<tr>
<td>Netherlands</td>
<td>79.3</td>
<td>76.4</td>
</tr>
<tr>
<td>Austria</td>
<td>61.8</td>
<td>64.7</td>
</tr>
<tr>
<td>Portugal</td>
<td>59.1</td>
<td>62.1</td>
</tr>
<tr>
<td>Finland</td>
<td>55.9</td>
<td>58.0</td>
</tr>
<tr>
<td>Sweden</td>
<td>73.9</td>
<td>73.7</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>45.4</td>
<td>48.5</td>
</tr>
<tr>
<td>EUROZONE</td>
<td>66.3</td>
<td>69</td>
</tr>
</tbody>
</table>

Source: Eurostat, Free – data, Euro – indicators (:- not available r – revised)

It is, however, worth underlining that also countries with the opt – out clause (Denmark and the United Kingdom) significantly improved their budgetary stance in that period. This leads to the first qualification on the efficiency of Maastricht fiscal criteria. A research by Hallet, Strauch, von Hagen\(^7\) shows that some of the fiscal consolidation in the 1990s can be explained as the aftermath of sizeable fiscal expansion of the 1970s and 1980s. The study states that the noticeable change in fiscal policy in the EC Member States during the 1990s could be called “Maastricht effect”. However “…based on earlier patterns of fiscal policy reactions, and given the accompanying conditions of the 1990s, one would have expected larger fiscal

\(^6\) This was possible due to special clause included in Treaty – Art. 104 para. 2b stating that excessive debt ratio is permitted if it is “sufficiently diminishing and approaching the reference value at a satisfactory pace”.

surpluses in the EU to prevail during the 1990s. The consolidation, due to Maastricht obligations, was present mainly in the first half of the 1990s. A good sign, however, is that fiscal retrenchment in the 1990s was in majority based on expenditure cuts, which is regarded as more efficient in permanent reduction of deficit and debt stock than revenue based consolidation.  

The second qualification is based on the observation that an average EU debt ratio was actually rising in the above-mentioned period. In 1992 it accounted for almost 60% of the EU GDP, while in 1997 it reached its peak of 74.9%. The explanation lies in the fact that mostly small and medium size countries had been successful in lowering their debt stock, whereas countries like Germany or France, which create most of the EU GDP, were struggling to get rid of excessive deficit, but still their debt was rapidly increasing. According to von Hagen, the average debt ratio of large countries (Germany, France, Spain, Italy and UK) rose by almost 19% in the 1992-1997 period, while in the medium-sized states (Belgium, the Netherlands, Austria, Sweden) by only 4% and by only 3.3% in the so called small states. One of possible explanations of this phenomenon was that smaller countries had to undertake significant consolidation measures to become successful candidates. On the contrary large countries, such as Germany or France knew that creating a monetary union without them would in essence deprive the whole project of the economic sense, thus they had a smaller incentive to pursue consolidation policy.  

The final objection results from the fact that some of the countries used suspicious measures, which nowadays could be regarded as creative accounting. These so called “fiscal fiddles” were merely tools of improving the long–term budgetary situation in candidate countries. Instead they were one–time use measures aimed at improving the statistics just before the assessment time came. Thus Germany reclassified hospital debt, which moved it

8 Ibidem, p. 62
10 Germany was paying off the costs of unification, while France was suffering from subdued economic performance
out of the public sector debt. Italy introduced an euro – tax, while Spain privatized some state owned companies and Belgium sold some of its gold reserves\textsuperscript{12}.

To summarize, it can be argued that in the run up to the creation of the Monetary Union, the Maastricht criteria on the budgetary temperance were successful. Yet, if one looks into detail, the picture becomes somehow blurred. In order to maintain the political pressure on the governments to avoid budgetary imbalances while being in the EMU, the Stability and Growth Pact was designed in 1997. The rationale of having such a constraint present in the monetary union will be presented in the next subChapter.

\subsection*{1.2 Theoretical economic rationale for rules constraining the fiscal policy}

The EMU area is not a homogeneous entity. Moreover, after the introduction of the Euro it combines a multiple national fiscal authorities with one monetary policy conducted on the supranational level by the ECB. The theory of policy coordination reveals that when pursuing policy includes large externalities, a system for coordination should reduce their cost. Thus, it should contribute to more efficient policy outcomes and greater stability. Traditionally countries represented different attitudes towards the desired budgetary stance. This in turn requires a detailed look into the possible threats to the whole system in case governments are left without proper framework regulating fiscal developments and coordination mechanism.

To better illustrate the point, we can imagine a member of a monetary union, which in lack of any restrictions, pursues expansionary fiscal policy\textsuperscript{13}. At the national level, the country is likely to run a large budget deficit, which in long term will result in high stock of public debt. Such policy will end up in ever growing costs of public debt servicing. However, the most important dimension are potential spillover effects on other parties in the monetary union. The problem is due to the fact that the country in question will not face the whole cost of its irresponsible fiscal policy, as a part of the cost would be transferred onto other participants of the monetary union in form of externality.

Expansionary fiscal policy may lead to rising real interest rates, which in case of the monetary union, would affect all the members by rising the cost of servicing their debt. If other countries wished to maintain their debt/GDP ratio, they would need to pursue more


\textsuperscript{13} For example Italy was known for expansionary fiscal policies resulting in high deficit and debt accumulation
restrictive fiscal policy\textsuperscript{14}. However, as stated by Eichengreen and Wyplosz\textsuperscript{15}, the EU members borrow on the global and not national financial market, which implies that the scope of influence of expansionary fiscal policy in one country of the monetary union on other countries remains rather unclear and even if exists, is a matter of income redistribution within the EU states. On the other hand, it might be argued that expansionary policy of a small or medium-sized country is unlikely to have a significant influence on the overall EMU interest rate. Additionally improved and cheap access to the resources of global financial market assets have lowered the cost of higher interest payments. That, altogether, might create an incentive for an individual state to issue additional debt, since it may believe it will not have any major influence on the EMU system\textsuperscript{16}. Such narrow-minded thinking might pose a threat to the stability of the EMU in long term.

Another threat attributed to an excessively lax budgetary stance is the risk of financial default. A country can take advantage from not facing the full cost of the debt issuing and pursue the policy of active public sector getting into fiscal trouble from which it would not be able to disentangle itself. If investors became aware of such situation they would fear the suspension or modification of payments, which would make them sell the bonds of the country in question. That could evoke the collapse of Europe’s banking and financial system\textsuperscript{17}. The ECB being the guard of the stability of the whole EMU system would become under pressure to either lower the interest rates or to treat the debt instruments of the country in a favourable manner. This is generally called the “default risk”. Although the ECB’s independence is guaranteed by the Treaty and bail–out is explicitly forbidden\textsuperscript{18}, one should remember that the ECB can monetise the debt by open market purchases on the secondary market. Both, irresponsible fiscal policy resulting in government default and ECB circumventing the Treaty by debt monetising seem highly unlikely outcomes. However, in theory they cannot be ruled out, so should be regarded as a threat. In this vein it is also possible that due to high capital market integration, financial institutions present in the EU will progressively increase the

\textsuperscript{14} de Grauwe, Economics of Monetary ..., op. cit. p. 203
\textsuperscript{15} Eichengreen B., Wyplosz Ch., The Stability Pact: more than a minor nuisance?, Economic Policy, 26, p. 77
\textsuperscript{17} Eichengreen B., Wyplosz Ch., The Stability Pact ..., op. cit., p. 71
\textsuperscript{18} Art. 101 of the Maastricht Treaty
share of government bonds in their portfolios. This implies a higher risk to all other countries in case of insolvency in any one of them.\textsuperscript{19}

There exists another mechanism involving the ECB and national fiscal authorities, which without posing the threat of default may actually lead to a bias towards excessive deficit.\textsuperscript{20} Consider a country within a monetary union that prefers a high level of economic activity but does not like inflation. Since the common inflation rate is calculated relatively to the size of the country (measured by its GDP as a percentage of the Union’s GDP at large), a country which would try to boost its economy by expansionary fiscal policy will not face all cost of such action. The central bank will tighten the monetary policy so as to prevent the inflation rate from an unexpected growth. Thus, thanks to central bank’s anti-inflationary policy, a part of the unemployment and the cost associated with inflationary pressures in this country would be borne by all the members of the monetary union. As the ECB is strictly responsible for maintaining low and stable level inflation\textsuperscript{21} any of the EMU members could free-ride on others taking advantage from a common goal of a low inflation rate.

Last, but not least one should consider an argument from the political economy perspective. Governments usually consist of politicians who face the uncertainty of being re-elected. The potential temptation to increase public spending before the elections seems plausible. In absence of any fiscal constraints such action might evoke the negative externalities mentioned above, while the government would face the problem of paying off the expenditure afterwards and only if it is re-elected. Furthermore, if the incumbent government fears that the opposition is more likely to win the next election, it can decrease the amount of financial assets available to the next government by pursuing excessive budgetary expenditure. That, in turn, would put the new authorities in a bad initial position, as their first task would be to pay off debts made by predecessors. If one assumes that strict supranational fiscal rules are in force, politicians also need to be concerned about their international image. This stems from the fact that in case of excessively expansionary expenditures the country and government responsible for such situation would face the risk of being accused of breaching its international obligations.


\textsuperscript{21} Art. 105 of the Maastricht Treaty
On the other hand, it might be argued that in the presence of highly integrated global capital market with very good and reliable sources of information on the current budgetary situation in the EMU Member States, the risk premia are already incorporated in the price of governmental bonds, thus making the upper constraints on budgetary policy not justifiable. Moreover, apart from the argumentation based on empirical analysis provided by Eichengreen & Wyplosz\(^{22}\), it is possible to find theoretical scenarios in which such restrictions may lead to sub–optimal outcomes\(^{23}\).

Consider a country subject to a cyclical shock with credit constrained households. The government has to choose between smoothing the consumption, i.e. lowering taxes in an economic slowdown and raising them during a prosperity period and minimizing the cost of taxes by smoothing their application. The government which would like to pursue a countercyclical policy should be able to reduce the adverse effects of a negative shock. However, if some strict fiscal rule is in place, it might become impossible for the authorities to smooth the consumption without infringing the rule.

A similar way of argument, though based on other need than consumption smoothing can be developed. This argument concerns mainly the developing countries becoming candidates for the monetary union. It is clear that lower developed countries suffer from infrastructural underinvestment\(^{24}\). Such infrastructure would be to the benefit of current and next generations. However, from the equity and efficiency point of view, there is no ground that all of costs should be borne by current tax payers. Hence some of the expenditures should be covered by future generations. While investment in infrastructure and expenditure is made now, it might be justified for the government to run deficit and debt, which will be paid off in the future. The authorities, which takes responsibility for such investments should have the ability to take advantage of the cost spreading offered by public debt. On this ground also the costs of rigid labour market and excessive social system reforms should be justified. Again too restrictive and inflexible budgetary constraints may result in sub–optimal economic policy.

In conclusion, it might be argued that even rational governments may pursue policies which would eventually lead to the default. Theoretically, in a monetary union exists a strong

\(^{22}\) Eichengreen B., Wyplosz Ch., *The Stability Pact...*, op. cit.,


\(^{24}\) Public goods such as highways, bridges, airports, hospitals are very expensive investments, which should be usually provided by the government in cooperation with the private sector
incentive for an overly lax budgetary policy, as some of its cost may be transferred onto other parties. The risk of negative externalities is one of the main grounds for designing a fiscal framework, restraining the freedom of budgetary policy. The second potential result of over-expansionary fiscal policy is the risk of exerting pressure on the ECB which might jeopardize the achievement of low and stable inflation or deteriorate the policy mix by inducing too tight monetary policy. On the other hand, one can notice that over-restrictive fiscal rules might become much of a problem for countries facing an economic slowdown or in the need of large infrastructural investments. The presented theoretical rationale seems to justify the presence of fiscal constraints applied at a national level. However, it also shows that such rules should be designed in a special way so as not to hamper the EMU economy. The Stability and Growth Pact was supposed to be such a reasonable set of rules.

1.3 Legal and economic construction of the Stability and Growth Pact (SGP)

First, it has to be underlined that the negotiations on the SGP were very difficult and the final outcome was a consensus between the participating parties. The original proposition of German Federal Minister of Finance - Theo Waigel was modified in many aspects. This might be one of the reasons why in the end, the Council adopted quite an extraordinary legal structure.

1.3.1 The history of SGP

Already in September 1995 some thoughts on additional rules governing the budgetary situation in future EMU member states was presented at the ECOFIN Council meeting by the German delegation. They included:

- in order to assure that the 3% GDP deficit ceiling would not be breached during any stage of economic cycle more restrictive budgetary targets should be devised,
- automatic sanctions should be applied for infringing the rules.

This evoked some fears among the delegations that German side would wish to renegotiate the convergence criteria in order to prevent countries with bad budgetary record from proceeding to the third stage of EMU creation. Also the Commission showed signs of reluctance for

reopening any discussion on the Treaty. Yet, Mr Waigel managed to convince the parties that such an agreement would be to the benefit of all countries, assuring the stability of the EMU for the future generations of finance ministers. In the draft proposal it was clearly stated that fiscal policy as such will remain the sole competence of national authorities, but in order to exploit all advantages of the monetary union and avoid the threat of adverse influence on the monetary policy a rule for sound fiscal policies should be established. Although the Treaty of Maastricht includes such rules, the paper envisaged their clarification and smoothing of their implementation by introducing the notion of “Stability Pact for Europe”. Member States should explicitly commit themselves to pursuing sound fiscal policy, which would at the same time promote growth and employment. That should be also a positive sign for the international financial markets giving additional credibility to the whole project of the monetary union. The main points of the proposals were as follows:

- 3% deficit to GDP ratio should not be exceeded also in case of an economic slowdown, which implies deficit target of 1 per cent of GDP, during normal economic conditions, assuring the avoidance of breaching the Pact,
- government expenditure should not rise faster than the increase in nominal GDP in medium term,
- exceptions to the rule would require QMV voting among the states participating in the monetary union and only in extreme cases,
- the debt is to be consistently reduced even if it decreases below the Treaty threshold of 60%GDP,
- if, either during budgetary planning or implementation, a country fails to stay under the 3% deficit ceiling an automatic procedure should be initiated, requiring the country to make a non-interest bearing deposit accounting for 0.25% of its GDP for each percentage point in excess of the above-mentioned ceiling. The deposit would be converted into a fine if the situation would not be corrected within 2 years of its occurrence.

Any regulation on the budgetary spending and taxing was inadmissible as the Maastricht Treaty envisages that all decisions regarding the public expenditure and tax policy are the sole competence of national authorities. Also the suggestion concerning the reduction of the public debt was deemed unnecessary, due to the Treaty obligation and logic implication arising from
the requirement that Members States ought to meet the objective of budgets in “close to balance or in surplus” positions. Moreover, the Commission proposed some modification to the proposal. It suggested the notion of “balanced budget” in medium-term, instead of the “medium-term deficit ceiling 1% of GDP during normal economic periods”. This proposal was based on the calculations made by the Commission, which revealed large differences between the elasticity of budget positions to cyclical economic developments among the countries. It could imply that in case of recession there would be no adequate safety margins in some of the countries. Moreover, some cohesion countries outlined that a higher deficit might be justifiable on the grounds of increased investment needs. The Commission also pointed out that improvements in monitoring procedure shall be made together with closer coordination of economic objectives. This resulted in introducing the tool of “stability programmes” with medium-term budgetary targets for the countries entering the third stage of EMU creation, while other EU Member States are obliged to prepare “convergence programmes”. However, not all of the Commission suggestions found sufficient support. For example the proposal to focus on the cyclically adjusted budget positions was rejected as countries argued that actual deficits were easily observable and understood, whereas there was no agreed procedure on the cyclically adjusted measurement of budget balances. Also the suggestion to specify the period in which the Member States are required to balance their budgets was turned down.

Until December 1996 three important issues remained unresolved:
- the question of automatic imposition of sanctions,
- the problem of defining “severe recession” meaning the extreme case, in which sanctions could be waived,
- the size of pecuniary sanctions.

During the meeting of finance ministers and EU heads of state and governments in December 1996 all the remaining issues were resolved, though it took a considerable amount of effort and time (24 hours long negotiations) to reach the consensus. It was decided that only an economic situation resulting in 2% decline in GDP in annual terms will be deemed exceptional and will be a ground for waiving the sanctions. A decrease of GDP between 0.75% - 2% might also be considered an exceptional severe economic downturn, but this requires a Council decision. Also the level of fines was decided amounting to 0.2% of GDP as
a fixed deposit for infringing the rules for over 2 years with additional variable component equal to 0.1% of GDP for every percentage point of budget deficit in excess of reference value. One of the key points of the German proposal, i.e. automatic imposition of fines would require an amendment to the Maastricht Treaty. Therefore, all the parties finally agreed on semi-automatic mechanism, which left the ultimate decision within the Council’s discretionary powers.

1.3.2 Legal construction of the Stability and Growth Pact

The Stability and Growth Pact consists of three legal acts – one resolution and two regulations. The Resolution of the European Council on the Stability and Growth Pact of 17 June 1997 aims at enforcing swift and rigorous application of the Pact. It is a political declaration, stating the main obligations arising from the Pact for the Council, the Member States and the Commission. Two Council Regulations containing detailed rules on the application of the Pact are based on the Treaty provisions. Regulation 1466/97/EC, whose goal is to tighten surveillance on member state budgets and the coordination of economic policies, is based on Article 99 of the Treaty and constitutes the preventive arm of the Pact. The dissuasive part of the Pact is the Regulation 1467/97/EC “on speeding up and clarifying the implementation of the excessive deficit procedure” and has Article 104 as its legal base.

According to Regulation 1466/97/EC each member state is required to prepare Stability or Convergence Programmes, which are focused on the public finance situation. The Programmes should include “the medium-term objective for the budgetary position of close to balance or in surplus, the adjustment path towards this objective for the general government surplus/deficit and the expected path of the general government debt ratio”. Within two months of the submission of the Programme the Council is ought to examine it and issue its opinion with a special attention paid to whether the Programme objectives allow for sufficient safety margin, which would ensure the avoidance of an excessive deficit. In this assessment the Council should also consider relevant structural and cyclical features of each economy. It is also worth underlining that the Programmes should be consistent with Broad

27 Council Regulation 1466/97/EC of 7 July 1997, O.J. 1997, L 209/1
28 Stability Programmes are prepared by countries that adopted the Euro, while other Member States prepare Convergence Programmes. For more details on those and BEPG see subChapter 1.3.3
Economic Policy Guidelines (BEPG) and facilitate closer coordination of economic policies. The Council issues its opinion on a recommendation from the Commission and after consulting the Economic and Financial Committee. If the Council considers that the contents and the objective of the Programme need strengthening, it shall invite the country concerned to adjust its Programme. In the course of multilateral surveillance, also the implementation of the Programmes is monitored with the purpose of detecting significant divergence (actual or expected) of the budgetary position from the medium-term objective or in the adjustment path towards it. If such deviations are probable the Council shall address a recommendation to take the necessary adjustment measures. Such a recommendation is an early warning, aiming at the prevention of excessive deficit occurrence.

It should be noticed that Regulation 1466/97 has a form of open coordination. Its application is based on Member States’ self commitment, multilateral peer review and consensus building. Although at first sight, the early warning procedure might seem well designed to monitor the budgetary situation in Member States since it requires a production of detailed medium-term plans in a systematic, timely manner, a deeper legal analysis may cast some doubts on its efficiency. As Amtenbrink and De Haan note, although some common rules on budgetary accounting and on the content and format of Stability/Convergence Programmes had been established, it still does not exclude using inconsistent statistical data or creative bookkeeping. As they argue, it would be very difficult to prove whether the country concerned, used false data either intentionally or unintentionally, or whether the divergence from real values was due to a different interpretation of economic variables. Furthermore, where the Council considers that the objectives and contents of the Programme should be strengthened, it shall issue an opinion inviting the member state concerned to adjust its Programme, which virtually has no legal binding force. Moreover, the Council can do little to force any member state to execute its Programme and ensure the attainment of the goal of balanced budgets. This is due to the fact that the only tool available to the Council under the early warning procedure is a public recommendation stating the need of undertaking prompt corrective measures. From strictly legal point of view, the surveillance procedure relies in majority on the political will and fulfilling the commitments as agreed in the Resolution. The

situation changes when a country is actually running an excessive deficit, as in such case Excessive Deficit Procedure comes in force, under which more stringent actions might be taken.

Excessive Deficit Procedure which was first introduced in Article 104 of the Maastricht Treaty, was clarified in Regulation 1467/97/EC. It is an example of a close method of coordination, characterized by top-down policy formulation together with binding rules and equipped with the tools for punishment. The procedure introduces strict obligations for the Council and the Commission, strict time frame and the list of available sanctions. Although this part of the Pact was negotiated very long, it still contains some ambiguities. Moreover, it leaves a considerable area in the discretion of the Council.

The Commission monitors the budgetary situation basing on the data forwarded by the Member States. If it considers that there exists an actual excessive deficit or a threat of its occurrence in the future, it is required to prepare a report. Within two weeks the Economic and Financial Committee is obliged to formulate the opinion on the Commission’s report. Taking this opinion into account, the Commission shall address an opinion and recommendation to the Council if it considers that an excessive deficit exists. On this basis the Council might take the decision on the existence of excessive deficit. It is clear that it is more a political decision taken by the countries gathered in the Council more than an automatic mechanism. A consensus in the Council may actually stop the procedure even if a deficit could be deemed as excessive from the objective point of view. Moreover, the procedure following the Treaty allows for some exceptions. It was clarified in the Regulation that excessive deficit should be seen as exceptional and temporary if it results from “an unusual event outside the control of the Member State concerned and which has a major impact on the financial position of the general government, or when resulting from a severe economic downturn”. A natural disaster on national scale or a war may be deemed to be such an “unusual event”. According to the Regulation an economic slowdown characterized by the decrease of GDP by at least 2% is to be seen as “severe economic downturn”. Furthermore, while deciding on the existence of an excessive deficit the Council should take into account all the observations made by the country concerned. The burden of proving that the slowdown was exceptional and justifies the

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31 Amtenbrink F., De Haan J., Economic governance in..., op. cit., p. 1086
excessive deficit, even though the recession amounted to a GDP fall of less than 2%, is carried by the member state concerned. Nevertheless, it must be noted however that in the Resolution on the SGP Member States committed themselves not to invoke the benefits of this exemption in the EDP procedure if the decrease in GDP was less than 0.75%. At this point it is valuable to consider how often those exemptions are likely to be invoked. Eichengreen and Wyplosz\textsuperscript{32} reviewed the data on the occurrence of budget deficits exceeding 3%, considering at the same time which of them were accompanied by recession in the period of 1955-1996. The research reveals that out of 186 cases (for the EU countries) when deficit exceeded 3% in only 4 cases it coincided with a GDP fall of more than 2% and 22 times the slowdown resulted in a GDP decrease between 0.75% - 2%. Basing on the past developments one can suspect that only in an insignificant number of cases a country facing an excessive deficit would be granted an automatic exemption from the EDP due to severe slowdown. On the other hand in almost 12% of the cases the deficit could be deemed not excessive if only the member state concerned was able to prepare sufficient evidence to convince the Council that the economic slowdown of less than 2% could justify the breach of the Treaty. Moreover, it is to be underlined that both values are not applied in a strictly automatic manner, thus the Council should also take into account any other factors whilst deciding on the excessive deficit existence. When the GDP fall is less than 2% the Regulation explicitly states the “abruptness of the downturn or on the accumulated loss of output relative to past trends” as being of special importance. This additionally illustrates the scope of discretionary power left within the Council.

As compared to the multilateral surveillance procedure one must note that EDP is capable of creating legal obligations. If the procedure is initiated and the Commission issues a recommendation to the Council, it is obliged to take a decision whether an excessive deficit exists or not. If the Council confirms the view of the Commission, it is obliged to issue a recommendation to the member state concerned on how to bring the deficit back in line with the Treaty. According to the Regulation, the Council is also obliged to set the deadline for the introduction of effective corrective measures, which cannot exceed four months. If on the expiry of the deadline the Council considers that there has been no effective action taken it may make the recommendation public. If the country concerned still fails to take appropriate and effective measures the Council, in accordance with Article 104 (9), can give a notice

\textsuperscript{32} Eichengreen B., Wyplosz Ch., \textit{The Stability Pact: more...}, op. cit., p. 87
requesting the country to take specified measures in order to remedy the situation. If the country fails to do so, the Council shall impose sanctions. Any such decision should be taken within two months of issuing the notice. There are four types of sanctions:

- “to require the Member State concerned to publish additional information, to be specified by the Council, before issuing bonds and securities;
- to invite the European Investment Bank to reconsider its lending policy towards the Member State concerned;
- to require the Member State concerned to make a non-interest-bearing deposit of an appropriate size with the Community until the excessive deficit has, in the view of the Council, been corrected;
- to impose fines of an appropriate size”.

Whenever the Council takes a decision to impose sanctions pursuant to the Article 104(11), it is urged to require a non-interest bearing deposit, already explained in 1.3.1. If the excessive deficit is not corrected in the view of the Council within two years of the decision to impose sanctions, the Council in accord with the Resolution is urged to transform the deposit into a non-refundable fine.

Concluding, one of the main aims of the Stability and Growth Pact was to improve and clarify the multilateral surveillance and excessive deficit procedures, which would add credibility to the Eurozone fiscal rules. The Pact, legally based on the Treaty, consists of two Regulations and a Council Resolution. The advantage of the Regulations is that they are binding and directly applicable in all Member States while the Resolution is only a declaration of good will and political commitment, but may not inflict any legal action itself. Furthermore, as it has been shown, the Regulations are not unambiguous and leave a lot of discretionary power within the Council. A mix of open and closed method of coordination might in some cases be the core of problems as regards the application of the Pact. Another problem in the application of the EDP lies in the reluctance of the finance ministers to punish another country, knowing that in the future they may find themselves in the same uncomfortable position.

33 Article 104 (ex Article 104c) of the Maastricht Treaty
1.3.3 Broad Economic Policy Guidelines and Stability/Convergence Programmes

On the contrary to the monetary policy in the EMU, which is pursued on supranational level by the ECB, other areas of economic policy remain within the power of the national governments, though are subject to the mechanism of coordination. The economic policy coordination process in the EMU uses many tools and methods, e.g. information exchange, sharing best practices, dialogue\textsuperscript{34}, common assessments, common policy rules and objectives. The main tool of this multilayered, complex process are Broad Economic Policy Guidelines, which in accordance with the Art. 99 of the Treaty are decided by the Council on the proposal from the Commission and with the recommendation made by ECOFIN. The main goal of the BEPG is twofold:

- it is a guidance for the Member States, presenting the main directions of the economic policy, which shall be pursued, including country specific recommendations,
- it consolidates and summarizes all the existing coordination processes in the EMU.

The current medium – term economic strategy for the EU is stated in BEPG for 2003-2005 and concentrates on three broad areas:

- growth and stability oriented macroeconomic policies,
- the need for economic reforms to raise Europe’s growth potential,
- strengthening sustainability in the area of economic stability with special focus on the problem of ageing population\textsuperscript{35}.

BEPG play a very important role in the surveillance procedure as national budgetary and economic targets presented in Stability/Convergence Programmes prepared by the Member States must go in line with BEPG requirements. As noted before, the Programmes are the main source of information concerning budgetary developments and targets in Member States. They are to be submitted annually at the time or shortly after the adoption of draft national budgets. The requirement of the inclusion of prospect and ongoing budgetary initiatives and reforms allows for improved transparency of planned fiscal developments. The content of the Programmes is defined in the \textit{Pact}, yet an additional document was prepared by the Economic

\textsuperscript{34} For example The Cologne Process is an informal macroeconomic dialogue in form of biannual meetings between public authorities and wage bargainers representation, which aims at the improvement of their relations, so as to achieve higher employment and growth, for more details on economic policy coordination in EMU see: von Hagen J., Mundschenk S., \textit{The functioning of economic policy coordination} in Buti M., Sapir A., “EMU and Economic Policy in Europe – The Challenge of the Early Years”, 2003

and Financial Committee in order to clarify the requirements on qualitative and quantitative information and format in which it shall be presented. The information should include \textit{inter alia:} medium – term budgetary targets, including the expected path of the general debt ratio development, the main economic assumptions, including expected sources of GDP growth and potential changes in interest rates, information on a current cyclical position of the economy and expected inflation. They should include the projections for at least three following years. Member States should also present the grounds for their choice of budgetary objectives.

\subsection*{1.4 Tensions and potential weaknesses of the SGP}

As mentioned above the \textit{Pact} and the underlying articles of the Treaty are a unique construction for a new experiment which a monetary union between independent states can be held for. It is thus not surprising that since the beginning the \textit{Pact} aroused much interest not only among politicians, but also academics. The will to enforce fiscal discipline and eliminate the free – rider problems between countries entering the Eurozone was sufficient to create a political consensus on the introduction of the \textit{Pact}. Yet, the academic circles pointed out that the design of the rules might cause some problems. First of all, the key figure of 3\% as used in the Treaty and the SGP was found to be without sound economic rationale. It is rather regarded as a tough but achievable limit to prevent the members states from pursuing overly lax fiscal policy, thus sufficient to deal with the threat of insolvency. Secondly, the SGP, due to its construction, is not capable of preventing the use of pro-cyclical fiscal policy in periods of an economic upswing. Thirdly, the actual vs. cyclically adjusted deficit ratio issue was for a long time under discussion, which eventually led to the change of the \textit{Pact’s} interpretation. Also as will be shown, some of the legal aspects of the \textit{Pact’s} construction cast doubts on its enforceability. Predictably, after some years of the functioning of the SGP the weaknesses of its initial design became apparent. Some of those will be touched upon below.

\begin{flushright}
36 See European Commission, \textit{Opinion on the content and format of stability and convergence programmes (2001 code of conduct)} in, \textit{“European Economy”} no 3/2002
\end{flushright}

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37 See for example Eichengreen B., Wyplosz Ch., \textit{The Stability Pact...}, op. cit. ; Canzoneri M., Diba B, \textit{The Stability and Growth Pact Revisited: A Delicate Balance or an Albatross?} Empirica vol. 6 no. 3, 1999
\end{flushright}
1.4.1 Asymmetric construction of the SGP

One of the major aims of the SGP is to prevent the governments from pursuing pro-cyclical policies. The economic stabilization is to be brought by the functioning of automatic stabilizers, which should work symmetrically during the whole business cycle. The weaknesses of the Pact lies in the fact that it does not provide sufficient incentives to maintain budgetary discipline during the periods of a strong economic growth. At such point of cycle the budget revenues increase, whilst expenditures connected with social schemes are likely to fall. Consequently, the government has additional means to pursue expansionary policy or cut taxes, without the risk of breaching the actual deficit criterion. It is true that such tax burdens are very high in most of the EMU countries. Thus a reform aimed at lowering tax burden (especially on labour) could be an advisable step forward towards more growth and sustainability in the future. Yet, excessive fiscal relaxation not accompanied by appropriate adjustment in expenditure may result in lack of budgetary balance in case of a sudden economic slowdown. That could force the government to pursue pro-cyclical, tighter fiscal policy in order to avoid excessive deficit, which is in line with the SGP rules, but against its economic rationale. This also brings up another issue of the importance of business cycle position in the assessment of budgetary stance.

1.4.2 Actual vs. cyclically adjusted budget balances

During the negotiations in 1996 a large part of the debate was devoted to the “medium – term target” notion. It is noteworthy that from the very start the Commission stressed the need to focus on cyclically adjusted ratios rather than on actual deficits. This arises from the fact that government budget balances are influenced not only by the fiscal policy pursued by the authorities, but also by events beyond their direct control. The most important factor which can blur the image is the change in economic activity. During recession the budget balance is likely to deteriorate due to the fall of tax revenues and increased expenditures on social security. Thereby, the budget deficit will rise considerably, even though the fiscal policy might have not changed at all. Having in mind that the main aim of the SGP was to prevent pro-cyclical policies and ensure that Member States would have sufficient budgetary capacity to deal with negative shocks, the Commission wanted the “medium – term target” to be interpreted in the light of cyclically adjusted figures. However, in 1996 the Member States
refused to go along this line, arguing that actual deficits were easier observable and understood. Moreover, they rightly emphasized that there is no wide consensus on what is an objective and economically sound method of cyclical adjustment. Thus, contrary to the Commission’s point of view and far from what was suggested by the academic analyses, the budget balances were to be assessed in the light of actual figures.

As it will be further explained in Chapter 2, the economic situation was subject to strong cyclical fluctuations, which eventually led to a situation where 3% hard cap imposed on the national budgets appeared to be too tight with respect to some countries. The strong economic growth which started in 1996 and reached its peak of 3,5% of GDP in the year 2000, together with additional surpluses thanks to UMTS license fees gave an illusory image that after “fiscal fatigue” experienced by most of the Member States in the run up to the EMU, the coming years would allow for easy conformity with the SGP rules. Nevertheless, the sharp rise in oil prices in 2000 and global stock market crash experienced in 2001 revealed that countries which did not use the good times for performing essential reforms would face a hard time under current rules of the *Pact*.

In March 2003, the Council agreed that following the Commission Communication on “Strengthening the coordination of budgetary policies”\(^\text{38}\) the “medium – term target of budgets close to balance or in surplus” should be measured in terms of the cyclically adjusted figures. Additionally, due account should be taken of one–off budgetary measures, which have only transitory impact on budgetary positions. The members of the Eurozone agreed that countries with significant budget deficits should strive to improve their stance at the annual speed of 0,5% GDP in cyclically adjusted terms. It was a clear sign that the automatic stabilizers should work symmetrically during the whole business cycle and discourage governments from using pro–cyclical measures also in good times. However, this common agreement should not be treated by the Council as an enforceable rule. Thus, breaching it will not in any case activate the EDP. Still the EDP should be initiated if the actual deficit exceeds 3% of the GDP, but in its assessment the Council should take due account of the underlying economic situation.

Another change, which concerned the technical side of cyclical adjustment procedure, was switch in the method of estimating output gaps. Until 2001 the Commissions used the HP

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statistical filter to estimate growth trend and related output gaps. It is characterized by simplicity, low data requirements and allows for consistent treatment of members states. Yet, had only a weak link to the economic theory and provided for no normative content. This triggered the Commission to endorse a so-called production function approach as a better proxy of output gap, since it has strong economic base and allows for capturing the influence of specific features of individual Member States\(^{39}\). This leads to the observation that the way the SGP is being interpreted is still evolving. It is distressing that when countries face difficulties with respecting the rules the Council has a considerable discretion, which in turn makes the threat of being sanctioned for breaching the 3 per cent hard – ceiling less credible.

1.4.3 Credibility and enforceability of the Pact

One of the most heavily debated issue is whether the Pact is constructed in such a way as to be more than a “scare crow”. On the one hand, we can bring up the weight of the political commitments, which accompanied its creation and were explicitly stated in the Resolution. On the other hand, its rationale, construction and first years of operation seem to prove that it is not a perfect tool of maintaining the fiscal discipline.

First of all, it must be noted that under the multilateral surveillance procedure the Council should issue a recommendation requiring the remedy of the difficulties identified. However, at this stage no pecuniary or other tangible sanctions can be imposed if the country fails to take measures pursuant to the recommendation. Moreover, the dissuasive part of the Pact is not free of weaknesses. As it was presented in 1.3.2, the Pact leaves major discretionary power within the Council. This, however in line with the Treaty, might cause problems with Pact’s enforcement. As Buiter\(^{40}\) suggests, the ECOFIN has the legitimacy and is likely to have sufficient competence to enforce the rules, but “it manifestly does not have the collective capacity to commit itself to an impartial and consistent enforcement of the rules”. One has to keep in mind that the same ministers who are responsible for drafts of the national budget are to decide whether they and their colleagues did a bad job planning the fiscal developments for the next years, especially if they cannot avoid breaching the 3 per cent


\(^{40}\) Buiter W.H., Ten commandments for a fiscal rule in the EMU, Oxford Review of Economic Policy, vol. 19 no 1, 2003, p. 97
threshold. Furthermore, additional attention should be devoted to the voting procedure as foreseen in the Treaty. As Artis and Winkler\textsuperscript{41} rightly notice the decision on the existence of an excessive deficit is taken (Article 104(6)) using the QMV procedure, but including the country concerned and even euro–outsiders. Theoretically, if either Germany, France or Italy (29 votes each) were suffering from an excessive deficit they might easily get off the hook of the EDP by convincing some of the out countries (e.g. UK - 29, Czech Republic - 12, Hungary -12 Denmark - 7) to vote against the decision, thus forming a blocking minority, which is 89 votes. Such a scenario, although unlikely, poses a threat to the credibility of the whole system as it allows for a situation where the EDP procedure cannot be continued despite the fact that all Eurozone members, except for the one concerned, deem the deficit excessive. In the subsequent steps of the EDP the country under examination and outs are excluded from the voting, thus making it more credible, but if the EDP is not initiated no subsequent steps will be taken.

On the other hand it is obvious that requiring a non–interest bearing deposit and the potential conversion into a fine would be no direct remedy for an excessive deficit. On the contrary, it will aggravate the budgetary imbalance, causing a directly reverse effect to the one it was supposed to bring about. Of course, one could argue that the need to transfer the money would be a great incentive to improve the excessive deficit situation in order to recover the deposit. However, the threat of fine imposition is most efficient as long as it remains only a threat. Thus, a potential offender might suspect in advance that the only credible sanction is “naming and shaming”, which does not seem very efficient in inducing fiscal retrenchment. Apart from the fact that a potential offender might deem the pecuniary sanctions illusory, also the behaviour of other Member States might be crucial in deciding which fiscal policy to pursue.

\section*{1.4.4 The choice of the fiscal policy under SGP – coordination game}

It must be stressed that the fiscal coordination is not a game of a single player. The Member States follow closely the fiscal developments in other countries, which may play a significant role in deciding as whether to strive to stay in line with the rules. An interesting study of this

issue which used the game theory perspective was developed by de Haan, Berger and Jansen. The study starts with the assumption that the size of the country matters in this type of the political economy considerations. The authors use the notion of the expected utility of the fiscal policy, which is contingent on the type and consequences of the fiscal policy chosen, i.e. the level of the deficit, probability of being fined and the potential size of the fine. The fine in this perspective is not limited to the pecuniary dimension, but it is also a loss of “political capital”, which might be illustrated by the loss of informal bargaining power within the Council as a result of breaching the rules. Thus it is assumed that large countries face less risk and smaller consequences of breaching the Pact, as compared to small countries. Furthermore, taking into account that the outcome of the procedure envisaged by the Pact is conditional on the political decision, an assumption is made that “it will be politically easier (or less costly) to sanction one country for fiscal misbehaviour than many”. This is in line with the aforementioned argument that the Council lacks collective political capacity to fine any of the Member States (leave aside the possibility of penalizing more than one member state). It appears clearly that not only the size of the country, hence its position in the Council matters but the types of fiscal policies pursued by other Member States may also have an influence the final outcome of the proceedings in the Council. In the discussed example the probability of being fined for a loose fiscal policy is assumed to be lower if more countries run lax fiscal policy, thus enlarging the group of member state being subject to the EDP.

As the result of the above considerations, the authors identify three fiscal policy regimes. Large countries are assumed to prefer loose fiscal policy, as their size implies that their loss of “political capital” and reputation will not be of considerable importance. On the other hand when the member state in question has small and limited bargaining power in the EMU, which is the case of the smaller states, it is more likely to stay in line with the rules, so as not to face the threat of reputation loss. Between those extremes the authors find an intermediate regime in which the choice of the fiscal policy is the outcome of a coordination game. If a Member State assumes that other countries will pursue lax fiscal policy, it will be more inclined to breach the rules. However, if all other Member States are likely to play in accordance with the rules, it would rather stick to a tight fiscal policy, not risking to be the

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only one under threat of penalty. The Stability/Convergence Programmes are to include the projections for the next fiscal years, which gives information on the future directions of the fiscal policies within the EU, facilitating conditional behaviour. The authors presented this situation as a game which can be illustrated in form of a simple matrix (figure 1). There are two Nash – equilibria (A,A and C,C). Since the payoffs for individual players are higher in case of pursuing lax policy by both players, the most likely outcome of the repeated coordination game would be (A, A), which is the least desirable from the SGP perspective.

<table>
<thead>
<tr>
<th>Player A</th>
<th>Lax Policy</th>
<th>Tight Policy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lax Policy</td>
<td>A, A</td>
<td>B, C</td>
</tr>
<tr>
<td>Tight Policy</td>
<td>C, B</td>
<td>C, C</td>
</tr>
</tbody>
</table>

Where A>C>B (expected utility of choosing specific fiscal regimes)


Concluding, large countries as distinct from the smaller Member States are less likely to stick to the rules envisaged by the SGP. The smaller states are theoretically more inclined to more rigorous application of the rules since they face higher probability of being fined. Furthermore, it might be suspected that if large countries would breach the rules it might invoke a contagion among other members states. However, some qualifications may be made to the above considerations. First of all, a rational government, while setting the fiscal policy should focus upon the internal macroeconomic situation rather than on the fiscal plans of other Member States. Moreover, it is clear that running an excessively lax fiscal policy is a short – term remedy for problems in economy, which in long – term leads to the increase of public debt and additional problems with balancing the budget. It must be remembered that all policies run by governments are subject to strong public opinion surveillance. This might be a strong incentive for a government to pursue a balanced fiscal policy. Furthermore it is not impossible that the Council would impose a fine on a large country like, e.g. Germany or France, if it would fail to meet the Pact’s requirements in a permanent way. The assumptions made, although plausible, disregard the fact that members states, the Commission and the Council explicitly committed themselves to full implementation of the SGP. However, in the light of empirical evidence which will be presented in Chapter 2, it appears that the authors
rightly foreseen that political commitments will not be a sufficient incentive for the Member States and the Council to follow the rules of the SGP.

### 1.4.5 SGP - potential problems in the future

The *Pact* was agreed in 1997, when the eastern enlargement was a distant future, thus it was designed for and by the representatives of the 15 countries creating the EMU. On 1st May 2004 ten countries joined the EU\(^{43}\). The differences in the level of economic development are still remarkable. This can be illustrated by the differences in GDP per capita between old and new members of the EU. (Table 2)

#### Table 2: GDP per capita in PPS at current market prices in the years 1999-2001 for six EU countries (in Euros)

<table>
<thead>
<tr>
<th></th>
<th>Latvia</th>
<th>Lithuania</th>
<th>Estonia</th>
<th>Austria</th>
<th>Denmark</th>
<th>Luxembourg</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>6 430</td>
<td>7 440</td>
<td>7510</td>
<td>24 260</td>
<td>24 710</td>
<td>40 370</td>
</tr>
<tr>
<td>2000</td>
<td>7 140</td>
<td>8 109</td>
<td>8490</td>
<td>25 920</td>
<td>26 180</td>
<td>45 080</td>
</tr>
<tr>
<td>2001</td>
<td>7 790</td>
<td>8 850</td>
<td>9020</td>
<td>26 140</td>
<td>26 930</td>
<td>45 330</td>
</tr>
<tr>
<td>2004(f)</td>
<td>9 680</td>
<td>11 610</td>
<td>11 480</td>
<td>27 910</td>
<td>28 400</td>
<td>40 720</td>
</tr>
<tr>
<td>2005(f)</td>
<td>10 490</td>
<td>12 620</td>
<td>12 840</td>
<td>28 990</td>
<td>29 440</td>
<td>50 100</td>
</tr>
</tbody>
</table>

Note: three poorest and three richest countries in EU in terms of GDP per capita measured in 1999; (f)- forecast
Source: Eurostat yearbook 2004

It can be noted that the variation in the GDP level between the poorest and the richest countries was and remains considerable. Yet, it is clear that transition economies develop faster as a result of real convergence process. The catch – up period, which may last for a couple of decades is likely to be characterized by a higher GDP growth in new Member States\(^{44}\). On the other hand, the transition economies suffer from lack of infrastructure, poor educational system and are in the need of costly reforms, which can be pursued only on the national level. Thus it is clear that in some cases the 3% of GDP threshold relating to budget deficit might appear to be too tight for the new Member States\(^{45}\). In this end the SGP may be a negative incentive preventing the countries from the pursuit of necessary reforms. It must be stressed that faster growth and additional returns from the investments, which will bear fruits in the future, might allow these states to withstand a higher deficit ratio without the risk of

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\(^{43}\) 8 of those being formerly centrally planned economies from Central and Eastern Europe – Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia,

\(^{44}\) Buiter W.H., *Ten commandments for a fiscal,...*, op. cit., p. 93

\(^{45}\) This is already a fact as 6 of the new members states are subject to the EDP procedure following the Council opinions from 5th July 2004
debt – GDP ratio deterioration. In this vein it might be argued that uniform application of the SGP rules would not be the optimal outcome and new Member States should be allowed more flexibility\textsuperscript{46}.

Another important issue, which will inevitably affect the EU economy and can create a threat of the SGP being repeatedly breached is the ageing population phenomenon\textsuperscript{47}. After a boom in birth rates after World War II, many European countries experience currently birth rates under the replacement levels. This results in decreasing labour supply. Moreover the life expectancy has been increasing approx. by 2 \(\frac{1}{2}\) years a decade. Although it is a very positive development, it also means that social security systems must support pensioners for longer time after they retire. The pay-as-you-go system, which is widely used among European social systems, will inevitably result in increased burden on public finances in the future. Thus, if the pension schemes remain unreformed it is likely that the Member States will face an additional challenge trying to stick to the SGP rules. Of course, the reforms should be undertaken and the SGP should not be an excuse for the governments. However some of them may require a temporary deterioration of budget balance. For example stimulation of private pension saving by offering tax breaks, which appears to be efficient incentive for the use of private pension schemes, proves to be costly for the national budgets due to decrease in revenues. The net tax cost varies between 10 per cent in Slovak Republic to even 35 per cent in Germany\textsuperscript{48}.

In short, the actual deficit criterion disregard the background of the deficit existence. This might be a major shortcoming especially for the new Member States, which face large investment needs. Also other Member States might face a difficult choice, as while trying to reform their pension system they might become subject to the EDP. The above considerations lead to the last, but not least important issue, which concerns the design of the \textit{Pact}.

\textsuperscript{46} This will be further developed in Chapters 3, 4
2. SGP implementation in the period 1999 - 2004

2.1 Economic situation in the first years of the EMU

Although the EMU is only 5 years old, the economic conditions in the EU have been subject to some major fluctuations.

Figure 2: GDP growth and budget balances for EU-15/Eurozone in 1999-2004

As figure 2 presents, in terms of GDP growth the period may be decomposed into two parts:
- 1999-2000 – period of strong economic growth,

It is assumed that strong economic growth in the first two years of the EMU is a positive outcome of the real convergence process, which was accelerated by the EMU run-up period. The real interest rates were converging at low level, the inflation declined considerably (from above 4.9% in 1990 to 1.1% in 1998 for the Eurozone). Privatisation and deregulation process led to the improvement of business atmosphere, which together with reforms on labour markets led to the decrease in unemployment rate in the Eurozone from 10.2% in 1998 to 8.4% in 2000). The mix of those positive developments resulted in economic growth amounting to 3.5%GDP in the year 2000.

The period of prosperity did not last long and from mid-2000 onwards the growth ratio began to decrease. In the first half of the 2001 the euro area registered two consecutive
quarters of a negative GDP growth. Following this adverse conditions the economic situation improved, but it was still characterized by very low GDP expansion. The protracted slowdown is said to be caused by three major external shocks.

First of all, a very significant rise in oil prices is to be noticed. In January 1999 the price of oil amounted to USD 12 per barrel then it rose to USD 30 in mid 2000\textsuperscript{49}. After the subsequent decline in oil price, the American intervention in Iraq contributed to instability on oil markets, which eventually led to renewed increase in oil price\textsuperscript{50}. Moreover, the gradual devaluation of the Euro until 2001 (Figure 3) additionally reduced the European household’s purchasing power. This additionally lowered the level of domestic demand, which is one of the main factors influencing the level of economic activity.

![Figure 3: Euro exchange rate against USD and GBP between 1998-2003 (annual average)](source)

Secondly, there was a large correction of stock market prices, especially with respect to technology and telecommunication sector. This implied a shrink in hardware production and stagnation in computer-related services until 2003, and reduced household spending. Thirdly, the Euro area was adversely affected by the stagnation in the world trade growth.

Figure 2 presents also the nominal budget deficits levels in the EU during the period concerned. Not surprisingly, the budgetary stance improved during the period of upswing and deteriorated when European economy was facing major economic slowdown. This reflects the operation of the automatic stabilizers. However, it is also clear that the attitude of European

\textsuperscript{49} Some of the adverse economic developments can also be attributed to the Sept. 11 (2000) terrorists attacks in the USA, which caused political and economic instability, followed by a proclamation of war against terrorism, intervention in Afghanistan and subsequent increase of USA budget deficit and trade balance

\textsuperscript{50} In November 2004 the oil price peaked at almost USD 50 per barrel
governments towards fiscal policy was of significant importance. It is worth noting that the budget deficits is that the Eurozone recorded lower budgetary surplus in 2000 as compared to the whole EU. On the other hand, during the economic slowdown the euro area itself shows larger average budget deficits than when one looks at the whole EU. Thus, it might be argued that the Member States, which did not introduce the Euro were actually performing better in terms of budgetary consolidation than those which did. This is a rather unexpected development as the UK, Denmark and Sweden do not face the threat of fines under the EDP procedure. Nevertheless, they pursued more stable fiscal policy than those Member States, which were subject to the dissuasive part of the Pact.

Another piece of evidence of the positive influence of prosperity on the public finance situation can be found in the government debt figures.

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eurozone</td>
<td>74.3</td>
<td>72.9</td>
<td>70.6</td>
<td>69.6</td>
<td>69.6</td>
<td>70.9</td>
<td>71.3</td>
</tr>
<tr>
<td>EU-15</td>
<td>69.0</td>
<td>68.0</td>
<td>64.2</td>
<td>63.4</td>
<td>62.8</td>
<td>64.4</td>
<td>64.6</td>
</tr>
</tbody>
</table>

Source: European Commission, European Economy Statistical annex, ECFIN/174/2004 EN

The average debt/GDP ratio in the Eurozone was rapidly declining until 2001, when it amounted to 69.6%. In the second year of economic slowdown it remained unchanged. Predictably, in 2003 it increased by 1.3% and in 2004 by 0.4% reflecting the increased borrowing needs of the large Member States (Germany and France), which had to finance their significant budget deficits. A similar image can be drawn for the aggregated EU figures. Also the UK being one of the European “big four”, had considerable problems in balancing its budget and let its debt increase.

2.2 A brief analysis of economic performance of individual MS in 1999-2003

The EU, although characterized by high level of economic integration, is not one entity and during both, the time of strong economic growth and protracted slowdown, the Member States were facing somewhat different economic conditions. Therefore, the aggregated data must be decomposed in order to assess the performance of individual countries. The figures on the budgetary developments are presented in Table 4.

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51 This is caused by the fact that, although the Scandinavian non-participants were performing well in terms of budgetary stabilization they are too small in terms of economy size to considerably change the general statistical image.
As it might have been suspected the performance of individual countries gives a mixed image. In the years of an economic upswing none of the countries breached the 3%GDP threshold in terms of the actual deficit. In 1999 Finland, Ireland, Luxembourg and the Netherlands have recorded even budget surpluses, while only Portugal and Austria had deficits of over 2 per cent GDP. Large budget surpluses were also the case for countries remaining outside the euro area. Besides, cyclically adjusted figures show that even if the countries did not experience rapid economic growth, most of them would stay within the SGP limit. In this respect Portugal is an exception, which was a clear sign that in case of an economic slowdown it was likely to infringe the rules.

Similar situation can be observed in the data for the year 2000. Thanks to the period of prosperity and large revenues generated by the UMTS proceedings, some of the countries increased their budgetary surpluses (e.g. Finland, Luxembourg, Ireland), whereas some managed to reduce their deficit ratios considerably. This is the case of Austria, Belgium, Germany, France and Italy. This positive image, however, does not fully reflect the budgetary developments in those countries. With the exception of Austria, the listed Member States recorded a deterioration in cyclically adjusted budget balances. This is contrary to the “close
to balance or in surplus” requirement of the SGP and it might be suspected that had there been no growth, the figures for the actual deficits might have looked much worse. It might be argued that since the Member States remained below the SGP threshold, one should not contest the Pact’s efficiency. However, one should recall that it was designed as an incentive to avoid the pursuance of pro-cyclical policy. Looking from this angle, the Member States should have continued fiscal consolidation process during the first two years of SGP operation, as economic conditions were favourable. In this perspective, the years 1999-2000 seem to provide less convincing evidence of SGP efficiency.

An interesting study of fiscal policy stance was conducted by Fatas, von Hagen, Hughes Hallet, Strauch, Sibert⁵². They argued that in 1999 none of the Member States, with the exception of Denmark, did tighten their fiscal policy with Austria, Belgium, Finland, Ireland, Portugal and France showing the largest fiscal expansion. Nevertheless, this conclusion is drawn under assumption that no expenditure growth should be allowed, which might be treated as an over-restrictive limitation. Another set of data, calculated under assumption that government spending should increase in line with revenues, reveals a less negative picture. Belgium, Austria and Ireland are countries that spent all of the extra revenue generated during the year, while France, Germany, Portugal, Finland and Greece are the Member States which let the expenditures grow only slightly slower than the revenues grew. Concluding, although the picture is mixed it might be argued that Belgium, France, Austria, Portugal and Greece failed to consolidate their budgets taking advantage of the positive economic conditions present in 1999.

As it was mentioned above, the year 2000 was characterized by high ratio of GDP growth and large reductions in actual deficits. Under the assumption of no expenditure growth, the performance of Member States is diverse. Finland, Italy, the UK and the Netherlands managed to reduce the expenditure. On the other hand, Greece, Portugal, Spain, Denmark and France pursued expansionary fiscal policy. It, however, follows from the above-mentioned research that none of the countries allowed the new expenditures overgrow the additional revenues. For most of the Member States it may be concluded that during the period of favourable economic conditions they allowed the expenditure to increase more less in line with the revenues. Although it cannot be regarded as a proof of unsustainable policy, it also

shows the inability of the Member States to save a significant part of the extra revenues created during rapid economic growth. Bearing in mind that for the attainment of balanced budgetary stance in long term it is crucial to keep the fiscal expansion under strict control during an economic upswing, the policies pursued by some Member States might in time become a distressing problem for them.

After the introduction of the Euro, the Member States were taking advantage of favourable economic conditions. Unfortunately, the very good situation at the start of the EMU was followed by a period of adverse economic developments. Figure 4 indicates the strength of the major economic slowdown, which started in 2001 and lasted until 2003.

Figure 4: GDP growth in EU (1999-2004) – annual percentage change of GDP

This adverse economic conditions negatively influenced the budgets of some countries, especially Germany, Italy and Portugal. In case of Portugal, the actual deficit peaked at 4.4% of GDP, which was the ground for the initiation of the EDP procedure against this member state in 2002. Most of the Eurozone countries recorded also a significant deterioration of

An interesting issue is that until July 2002 the actual deficit ratio of Portugal was said to amount to 2.2%GDP for 2001. Then it was revised to 4.4%, which expressly shows the problems with obtaining the accurate and full information from the Member States. This might cause the inability of EDP early procedure to work properly.
cyclically adjusted deficits, the largest present in Ireland (-1,9%), Germany (-1,4%), the Netherlands (-1%), Portugal (-1%). The exceptions to this trend were Austria and Belgium, which managed to keep these figures almost in balance, compare this to their actual deficits.

To better illustrate the negative consequences of the downswing and composition of fiscal adjustment, one may consider the change in revenues and expenditure recorded in the EU in 2001 (Table 4).

Table 5: Annual (2001-2000) change in the total government expenditures and revenues as percentage of GDP

<table>
<thead>
<tr>
<th>Country</th>
<th>Change in Expenditures</th>
<th>Change in Revenues</th>
<th>Aggregated change in budgetary positions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>-0,6</td>
<td>2,5</td>
<td>3,1</td>
</tr>
<tr>
<td>Belgium</td>
<td>0,1</td>
<td>0,3</td>
<td>0,2</td>
</tr>
<tr>
<td>Germany</td>
<td>2,6</td>
<td>-1,6</td>
<td>-4,2</td>
</tr>
<tr>
<td>Greece</td>
<td>-2,1</td>
<td>-1</td>
<td>1,1</td>
</tr>
<tr>
<td>France</td>
<td>-0,1</td>
<td>0</td>
<td>0,1</td>
</tr>
<tr>
<td>Finland</td>
<td>0,1</td>
<td>-1,7</td>
<td>-1,8</td>
</tr>
<tr>
<td>Ireland</td>
<td>1,7</td>
<td>-1,4</td>
<td>-3,1</td>
</tr>
<tr>
<td>Italy</td>
<td>1,8</td>
<td>0</td>
<td>-1,8</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>0,6</td>
<td>0,7</td>
<td>0,1</td>
</tr>
<tr>
<td>Netherlands</td>
<td>1,3</td>
<td>-0,9</td>
<td>-2,2</td>
</tr>
<tr>
<td>Portugal</td>
<td>1,1</td>
<td>-0,6</td>
<td>-1,7</td>
</tr>
<tr>
<td>Spain</td>
<td>-0,1</td>
<td>0</td>
<td>0,1</td>
</tr>
<tr>
<td>Eurozone</td>
<td>1</td>
<td>-0,6</td>
<td>-1,6</td>
</tr>
<tr>
<td>Denmark</td>
<td>0,3</td>
<td>0,7</td>
<td>0,4</td>
</tr>
<tr>
<td>Sweden</td>
<td>-0,2</td>
<td>-2,6</td>
<td>-2,4</td>
</tr>
<tr>
<td>UK</td>
<td>3,4</td>
<td>0,1</td>
<td>-3,3</td>
</tr>
</tbody>
</table>


The most important observation from this set of data is to be drawn from the third column of Table 5. The countries written **Bold** increased (Sweden excluded) their expenditures as compared to the year 2000, while in most cases their revenue decreased significantly. This is in line with the above-mentioned research, which suggests that Germany, Ireland, Italy, the Netherlands, Finland and Portugal pursued extra expenditures, though their revenues were decreasing. In part, this might be attributed to the operation of automatic stabilizers, but one should bear in mind that for most of the EMU members the year 2001 was not the worst year in terms of GDP growth in the period concerned. Consequently, it might have been argued that had the countries not changed their fiscal stance by curbing their expenditure as they were coming off the cyclical peak, there would have been major problems in respecting the 3%GDP
deficit threshold. Unsurprisingly this became truth in 2002, when the two largest economies – France, Germany – recorded actual deficits amounting to respectively 3,1 and 3,5 per cent of GDP.

As a consequence of low GDP growth in 2002 most of the EU countries, with the exception of Spain and Portugal, recorded a deterioration of the actual deficit figures.

Figure 5: Fiscal policy stance and growth in the EU in 2002

Figure 5 plots the correlation between the real GDP growth and change in cyclically adjusted budget balances. Apparently, there is no positive correlation for all the Member States. In case of Sweden, Luxembourg, France, Ireland and the Netherlands, the cyclically adjusted balances present significantly negative developments. Portugal owes such a positive performance not only to the fact that it managed to reduce its expenditure as compared to 2001, but also to wide use of one-off budgetary measures amounting to 1,5% of GDP \(^{54}\), which allowed it to reduce the deficit considerably. Similar was the case of Italy. Also countries outside the Eurozone, with the exception of Denmark, experienced significant problems in balancing their budgets.

\(^{54}\) In 2002 Portugal used different kinds of one-off measures with diverse size of positive influence on budget balance (in percent of GDP) - tax amnesties/settlements (1%), sales of real assets (0,3%)
Thus, it becomes evident that the economic slowdown had a sizeable influence on the fiscal situation in the EMU in 2002.

2003 was the last year, in the period concerned, characterized by very low levels of economic activity. The aggregated GDP growth for the Eurozone bottomed at 0.5% of GDP together with stable inflation of 2% and very low levels of interest rates amounting to 2.3% for short-term interest rate and 4.1% for long-term interest rate. Thus, the Member States faced a continued challenge in balancing their budgets. In actual terms the budgetary positions deteriorated in 9 out of 12 countries participating in the Euro, with the most considerable slippage in Luxembourg (-2.8%), Finland (-2.2%), the Netherlands (-1.6%), the UK (-1.6%), Greece (-1.5%), France (-1%), Austria (-0.9%), Germany (-0.4%). It is noteworthy however, that in case of Luxembourg and Finland such worsening of budget balance did not create any threat under the surveillance mechanism since those countries were running substantial surpluses. The most distressing fact was that five countries – Germany, Greece, France, the Netherlands and the UK actually breached the rules of the SGP. Bearing in mind that Germany and France were already subject to the SGP procedures, one can argue that the Pact did not induce the Member States to curb the deficits despite earlier commitments. In terms of cyclically adjusted deficits the evidence is mixed. For example, Greece, the UK and Austria recorded significant deterioration of 1.7%; 1.5%; 0.6% respectively. On the other hand, Ireland managed to reduce its cyclically adjusted budget deficit by 2%, Sweden by 1.3% and Portugal by 1%. Only six countries, among them four from the Eurozone, achieved in 2003 the position of close to balance or in surplus in terms of the adjusted figures. In this perspective the fiscal policy pursued in most of the full EMU participants might be said to be to lax and not foretelling better future. The reasons for such unsatisfactory outcome are, of course, diverse for individual countries, yet two things might be suspected to be of significant importance. First of all, the fact that from the very start of the EMU some of the Member States were running large budget deficits. Secondly, some Member States did not pursue enough fiscal consolidation. Partly, the bad performance might be attributed to the protracted slowdown period, which adversely hit Germany and France thus negatively influencing the whole EU economy. All the same, during the first years of the Euro some countries managed

55 the nominal German interest rates are taken as the benchmark for the whole euro area - following the European Commission, EMU after 5 years, European Economy Special Report No 1/2004
56 A detailed description of the SGP procedures implementation will be offered in section 2.3
to reduce their deficits, taking advantage of the prosperity period e.g. Spain –1,2% in 1999 and 0,4% in 2003; Austria –2,4% in 1999 and –1,3% in 2003, while other countries failed to restrain from strong increase in expenditures therefore letting their deficit to rise. This was the case of Germany, France, the Netherlands, Greece, the UK and permanently balancing on the verge of SGP ceiling – Portugal. It is surprising that the designers and biggest supporters of the SGP became one of the first to become subject to its procedures. In this light it is inevitable to look at the SGP procedures implementation in detail.

2.3 EDP implementation against Portugal, Germany and France

SGP was supposed to clarify and induce the timely application of the Treaty articles concerning budgetary surveillance in the EU. Although the Commission has been performing well as the guard of the public finance stance, not all of the Member States showed sufficient caution while designing their fiscal policies, which together with bad economic climate resulted in proceedings in line with the Pact’s rules.\(^{57}\)

As the economic conditions and budget positions significantly worsened in February 2002 the Commission, exercising its powers, prepared an early warning to be addressed to Portugal. The country concerned made a commitment that it would undertake measures not to breach the deficit ceiling. On this basis, the Council did not adopt the early warning. However, after it became clear that Portugal had explicitly infringed the SGP, the Commission prepared another report for the Council. On the 5 November 2002 the Council decided that an excessive deficit existed in Portugal.\(^{58}\) In its recommendation, the Council set the deadline of 31 December 2002 for Portuguese authorities to take measures to correct the excessive deficit. Accordingly to the SGP, the situation should be improved no later than the year following its identification, in this case the end of 2003. The response of the Portuguese authorities was prompt and budget deficit was curbed to 2,7% of GDP already in 2002. Still, the improvement was mainly due to tax amnesty and not deep structural reforms. Similar development took place in 2003, when despite much lower than expected GDP growth, the Portuguese authorities managed to prevent the deficit from overgrowing the 3% SGP ceiling, again thanks to one-off measures. In its assessment of the 2004 update of Stability Programme of Portugal,

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\(^{57}\) Documents concerning the implementation of the procedures under SGP can be found at http://europa.eu.int/economy_finance/about/activitvies/sgp/procedures_en.htm

the Commission confirmed the forecast of GDP growth amounting to 1% in 2004, but it also underlined the possibility of lower than expected revenue growth, which if accompanied by any slippage in limiting the social expenditure, may result in breaching the 3% threshold. However, since Portugal conformed with the Council recommendation, the Commission suggested the Council to abrogate the procedure. The Council abrogated the decision on the existence of excessive deficit in Portugal on 11 May 2004, but following the Commission concerns it called for caution in 2004. The proceedings against Germany and France followed a different path.

Germany breached the SGP rules explicitly in 2002, recording the actual budget deficit of 3,5% of GDP. However, already in 2001 Germany recorded a deficit of 2,8%GDP being only slightly under the ceiling. Thus, the Commission, as in case of Portugal, prepared in February 2002 an early warning, which was also not adopted by the Council on the basis of German authority’s commitments. Basing on the optimistic forecast of GDP growth for 2002 projected at 1,25%GDP, German government expected its deficit to decrease to 2% of GDP in 200259. In reality, GDP growth almost vanished, which resulted in the actual deficit of 3,5% of GDP. The excessive deficit in Germany was identified by the Council in January 2003. At the same time the Recommendation was adopted with a view to bring the situation to an end. It specified the deadline of May 23rd 2003 for taking appropriate measures and the end of 2004 as the time by which the excessive deficit should be eliminated. The Council also invited Germany to undertake necessary measures to curb the deficit until the end of 2003. However, in the light of adverse economic conditions it was rather a wishful thinking. The expected 1,5% GDP growth turned into GDP decline of 0,1%. This resulted in 5% lower than projected growth of tax revenues. The unemployment rate rose by 0,9% for the second consecutive year, which put additional pressure on the expenditure side of the budget. Although the German authorities undertook substantial consolidation efforts amounting to EUR 20 billion, it must be underlined that the self imposed objectives for curbing the government expenditures were not met. The Federal level expenditures rose by 3%, while it was said to be reduced by 0,5% in 200360. The actual deficit peaked at 3,9% GDP in 2003, and it was suspected that Germany would not be able to go back in line with the SGP even in 2004. On this basis the Commission

59 German Federal Ministry of Finance, December 2001 Stability Program for Germany
decided to proceed with the excessive deficit procedure against Germany. In November 2003 it adopted two recommendations for the Council. First, under Art. 104(8) the Commission established that the measures undertaken by Germany were proving to be inadequate. Second, in line with Art. 104(9), the Commission recommended the Council to issue a notice to Germany requesting to apply new measures aiming at deficit reduction. In its recommendation the Commission advised Germany to put an end the situation of the excessive deficit as soon as possible and until the end of 2005 at the latest, which would give Germany an additional year for remedying the situation. It also stipulated that in terms of cyclically adjusted figures the balance should improve by 0,8%GDP and 0,5%GDP in 2004 and 2005 respectively and any higher than expected revenue should be devoted to deficit reduction. It is worth noting that France found itself in a similar situation. On 21 January 2003 it received early-warning, whose aim was to induce the French authorities to undertake measures ensuring that the 3% deficit threshold would not be breached in 2003. Later it became apparent that the SGP rules had already been infringed in 2002, when the deficit reached 3,1% of GDP. Although France was also influenced by negative economic conditions, the Commission argued that the large slippage in cyclically adjusted budget balance (-2,4%GDP in 2002 vs. –3,8%GDP in 2003) should be attributed to the insufficient budgetary consolidation. Following this assessment the Commission recommended the Council to decide on the existence of excessive deficit in France and address a recommendation under Art. 104(7) with a view to bring this situation to an end until 2004. The decision and the recommendation were adopted on 3 June 2003. The deadline for taking action was set for the 3 October 2003. The French authorities did not take sufficient measures, which resulted in further deterioration of budget balance and lack of improvement in cyclically adjusted terms. The Commission recommended to the Council that it should decide that France did not take an effective action in response to the recommendation under 104(7) and the Council should proceed with the SGP procedure.

The voting on Commission’s recommendations for Germany and France took place at the same ECOFIN meeting on 25 November 2003. It was clear that this voting was to be a real test for the commitments included in the Resolution on the SGP. However, since two largest European economies were at the spot, one could expect some problems in reaching the

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consensus within the Council. The Commission recognized not only infringements of the SGP, but also insufficient actions undertaken by Germany and France in order to remedy the situation. Therefore, it prepared for the ECOFIN draft recommendations under Art. 104(8) and under Art. 104(9) addressed to Germany and France. The latter listed the measures which in the Commission’s view should be implemented in order to improve the situation. In both cases the deadline for bringing the excessive deficit situation to an end was to be postponed until the end of 2005. The first voting concerned the recommendations under Art. 104(8) and it included also the “out” countries. Although eight countries (Austria, Belgium, Denmark, the Netherlands, Greece, Finland, Spain and Sweden) were for the adoption of the recommendation, it accounted for only 37 out of 87 votes, which explicitly was not even a simple majority. Thus the European “heavy – weight” countries formed a blocking minority, which paradoxically was a “blocking majority”. The second voting was taken only by the Eurozone countries and with the same countries voting for, the recommendations under Art. 104(9) were not adopted. Interestingly, in the absence of formal decisions, the Council adopted conclusions recommending the countries concerned to take specific measures, which reflected the Commission’s draft recommendations. Moreover the Council decided that the procedure should be held in abeyance. This shows that although the Council agreed with the economic analysis conducted by the Commission services, the views on how to implement the SGP were diverse. Smaller countries and the Commission wanted to proceed to the next step, whereas countries which were subject to SGP and those being close to the SGP ceiling (with the exception of Ireland and Luxembourg) decided to give Germany and France additional time, without the recourse to stronger legal actions. This practically halted the procedure and deferred the threat of pecuniary sanctions.

The Commission, playing the role of the Treaty Guardian, reproached the Council that the failure to take decision and the adoption of draft conclusions were outside the spirit and the letter of the Treaty and the SGP. It also suggested that the Council had every right not to proceed with the SGP. This however, would require reaching a consensus that in the light of objective economic factors there is no need to adopt the recommendations prepared by the Commission. It would consequently mean that the Council confirms that Germany and France were effectively implementing the measures contained in the recommendation under 104(7). In the light of Council’s conclusions it is clear that the Council was of totally opposite point of
view. In other words, despite the fact that the Council endorsed the Commission’s economic assessment, by lack of decision it virtually suspended the procedure. With a view to clarify the situation for the future, the Commission decided to file a complaint against the Council with the European Court of Justice. Firstly, the Commission sought annulment of the decision not to adopt the measures contained in its recommendation. Secondly, it demanded annulment of the conclusions adopted by the Council insofar as they involved putting the excessive deficit procedure against Germany and France in abeyance and modified the Recommendation issued under 104(7). The Court gave a ruling after applying an accelerated procedure on 13 July 2004.62

Neither the Council’s nor the Commission’s point of view were fully endorsed by the judgment. As far as the first part of the claim is concerned, the Court deemed the Commission’s allegation inadmissible, which reflects the fact that the Council indeed has the discretionary power of deciding whether or not to proceed with the procedure. The ruling reveals that contrary to what the Commission argued, the fact that the Council did not adopt the recommendations does not mean that it implicitly decided that the countries concerned had in actual fact taken effective measures. The inability of the Council to achieve the qualified majority means that no decision was taken.63 The Court also stated that, although the SGP contains specific deadlines for its implementation, there is no deadline stipulating when such a decision should be taken, thus on the basis of the Commission’s recommendation the Council may take vote and adopt it anytime in the future.64 Basing on this considerations, the Court deemed the first part Commission’s claim inadmissible, arguing that the lack of adoption of decision in this case, cannot give rise to challenge for the purposes of Art. 230 EC, under which the Court reviews the legality of acts adopted by EU institutions. However, in paragraph 35 of the judgment the Court stated that if the Council does not adopt formal measures recommended by the Commission pursuant to Art. 104(8) and 104(9) the latter may have recourse to legal remedy as provided by Art. 232 EC, that is a legal proceeding against EU institution for infringing the Treaty by a failure to act. The first part of the ruling

62 See: European Court of Justice, Judgment in Case C-27/04 of 13 July 2004, European Court reports 2004

63 ibidem para. 33

64 This was in line with para. 5 of the Council conclusions in which it explicitly stated that “The Council stands ready to take a decision under Article 104(9), on the basis of the Commission Recommendation, should [the Member State concerned] fail to act in accordance with the commitments set out in these conclusions…”
confirmed the wide discretionary powers lying within the Council, yet it also points out an alternative legal basis, which would be more suitable for legal actions, if such situation was to reoccur. As far as the Council’s conclusions are concerned, the Court concurred with the Commission arguments. It established that the conclusions were designed so as to have legal effects of holding the procedure in abeyance and putting off the deadline for bringing the excessive deficit situation to an end. This in turn makes the Commission’s action admissible. The ECJ decided that basing on the broad logic of the Treaty and the SGP, the Council did not have the right to suspend the EDP. Moreover, it should not have made the holding of the procedure in abeyance contingent on the fulfillment of commitments made by the Member States concerned. This could virtually restrict its own right to issue notice under Art. 104(9), as long as the commitments are considered to be complied with. Also the modification of country specific recommendations was found to be unlawful, since recommendations under 104(7) may only be altered by the adoption of new recommendations. This was not the case, thus the Council could not postpone the deadline, as it would constitute a modification of the existing recommendations adopted by the Council in the early 2003. In other words the Court annulled “the Council’s conclusions of 25 November 2003 adopted in respect of the French Republic and the Federal Republic of Germany respectively, in so far as they contain a decision to hold the excessive deficit procedure in abeyance and a decision modifying the recommendations previously adopted by the Council under Article 104(7) EC”65.

To conclude, the ECJ judgment might be called an example of Solomon’s wisdom, as it partly satisfied both parties. It was confirmed that the Council is not obliged to take a decision promptly after the Commission’s recommendation. It was also reaffirmed that the Commission plays a very significant role in the surveillance mechanism. Moreover, the judgment stated that the Council is not allowed to change its previous decisions without the recommendation and thus consent from the Commission. A very important aspect is that Germany and France, basing on the presumption of validity of Council conclusions had the right to assume that the deadline for eliminating the excessive deficit was postponed. This means that until the ruling was published the countries concerned could plan to bring the situation to an end before end of the 2005. Surprisingly, both Germany and France made a

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65 European Court of Justice, Judgment in Case C-27/04 ..., op. cit.
considerable effort already in 2004 which, as will be presented below, makes the end of 2005 a plausible date for excessive deficit elimination in the Member States concerned. The inability to achieve the qualified majority within the Council and some visible efforts undertaken by the countries concerned might be regarded as the reasons for the Commission’s restraint to adopt new recommendations under Art. 104(8) and 104(9) during 2004.

2.4 EDP in the year 2004 and prospects for the future

The year 2004 brought more optimism into the EU thanks to the long expected economic recovery and the enlargement of the EU. As mentioned above the EDP against Portugal was abrogated and following the events of November 2003 and the Court ruling the Commission decided to interpret the SGP rules with more flexibility and take better account of a country’s specific situation. Nevertheless, it must be noted that new Member States are subject to the EDP right from the beginning. Apart from six accession countries Czech Republic, Cyprus, Hungary, Malta, Poland, Slovakia, which face difficult time in balancing their budgets, the EDP was also initiated against Greece, the Netherlands and the United Kingdom. The response of the Member States concerned to the Council Recommendation under Art. 104(7) was diverse.

The Dutch authorities decided to intensify efforts for bringing the situation back in line with the Pact. After recording the deficit of 3.2% GDP in 2003, mainly due to negative GDP growth of 0.9%, the budget for 2004 already contained some saving plans which were further complemented by additional savings package amounting to 0.6 percentage point of GDP. Most importantly half of these measures were of structural nature (e.g. lower health expenditure, elimination of subsidies on employing low-skilled workers), which would bring deficit reduction also in 2005. The consolidation effort undertaken in 2004 and planned for the subsequent years is bringing effects and therefore the Commission expects the deficit to decline to 2.6% in 2005. Due to that in December 2004 the Commission stated that the Netherlands had taken effective action in response to the Council Recommendation.

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66 The main proposals regarding the clarification of the SGP implementation were presented in European Commission, Commission’s Communication on Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact, COM (2004) 581 final
67 European Commission, Commission assesses the updated stability programme of the Netherlands (2004-2007), IP/05/23
In Greece, the situation went in directly opposite direction. After recording in 2003 deficit amounting to 3.2% of GDP, the budget balance deteriorated significantly in 2004, despite the GDP growth being the highest in the euro area. In its March 2004 Notification, Greece expected its deficit to reach 3%GDP. However, in the end of 2004 it became apparent that it was likely to reach 5.3%GDP\(^68\), a figure considerably beyond the threshold agreed in SGP. This shows the inability of Greek authorities to undertake sufficient measures to remedy the situation. This in turn, resulted in Commission’s recommendation for the Council to proceed with the EDP under Art. 104(8) and 104(9)\(^69\). On 18 January 2005 the Council taken a decision that Greece did not take effective actions to bring the excessive deficit situation to an end pursuant to Council recommendation of 5 July 2004. The Commission, however, suggest extending the deadline for the elimination of excessive deficit until the end of 2006, which is supposed to ensure that the measures will bring balanced and lasting improvement of budgetary positions.

It is crucial to note that in this proceeding another issue is of great importance, i.e. the accountability of the statistical data forwarded by Greece. The Commission an initiated infringement procedure against Greece alleging that the latter had been providing the European Institutions with false and inconsistent data. This is said to have started when Greece applied for the membership in the Eurozone, and became a routine during the process of budgetary surveillance\(^70\). Table 6 presents the data on budget deficit before and after the revision of figures, which took place in September 2004. This upward adjustment was due to large underestimations of expenditure on military equipment and interest payments and overestimation of social security surpluses.

<table>
<thead>
<tr>
<th>Year</th>
<th>Commission’s report under 104(3)</th>
<th>EDP notification September 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>-2.0</td>
<td>-4.1</td>
</tr>
<tr>
<td>2001</td>
<td>-1.4</td>
<td>-3.7</td>
</tr>
<tr>
<td>2002</td>
<td>-1.5</td>
<td>-3.7</td>
</tr>
<tr>
<td>2003</td>
<td>-3.2</td>
<td>-4.6</td>
</tr>
</tbody>
</table>

Source: European Commission, Commission assessment in relation to the Commission recommendation for a Council decision establishing whether effective action has been taken by Greece in Response to the Council recommendation under Article 104(7)

\(^{68}\) European Commission, Commission proceeds with excessive deficit procedure for Greece, IP/04/1527

\(^{69}\) European Commission, Commission recommends further steps under the excessive deficit procedure for Greece, IP/05/153

\(^{70}\) European Commission, Commission reports on Greek statistics, starts infringement procedure, IP/04/1431
These figures suggest that Greece had been having problems balancing its budget for the last decade, despite high economic growth. This makes it a good example of a country that SGP was designed to deal with. Furthermore, the Commission claims that the fiscal effort in terms of both nominal and cyclically adjusted figures was negative, meaning that budget expansion more than consolidation was pursued. Concluding, the fact that Greece has been violating the Pact’s rules since 2000 additionally raises the probability of the Council reaching a qualified majority and proceeding with the EDP against Greece. If this becomes true, Greece will need to show a great endeavor to improve its budgetary stance in the following years or it will risk the threat of pecuniary sanctions. It is the more probable as the Commission on the contrary to what the Greek authorities claim, expects the budget deficit to remain above 3% in 2005, the end of which was the initial deadline for remedying the situation.

As it has been mentioned, the situation in Germany and France improved in 2004 and both countries are expected to bring the deficit in line with the Pact already in 2005, which might be regarded as the fulfillment of political commitments made in November 2003. Those positive developments should be attributed to the recovery of economic conditions and consolidation efforts. As far as Germany is concerned, budget deficit is expected to decline to 2.9% in 2005, if the projected GDP growth of 1.7% materializes. The planned savings package includes three elements which, unfortunately, cannot be regarded as structural measures, but rather a temporary relief. First of all, in 2005 and 2006 the costs of pension payments to the servants of the former public post office will be covered by the cash settlement office, which belongs to the private sector. This will significantly reduce government expenditure. Secondly, the Federal ministries are obliged to global expenditure savings. It is a general obligation to spend less and it is not incorporated in specified items in the budgetary plans. Nevertheless, similar measure was designed and respected in 2004, which might be a good prophet for the year 2005. The last measure is bringing all increases in remuneration for public service in 2005 to a halt. Moreover following the Commission’s decision of 20 October 2004 seven regional banks “Landesbanken” will be obliged to repay subsidies received from regional

71 For more detail see: European Commission, The situation of Germany and France in relation to their obligations under the excessive deficit procedure following the judgment of the Court of Justice, COM (2004) 813

50
governments as they were deemed illegal\textsuperscript{72}. These measures are said to be effective in bringing the deficit under the 3\%GDP threshold.

Also the French government expects the budget deficit to decline to 2,9\% of GDP in 2005, under the assumption of 2,5\% GDP growth. This optimistic scenario is to be realized thanks to the stabilization of State expenditures and positive effects of health reform initiated in 2004, which will decrease the government expenditure. Also some tax increases are to improve the situation on the revenue side.

Summing up, Germany, France and especially the Netherlands have made a considerable effort to bring the excessive deficit situation to an end. In 2005 the planned deficits in case of France and Germany are only slightly below the threshold. Notwithstanding, the political will of the countries concerned together with larger flexibility of the Commission in SGP interpretation have resulted in the Commission’s conclusion that for the time being no further steps under the EDP are necessary. On the contrary, Greece which has been running over-expansionary expenditure policy for the couple of last years is likely to become the first country that might face the threat of being subject to pecuniary sanctions.

\textsuperscript{72} European Commission, \textit{Commission orders Germany to recover more than €3 bln, plus interest, from WestLB and six other public banks}, IP/04/1261
3. Situation of the new EU Member States in the light of the Stability and Growth Pact

3.1 Introduction

On 1st May 2004 the European Union enlarged by 10 new countries. Although the accession was preceded by a long time of preparation and negotiation process, the new Member States still lag far behind the old ones in terms of economic development. This is due to the fact that with the exception of Malta and Cyprus, the new Member States are transition economies of Central and Eastern Europe. Being under strong influence of the former Soviet Union for almost 50 years resulted in major differences in the economic structure between the accession countries and other Member States. The new Member States are characterized by a considerably lower level of income, large share of population employment in agriculture (19.2% in Poland, 16.5% in Lithuania, 15.1% in Latvia, 9.9% in Slovenia), infrastructural underinvestment and many other structural problems.73 A large divergence is also to be found in terms of labour productivity. Only Malta, Cyprus and Slovenia record higher productivity levels as compared to, e.g. Portugal which is characterized by lowest productivity among the old EU members. On the other hand, this negative feature is balanced by significantly lower levels of labour and product costs in the new Member States. Table 7 presents the unit labour costs (as a percentage of EU – 15 average) in some of the accession countries in 2001.

Table 7: Unit labour costs in manufacturing in 8 accession countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Unit labour costs in 2001</th>
<th>Unit labour costs in 1995-2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>30</td>
<td>3,9</td>
</tr>
<tr>
<td>Estonia</td>
<td>31</td>
<td>2,5</td>
</tr>
<tr>
<td>Hungary</td>
<td>29</td>
<td>-1,2</td>
</tr>
<tr>
<td>Latvia</td>
<td>33</td>
<td>3,9</td>
</tr>
<tr>
<td>Lithuania</td>
<td>25</td>
<td>14,1</td>
</tr>
<tr>
<td>Poland</td>
<td>46</td>
<td>2,6</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>22</td>
<td>0,8</td>
</tr>
<tr>
<td>Slovenia</td>
<td>72</td>
<td>1,9</td>
</tr>
</tbody>
</table>

1) Percentage of EU – 15 level using current exchange prices
2) Average growth in 1995-2001, percentage change
Source: European Commission, EMU after 5 years, op. cit. p. 157

73 For more detailed account of those differences see: European Commission, EMU after 5 years, op. cit., pp. 155-159
It appears that in the new Member States, Poland and Slovenia excluded, the unit cost of manufacturing accounts for only 1/3 of the average EU – 15 level. Despite the fact that the average costs are increasing, notably fast in Lithuania, it is a very important feature of those economies. It might be treated as an advantage which boosts their competitiveness. This in turn is likely to be a source of increased economic activity, resulting in higher than the EU average economic growth.

Differences between old and new Member States are in many cases structural and of a persistent nature. This implies that before the accession countries achieve economic and institutional structure similar to the one in the rest of EU, a long convergence process will take place. This process, although accelerated by ever higher market integration and the EU financial help in form of structural and regional funds, may last many decades. It is likely to be vary fast in the beginning, but as the difference in terms of the GDP level between the old and new members decreases, it will most likely lose on speed. So far, the accession countries have been recording significantly higher levels of economic growth than the old EU, but still the economic gap remains enormous. Buiter and Grafe\textsuperscript{74} argue that assuming the EU economy grows on average by 2\%GDP annually, Slovenia is expected to catch-up the EU GDP average in 25 years if its GDP rises by 3,3\% every year. In case of Poland, if the convergence is to be fulfilled within the same time horizon, its GDP would have to grow by 6\% annually, whereas in case of Latvia it would have to be more than 7,3\% per year. This is a clear illustration of the real gap in terms of economic development between the new and old Member States.

While high economic growth may be a source of additional budgetary revenues, due to the working of the automatic stabilizers, the convergence process will require additional public resources to finance investments and reforms. Therefore, it is difficult to assess whether the new Member States will be able to keep the budgetary deficits below 3\% SGP threshold. In this respect it is important to examine the status of the accession countries in the fiscal surveillance mechanism.

\textsuperscript{74} Buiter W., Grafe C., \textit{Patching up the Pact…}, op. cit., p. 72
3.2 The legal situation of accession countries under the SGP

The accession countries are participating in the EMU as Member States with derogation, which means that they are obliged to introduce the Euro at some date in the future, however no deadline is established. Although, the monetary policy remained the sole competence of the new Member States, the economic policy, including fiscal issues is subject to coordination mechanisms described in Chapter 1. The budgetary situation of those countries is monitored under the surveillance framework and the EDP may be initiated against them. However, in line with Art. 122(3) of the Treaty Member States with derogation are not subject to Art. 104(9) and 104(11) of the Treaty, i.e. the Council notice and application of sanctions. This means that the accession countries will not face the threat of sanctions foreseen by the SGP. However, some other incentives remain in force to discipline the new Member States in case they permanently fail to act within the SGP boundaries.

First of all, most of the accession countries are willing to accept the Euro as soon as possible. To achieve this goal they need to fulfill the Maastricht criteria, including the one concerning the level of budget deficit. Not respecting the 3% GDP threshold and being under the EDP may considerably delay the introduction of the Euro in the Member States concerned.

Secondly, a sound fiscal policy and respecting the commitments presented in the Convergence Programmes will be a crucial factor in assessing the credibility of economic policies pursued by the accession countries. If a country fails to respect the Council’s recommendation under the EDP, the reaction of financial markets and foreign companies may adversely influence the economy.

Thirdly, there is a threat of losing some of the EU financial help. If the Council decides by a qualified majority on a recommendation from the Commission that the Member State concerned has not implemented the Convergence Programme in such way so as to avoid an excessive government deficit, it is possible to suspend the funding for projects under the Cohesion Fund. Although in a legal sense it poses a threat to the accession countries, one can

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76 One of the examples is a loss in terms of Foreign Direct Investments, which are very important for the process of restructuring accession countries’ economies e.g. the value of FDI in Czech Republic in 2002 amounted to 12.7%GDP, while in Lithuania 5.3%GDP

54
suspect that it would be politically unfeasible, particularly that such a decision requires achieving a qualified majority in the Council.

Concluding, the accession countries are subject neither to enhanced budgetary surveillance nor to sanctions. Still, persistent non-compliance with the Council recommendations may inflict a loss of political capital. Additionally, it may cause the suspension of project funding in the framework of the Cohesion Fund. Last but not least, a loss of credibility on the international arena may result in the aggravation of financial ratings and smaller volume of FDI.

3.3 Situation of public finance in accession countries

Although the accession countries face similar challenges arising from structural problems, their budgetary situation is quite diverse. On the one hand the Baltic States record favourable budgetary balance. Furthermore, their public debt to GDP ratio is extraordinarily low, as compared to most other Member States. On the other hand three biggest accession countries: Poland, Hungary and the Czech Republic had and are still having major problems in balancing their budgets, which also led to a significant increase in debt to GDP ratio. Also Malta and Cyprus, despite their high level of economic development were characterized by high deficit levels before the accession. (Table 8)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>-6.8</td>
<td>-12.6</td>
</tr>
<tr>
<td>Estonia</td>
<td>1.4</td>
<td>3.1</td>
</tr>
<tr>
<td>Cyprus</td>
<td>-4.6</td>
<td>-6.4</td>
</tr>
<tr>
<td>Latvia</td>
<td>-2.7</td>
<td>-1.5</td>
</tr>
<tr>
<td>Lithuania</td>
<td>-1.5</td>
<td>-1.9</td>
</tr>
<tr>
<td>Hungary</td>
<td>-9.2</td>
<td>-6.2</td>
</tr>
<tr>
<td>Malta</td>
<td>-5.8</td>
<td>-9.6</td>
</tr>
<tr>
<td>Poland</td>
<td>-3.6</td>
<td>-3.9</td>
</tr>
<tr>
<td>Slovenia</td>
<td>-2.4</td>
<td>-2.0</td>
</tr>
<tr>
<td>Slovakia</td>
<td>-5.7</td>
<td>-3.7</td>
</tr>
</tbody>
</table>


Six out of ten accession countries recorded deficit levels infringing the SGP rules in 2002 and 2003. Having analyzed the data forwarded by new Member States in March 2004, the
Commission initiated the EDP against Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia. On 5 July 2004, the Council decided that excessive deficit existed in each of the above-mentioned countries and issued a recommendation under Art. 104(7) to each of them, urging to bring the situation to an end. For all the countries concerned the deadline for taking appropriate measures was set for 5 November 2004. Conversely, the time limits for bringing the deficit below the 3% GDP threshold were prolonged and set individually. Although, at first sight it does not seem to be in line with the SGP, it is a result of the use of the exceptional clause contained in Art. 3(4) of Regulation 1467. It stipulates that situation of excessive deficit should be corrected in the year following its identification, unless there are special circumstances. The economic underdevelopment of the new Member States and the fact that the accession occurred while they were experiencing severe difficulties in balancing their budgets were deemed to be such special situation. Moreover, it might be argued that requiring the countries concerned to eliminate the excessive deficit by the end of 2005 would be without prospects for success and unjustifiable from the economic point of view. Thus, when the Commission assessed the first convergence programmes submitted by the accession countries, it devoted special attention to the issues of past budgetary developments, the current level of deficit (e.g. Czech Republic –12,6%GDP in 2003) and the proclaimed programme aimed at its elimination. In the end the deadlines were set basing on the deficit adjustment paths presented in the individual convergence programmes. The fact of deadlines differentiation might be a proof of a more flexible approach followed by the Commission with respect to the new Member States.

Following the Council’s recommendation under Art. 104(7) issued on 5 July 2004, the countries concerned undertook special measures in order to correct the situation. At the time of writing five out of the six Member States, excluding Hungary, received a positive opinion from the Commission for the consolidation effort. On 14 December 2004 the Commission published its communication to the Council on the action taken by the countries concerned in the light of the EDP. The communication stated that in the Commission’s view the Czech Republic, Malta, Cyprus, Poland and Slovakia had taken effective action within the given deadline and it appeared that those measures would be sufficient to achieve the deficit target in

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79 European Commission, The action taken by the Czech Republic, Cyprus, Malta, Poland, Slovakia in response to the Council recommendation under the excessive deficit procedure, SEC(2004) 1630/2
2005. This clearly indicated that the Commission looked at the progress in following the
adjustment path together with the ability to fulfill commitments included in the convergence
programmes. Since the imbalance was improved and substantial effort was recognized, the
Commission concluded that at this point no further steps under the EDP were necessary.
Although the Commission took a flexible approach to the EDP implementation against new
Member States, not all of them managed to satisfy the requirements.

In the convergence programme of March 2004, the Hungarian authorities presented an
ambitious plan towards the excessive deficit elimination. Although in 2003 Hungary recorded
a very significant deficit amounting to 6,2%GDP, the deficit targets for the following years
were significantly lower. (Table 9)

| Table 9: The comparison of Hungarian and Commission’s forecast on budget deficit (%GDP) |
|---------------------------------|--------|--------|--------|--------|--------|
|                                 | 2003   | 2004   | 2005   | 2006   | 2007   |
| Hungarian Convergence Programme | -5,9   | -4,6   | -4,1   | -3,6   | -3,1   |
| Commission forecast             | -6,2   | -5,5   | -5,2   | -4,7   | N/A    |


The planned reduction in budget deficit amounting to 1,3%GDP between years 2003 and 2004
in reality appeared to be an overoptimistic forecast. In response to the Council’s
Recommendation under Art. 104(7), the Hungarian authorities prepared a consolidation
package. Yet, due to expenditure slippages, an over-optimistic revenue forecast and upward
revision of 2003 budget deficit\(^{80}\), the official target for budget deficit in 2004 had to be revised
up to 5,3% GDP. Although it represented a significant improvement of 0,6%GDP as compared
to budget deficit in 2003, it was still not in line with the adjustment path proposed by the
Hungarian authorities. As a result of this slippage, the draft budget for 2005 foresees deficit of
a 4,7%GDP, a substantially higher figure than planned in May 2004. The further consolidation
is to be achieved thanks to debt servicing savings and some expenditure restraints. The
Commission carried out its own forecasts, which show that the deficit in 2005 is likely to be
much higher and amount to 5,2%GDP. Although Hungarian authorities took some measures in
order to remedy the situation of an excessive deficit, the Commission concluded that the

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\(^{80}\) European Commission, *Commission assessment in relation to the Commission recommendation for a Council
decision establishing whether effective action has been taken by HUNGARY in response to the Council
recommendation under Art. 104(7)*,
action was ineffective and on 22 December 2004 recommended the Council to decide accordingly. The Council took such a decision under Art. 104(8) on 18 January 2005 and this was practically the last step of the EDP available against the new Member State. Since the pecuniary sanctions cannot be imposed, the only penalties for not following the convergence programme may be in form of the above-mentioned loss of political and financial credibility. In long-term perspective, there is however a more distressing aspect of this case. Contrary to what had been planned in the convergence programme, the Hungarian authorities failed to undertake important structural reforms mainly in public administration, health and education. If such necessary reforms are further postponed Hungary might face even more serious problems in medium-term.

Concluding, the Recommendation issued under Art. 104(7) by the Council to 6 new Member States was of significant importance for pursuing the deficit adjustment path. However, despite higher than expected GDP growth in 2004, not all of the countries have conducted sufficient budgetary consolidation. Some, e.g. Hungary failed to undertake sufficient measures whereas in some, e.g. Poland, whose case will be discussed below, the ambitious public expenditures reform published in the Convergence Programme appears to be more of political promise than a real life event.

3.4 Closer look at the situation of Poland

3.4.1 Structural problems

Poland is the largest of the accession countries and with the Czech Republic and Hungary is regarded as the core of the enlargement. Although it is of considerable size and population, Polish GDP per capita amounts to only 45% of the average level for enlarged EU. Furthermore, as in case of other EU Member States, Poland is likely to be hit by the population ageing phenomenon and as a consequence an increase of expenditure for social security system. Table 10 presents the demographic forecast until 2050. It appears clearly that commencing in 2020, the Polish population is expected to decrease rapidly (39.4mln in 2020 to 35mln in 2050), whereas the life expectancy is expected to increase significantly. This,

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81 European Commission, Commission proceeds with excessive deficit procedure for Hungary, IP:04/1528
together with the fact that the retirement age is not likely to be changed in the near future\textsuperscript{82}, might lead to an increased financial burden for the society and the government.

<table>
<thead>
<tr>
<th>Table 10: Demographic forecast for Poland 2002-2050</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Population (mln)</td>
</tr>
<tr>
<td>Life expectancy (years from birth)</td>
</tr>
<tr>
<td>Males</td>
</tr>
<tr>
<td>Females</td>
</tr>
</tbody>
</table>

Source: Polish Government, May 2004 Convergence Programme for Poland

If one assumes that the retirement age remains at current levels, i.e. 65 years for men and 60 for women, one can expect that the number of pensioners will rapidly rise, while the number of the insured will decrease. This expectations are supported by the social forecast presented in Polish Convergence Programme\textsuperscript{83}. (Table 11)

<table>
<thead>
<tr>
<th>Table 11: Forecast for Social Security Sector 2002-2050, base scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Number of insured (mln)</td>
</tr>
<tr>
<td>Number of pensioners (mln)</td>
</tr>
<tr>
<td>Revenues for Insurance (%GDP)</td>
</tr>
<tr>
<td>Expenditures on Insurance (%GDP)</td>
</tr>
</tbody>
</table>

Source: Polish Government, May 2004 Convergence Programme for Poland

It can be clearly seen that the ratio of insured to pensioners will be decreasing, which means that a smaller and smaller number of working people will have to pay for social benefits of ever larger group of elderly persons. To counter the adverse financial consequences a reform of the pension system was undertaken by Polish authorities in 1999. It was based on the creation of individual pension accounts. Moreover a three-pillar system was introduced. The first pillar consists of obligatory contributions paid to Social Insurance Institution. The second

\textsuperscript{82} One of the main proposal of the so called “Hausner Plan” (plan for remedying public finance in Poland) was the gradual equalization of retirement age for men and women at 65 years, however it was not endorsed by the Polish Parliament

\textsuperscript{83} Social Insurance Institution is a governmental agency responsible for Polish security and insurance system
pillar is also compulsory, but governed by private pension funds. The third one is based on voluntary pension contributions. Linking pension benefits closer to pension contributions is expected to reduce the costs borne by the government. The governmental participation in the national insurance scheme is expected to decrease and the expenditures are assumed to be almost fully covered by insurance revenues in 2050. This is an example of a necessary structural reform, which, though resulted in additional expenditures at the time of implementation, is likely to bring significant improvement of the public finance situation in Poland in the future.

Nonetheless, one has to bear in mind that there are a lot of other structural problems remaining in Poland, e.g. a high unemployment rate (19.8%), underdeveloped infrastructure (e.g. less than 300km of highways), low productivity (approximately two times lower than EU – 15 average). To overcome the problems other reforms are inevitable. This will require large financial resources, a part of which will be provided by EU structural and regional funds. However, due to the principle of co-financing, the Polish budget will also have to contribute considerable amounts of funds. Thus, it is necessary to create budgetary means that could be devoted to this aim, without risking the possibility of putting the budgetary situation in imbalance. Yet, the empirical evidence shows that despite higher than expected GDP growth, Polish authorities record significant problems in balancing the budget, leave aside generating additional funds for investments.

3.4.2 Public finance situation and prospects for the future

Being a Member of the EU, Poland is obliged to avoid excessive government deficit and although not subject to pecuniary sanctions, is subject to surveillance mechanism. Moreover, reasonable fiscal policy and sound budgetary stance is an important, positive sign for external partners. Therefore, the budget balance should be treated with due respect. Similarly to other Member States, Poland recorded a period of economic stagnation in the first years of the new millennium, followed by economic recovery in 2003 and 2004 (Table 12).
Table 12: GDP growth and budget deficit in Poland 2000-2006 (in percent GDP)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP growth</td>
<td>4.0</td>
<td>1.4</td>
<td>1.0</td>
<td>3.7</td>
<td>5.0</td>
<td>5.0</td>
<td>5.6</td>
</tr>
<tr>
<td>(5.7)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Budget balance</td>
<td>-1.8</td>
<td>-3.5</td>
<td>-4.0</td>
<td>-4.1</td>
<td>-5.7</td>
<td>-4.2</td>
<td>-3.3</td>
</tr>
<tr>
<td>(-5.4)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross debt level</td>
<td>36.6</td>
<td>36.7</td>
<td>41.2</td>
<td>45.3</td>
<td>49</td>
<td>51.9</td>
<td>52.7</td>
</tr>
<tr>
<td>(45.9)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(47.6)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>(48)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: figures in brackets are revised forecast of Polish authorities presented in the Update of May 2004 Convergence Programme

As it has been mentioned above, the deficit of 4.1%GDP recorded in 2003 was the reason for putting Poland in an excessive deficit position in July 2004. Another source of concern was the rapid increase in the level of the public debt. Although well below the Treaty threshold of 60%GDP, during the years 2000-2003 it rose by almost 10%GDP as a result of lower budgetary revenues, over-expenditure and higher cost of debt servicing. In the Convergence Programme, Polish authorities presented an adjustment path for both the budget deficit and the public debt, which were accepted by the Council and the Commission. An ambitious plan for reforming public finances\(^{84}\) was prepared in order to accelerate the deficit reduction and diminish the significant share of determined expenditures\(^{85}\). (Table 13)

Table 13: Structure of general government sector expenditures 2003 – 2007 (in per cent)

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total expenditure</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Determined</td>
<td>42.5</td>
<td>40.7</td>
<td>40.7</td>
<td>39.1</td>
<td>39.3</td>
</tr>
<tr>
<td>Flexible</td>
<td>57.5</td>
<td>59.3</td>
<td>59.3</td>
<td>60.9</td>
<td>60.7</td>
</tr>
</tbody>
</table>

Source: Polish Government, Update of May 2004 Convergence Programme for Poland, 11.2004

The increase in flexible expenditures aimed to create an additional flexibility margin for the budget in case of an economic slowdown, while curbing expenditures and generating more revenue was supposed to be a response to ever increasing budget deficit and a large increase in the public debt.

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\(^{84}\) “Programme for Rationalization and Reduction of Public Expenditure”, so called Hausner Plan – named by the main author deputy prime minister Jerzy Hausner

\(^{85}\) These are the financial commitments of public sector arising from law or international treaties, such as social benefits, EU budget contribution, cost of public debt servicing
The plan foresaw remedying measures on both sides of the balance sheet. Additional revenues were planned to be the consequence of the changes in the tax system and the unification of competition rules among economic entities. The programme contained among others the following actions:

- extension of income tax base paid by farmers,
- gradual unification of VAT rates,
- enhancing efficiency of tax apparatus,
- reform of the farmers’ social security scheme and simplification of the financial structure of the Agricultural Social Insurance Fund,
- widening the basis for calculating social insurance contribution.

The core of the plan lied however in major expenditures curbing. The proposed measures included inter alia:

- significant cuts administrative expenditures of the public sector, by lowering the employment in the voivodship and a reduction of operational costs,
- changes in the rules of financing the national defence,
- further reform of the financial aspect of public health care institutions,
- gradual elimination of pre-retirement benefits granting with full elimination in 2006,
- elimination of automatic valorization of old-age and disability pensions and replacement of price-wage with price-only indexation of retirement and disability pensions,
- verification of persons entitled to disability pension and family pension access limitation.

This broad plan for reforming the public sector in Poland was regarded as a major step in diminishing the social burden on the budget and thus preparing it for additional expenses connected with the membership in the EU86 and the need of co-financing. It was also thought to have a favourable effect upon reducing the percentage share of the State in economic activity. Thus, the crowding-out effect would also be reduced. The estimated financial effect of Hausner Plan is presented in Table 14.

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86 The estimated annual contribution of the Polish budget to the EU budget amounts to 1,1% of the Polish GDP
Table 14: Estimated effect of the Hausner Plan on general government sector in 2005-2007

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue change</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>in PLN (bln)</td>
<td>7</td>
<td>7.6</td>
<td>8</td>
<td>22.6</td>
</tr>
<tr>
<td>in % GDP</td>
<td>0.75</td>
<td>0.75</td>
<td>0.73</td>
<td>-</td>
</tr>
<tr>
<td><strong>Expenditure change</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>in PLN (bln)</td>
<td>7.7</td>
<td>12.1</td>
<td>11.1</td>
<td>31</td>
</tr>
<tr>
<td>in % GDP</td>
<td>0.8</td>
<td>1.2</td>
<td>1</td>
<td>-</td>
</tr>
</tbody>
</table>

Source: Polish Government, May 2004 Convergence Programme for Poland; own calculations

Unsurprisingly, with time, the scope of reforms foreseen by the government was getting tighter and tighter due to lack of political support from the opposition. As a consequence some of the main proposals were abandoned, e.g.:

- verification of persons entitled to disability pension,
- gradual elimination of pre-retirement benefits granting with full elimination in 2006,
- equalization of retirement age for men and women.

Some actions have already been approved by the Parliament e.g. the change in the valorization method or the change of the national defence financing. Other important reforms which concerned the insurance scheme for farmers or the rules for employment of handicapped persons and which in the year 2005 were to bring savings amounting to PLN 3,5bln were postponed. In this perspective a distressing fact is that the year 2005 will be the year of parliamentary elections. Due to the elections the incumbent government might pursue over-expansionary policy to gain more votes. Deputy prime minister Jerzy Hausner has already stated that not only he was doubtful about the full execution of his plan, but also he was afraid of the Parliament legislating irresponsible social expenditures in the race for voters. This poses a great threat to the initiated budgetary consolidation process.

3.5 Lessons to be drawn by the new Member States

By joining the EMU, the accession countries entered the second stage of the preparation for the full participation in the monetary union. It means that they are not subject to pecuniary sanctions under the SGP, but in order to adopt the Euro they must fulfill the Maastricht criteria. Their situation is quite different from the one of the old Member States. On the one hand, they require large amounts of capital to finance their further development and structural reforms. Since the domestic sources of private funds are rather limited, it is viable that the necessary capital should be provided by the government, foreign direct investment and the EU structural funds. The investment expenses will be an additional burden for the budget, which may inflict higher levels of budget deficits. On the other hand, the catching-up process will
result in significantly higher levels of GDP growth. This, if accompanied by reasonable fiscal policy, is likely to generate extra revenues and thus decrease the threat of running excessive deficits.

Half of the accession countries are currently subject to the EDP. Although they presented ambitious plans for correcting the excessive deficit situation, so far it is difficult to judge whether their programmes will be fully executed. The new Member States are already characterized by a high level of economic integration with the rest of EU, therefore they are under the influence of similar cyclical developments, e.g. protracted economic slowdown of the 2001-2003 which led to rising budgetary expenditures and decreasing revenues. Bearing in mind the overall higher volatility of economic conditions in the new Member States, a due account should be taken to the budgetary developments. It is important that budgetary expenditures would contribute to structural reforms and large-scale investments. The EDP proceedings should be treated as good stimulants ensuring prudent fiscal policy. Yet, to assure sound budgetary positions the governments need to pursue complex and comprehensive public finances’ reforms.

The excessive budget deficit recorded in 2003 together with the Council Recommendation under Art. 104(7) were important incentives for the Polish authorities to plan corrective measures. It is already clear that ambitious Hausner Plan will not be fulfilled. This is the evidence that without political and public consensus it is impossible to pursue efficient budgetary consolidation. However, thanks to strong economic revival and some consolidation effort Poland managed to stay in line with budgetary adjustment path presented to the Council in May 2004. On the contrary, Hungary, which also experienced higher-than-expected GDP growth, failed to keep in line with Council Recommendation.

Concluding, new Member States should take advantage of high GDP growth and pursue necessary structural reforms. Notwithstanding, they should also proceed with ambitious consolidation efforts, since high cyclical volatility requires additional room for maneuver in case of adverse economic shocks. The accession countries subject to the EDP should take advantage of the Commission’s flexible approach to their cases in the surveillance mechanism and use this favourable treatment to reform public finances and prepare for population ageing. Moreover, reasonable fiscal policy will be a crucial factor in the run-up to the adoption of the Euro and should ensure staying below the 3%GDP deficit ratio required by the SGP.
4. SGP – problems and prospects

Since the Pact’s adoption in 1997, many concerns have arised mainly concerning its construction and efficiency in inducing Member States to pursue reasonable fiscal policies. Although the Commission estimates that without the EU fiscal framework the deficit-bias might have been larger, it also affirms that the fiscal policy pursued on average in the Eurozone might be regarded as pro-cyclical, which is presented in Figure 6.

![Figure 6: Fiscal stance and cyclical conditions in Eurozone, 1999-2005](source: European Commission, European Economy - Public Finances in EMU – 2004, SEC(2004) 761, p. 20)

It shows that while in the period of 1999 – 2001, when the European economy was characterized by a considerable positive output gap, the cyclically adjusted primary balance deteriorated significantly. This is a result of fiscal loosening pursued by some countries of the Eurozone. Moreover, the Figure presents that the years 2004 and 2005 are likely to be neutral in terms of fiscal stance. Since there are clear signs of an economic recovery in most of the Member States, the experience of the last years should additionally induce them to intensify efforts aimed at the improvement of the budgetary positions. The evidence given in Chapter 2 and 3 shows that although the plans for budgetary consolidation are present, their execution is facing numerous obstacles of a political and social nature. This in turn shows that the initial design of the Pact, which focused mainly on the numerical value of the actual budget deficit, disregarding the debt/GDP ratio and imposing rather unified application of its rules should be
reconsidered. Before turning to the discussion on proposals for Pact’s reform, it is inevitable to review its main weaknesses.

4.1 Problems experienced with the implementation of the Pact

4.1.1 Bad quality of statistical data

Firstly, one should consider the technical problem of obtaining correct data, which as the experience shows might become a crucial obstacle in the timely implementation of the Pact. The most remarkable cases are Portugal and Greece. The former one revised the data concerning its 2002 budget deficit as late as September 2004, which significantly delayed the initiation of the EDP. The latter had been failing to provide the Commission with proper statistical data since 1997, which resulted in the upward revision of the budget deficit figures for the period of 1997–2003 amounting to an annual average of 2.1%GDP. Furthermore, it has to be underlined that some of the accession countries (e.g. Poland) are still working on the full incorporation of ESA95 standard into their budgetary statistics. For those reasons it can be deduced that EU statistical governance still suffers from weaknesses and insufficiencies, which should be remedied in order to ensure integrity and accountability of data used under the surveillance mechanism and thus rising its efficiency.

4.1.2 Frequent use of one-off measures

The second source of concern may be found in the frequent recourse to one-off measures\textsuperscript{87}. Although not negative \textit{per se}, they usually result in only temporary effects on the budgetary balance, thus making the assessment more difficult. In most cases they are an easy source of additional revenues for the government and by bringing a temporary relief for the budget they might delay the execution of necessary structural reforms. The Commission’s Report on the public finance in the EMU reveals that one-off measures such as sales of real assets and licences or tax amnesties/settlements have been a common practice in the recent years with considerable influence on budget balances. In case of Portugal and Italy, for example, it might be even suspected that those measures were undertaken in the years 2002 – 2004 with the purpose of keeping the actual deficit under the 3%GDP threshold. In this respect it is

\textsuperscript{87} For more details see: European Commission, \textit{European Economy - Public Finances in ...}, op. cit., pp. 74-78
noteworthy that the accession countries are conducting the privatization process, which by generating additional revenues for the government may blur the image of budgetary stance. Therefore, there exists a need of formal definition of what constitutes an one-off measure and how it should be assessed under the surveillance mechanism, i.e. how to differentiate between measures taken in course of a reasonable policy and those implemented in order to obtain a more favourable image of the budgetary figures.

4.1.3 Problematic use of the CAB in gauging the consolidation effort

Another technical problem was identified in connection to the assessment of budgetary adjustment based on the cyclically adjusted figures. While the nominal budget deficits are used to assess the current budgetary balance of the Member States, the CAB is the main indicator examined under the close-to-balance-or-in-surplus construction. Its main advantage is that it corrects the actual figures for the influence of the economic cycle. Thus, it is used in the assessment of a close-to-balance position in medium term perspective and in measuring the risk of breaching the 3% GDP ceiling. Another key application of this indicator follows the 2002 Eurozone countries’ commitment to the annual reduction of the CAB amounting to 0.5%GDP as long as their nominal deficit stays above the SGP limit. The countries concerned are expected to propose measures ensuring that such reduction will occur. In case there was a divergence between planned and realized consolidation, the Commission treated this as a failure to execute the planned measures. On the contrary, some Member States claimed that they fully implemented the promised measures, but nevertheless, they did not achieve the targeted CAB correction. This results from the fact that the planned CAB reduction is contingent on the potential GDP growth. In case a GDP growth forecast is overly optimistic, Member States would have to execute additional consolidation measures in order to achieve the planned CAB improvement. If the forecast error is large, the fiscal policy of the Member State concerned might be perceived as overly expansionary (since it did not result in the targeted CAB correction), despite being pursued in line with the planned budgetary tightening. Currently the budgetary adjustment measured by the CAB is not corrected for the influence of

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88 This is due to the methodology of estimating the CAB
the unexpected growth surprises, however the Commission made some technical proposals which are to remedy this methodological problem\textsuperscript{89}.

\textbf{4.1.4 Mixed history of the SGP enforcement}

The next source of concern might be found in the mixed history of the SGP implementation. The empirical evidence shows that both the preventive and dissuasive part of the \textit{Pact} have some weaknesses. First of all, the early warning procedure did not prove to be efficient. In the beginning of 2002 the Council did not endorse the Commission’s recommendation to address an early warning to Germany and Portugal. This was attributable to the explicit political commitments of the countries concerned to avoid the occurrence of an excessive deficit situation. As described in Chapter 2 the countries failed to respect self-imposed obligations. In case of France the early warning was adopted after more than two months from the Commission’s recommendation.

Furthermore, the EDP proved itself difficult to be enforced. By contrast with the initial Waigel’s proposal, the \textit{Pact} does not foresee the automatic imposition of sanctions. Thus, the Council is able to reject the Commission’s recommendation in course of the EDP, because it failed to achieve the qualified majority. The cases of Germany and France, countries that repeatedly breached the 3\%GDP threshold, cast some shadow on the SGP credibility. As de Haan, Berger and Jansen state\textsuperscript{90}:

\textit{“There are no strong incentives for member states to prevent other member states from deviating from the non-binding political commitment to strive for a balanced budget...”}

As explained in Chapter 1, there exists a threat of contagion behaviour, due to weak enforcement mechanism and its low level of credibility. Indeed, more and more countries are becoming subject to the EDP. After the cases of Germany and France the procedure was initiated against the Netherlands, the UK and Greece. Portugal and Italy are permanently balancing on the verge of the SGP ceiling.

Following the above-mentioned concerns some improvements in legal construction of the surveillance mechanism and the EDP might be found in the EU Constitution. The changes

\textsuperscript{89} European Commission, \textit{European Economy - Public Finances in ...}, op. cit., pp. 82-83
aim at the reduction of influence on the decision making process in course of fiscal surveillance of the Member States that do not participate in the Euro. According to the Treaty establishing the Constitution for Europe, the country being under examination and countries with derogation will be excluded from the voting in the course of the multilateral surveillance mechanism (Art. III – 179) and the EDP (Art. III – 184). Other improvements partly reflect suggestions to reduce the risk of partisan implementation of the SGP as put forward by S. Eijffinger\textsuperscript{91}. The author proposes that the Commission should issue the first early warning without the Council’s participation and decide on the existence of the excessive deficit. Moreover, the sanction mechanism should be based on the Commission’s proposal as opposed to Commission’s recommendation. This would mean that a decision to deviate from the Commission’s assessment would require unanimity within the Council. However, as Eijffinger suspected it is unlikely that the Council would be able to significantly increase the Commission’s power in order to enhance the Pact’s credibility. Consequently, the Constitution makes only a small step in the suggested direction. It stipulates that the Commission shall have the power to issue a formal early warning directly to the Member State concerned. This is a sign of increasing the Commission’s role in the surveillance procedure which aims at accelerating and facilitating the initiation of the procedure. Therefore, it is likely to eliminate problems similar to those experienced with the current construction of the early warning procedure. Secondly, according to the Constitution, the Council is to take a decision on the existence of an excessive deficit, basing on the Commission’s proposal and not, as it used to be, recommendation. Therefore any divergence from the Commission’s proposal would require unanimity within the Council.

\textbf{4.1.5 High debt levels, budgetary risks and the scope for long-term sustainability}

One of the main shortcomings of the SGP lies in the fact that it disregards the debt level and its dynamics which are very crucial factors in assessing the stability of public finance and long-term perspectives. Maintaining a high debt/GDP ratio might have various negative consequences. First of all, it might lead to budget inflexibility following from large costs of

\textsuperscript{91} Eijffinger, S., \textit{Reform of the Stability and Growth Pact,} Briefing Paper for the European Parliament on “The Conduct of Monetary Policy and Evaluation of the Economic Situation in Europe – 1\textsuperscript{st} Quarter 2004 (February 2004)”
debt servicing or legal limits present in the national law on public finance. Secondly, it might result in higher interest rates. A highly indebted government will need to pay a higher premium to attract private savings, which in turn is likely to result in crowding out of private investment. Thirdly, a rapidly growing public debt may undermine the country’s financial and price stability. Such instability may result in internal economic perturbations and worsen the international financial ratings. Last but not least, as Artis and Buti note:

“...the market’s belief in the government’s ability to actually repay its debt is based on the government’s ability to tax and ability to pay off debt in its own currency”

Full participation in the EMU means that no individual country can implicitly promise to pay off its debt by using its own currency. Since the Treaty forbids a bail-out by ECB and national banks, governments should pursue a reasonable fiscal policy minimize the threat of instability by keeping the debt/GDP ratio at sustainable level.

As explained in Chapter 1, the Maastricht Treaty does include the maximal debt to GDP criterion. However, the authors of the Pact decided that the debt criterion will be satisfied thanks to the close-to-balance-or in surplus medium–term target for budgetary positions. The empirical evidence shows that similarly to the budget deficits the performance of various Member States in this respect is diverse. (Table 15)

### Table 15: Debt levels in some EU countries in 1998-2004 (in % of GDP)

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<thead>
<tr>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>119,6</td>
<td>114,9</td>
<td>109,1</td>
<td>108</td>
<td>105</td>
<td>100</td>
<td>95,8</td>
</tr>
<tr>
<td>Germany</td>
<td>60,9</td>
<td>61,2</td>
<td>60,2</td>
<td>59,4</td>
<td>60,9</td>
<td>64,2</td>
<td>65,9</td>
</tr>
<tr>
<td>Greece</td>
<td>105,8</td>
<td>105,2</td>
<td>114</td>
<td>114,7</td>
<td>112,5</td>
<td>109,9</td>
<td>112,2</td>
</tr>
<tr>
<td>Spain</td>
<td>64,6</td>
<td>63,1</td>
<td>61,1</td>
<td>57,5</td>
<td>54,4</td>
<td>50,7</td>
<td>48,2</td>
</tr>
<tr>
<td>France</td>
<td>59,5</td>
<td>58,5</td>
<td>56,8</td>
<td>56,5</td>
<td>58,8</td>
<td>63,7</td>
<td>64,9</td>
</tr>
<tr>
<td>Ireland</td>
<td>53,7</td>
<td>48,7</td>
<td>38,3</td>
<td>35,9</td>
<td>32,7</td>
<td>32,1</td>
<td>30,7</td>
</tr>
<tr>
<td>Eurozone</td>
<td>74,1</td>
<td>72,7</td>
<td>70,4</td>
<td>69,4</td>
<td>69,4</td>
<td>70,7</td>
<td>71,1</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>15</td>
<td>16</td>
<td>18,2</td>
<td>25,3</td>
<td>28,8</td>
<td>37,8</td>
<td>37,8</td>
</tr>
<tr>
<td>Hungary</td>
<td>61,6</td>
<td>60,9</td>
<td>55,4</td>
<td>53,5</td>
<td>57,2</td>
<td>59,1</td>
<td>59,7</td>
</tr>
<tr>
<td>Poland</td>
<td>N/A</td>
<td>40,1</td>
<td>36,8</td>
<td>36,7</td>
<td>41,4</td>
<td>45,4</td>
<td>47,7</td>
</tr>
</tbody>
</table>


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92 For example in Poland the maximum debt/GDP level is set at 60% in the Constitution, while the Public Finance Act stipulates that in case the debt goes beyond 55%GDP, specific severe cuts in expenditure must be undertaken.

Following the introduction of the Euro, the aggregated level of the public debt for the Eurozone started to fall and stabilized around 70% GDP in 2001. The decrease was thanks to a strong economic growth and the pre-EMU consolidation efforts. It is noteworthy that some of the Member States were successful in lowering the debt ratio (Belgium, Spain, Ireland) while others, notably those currently under the EDP, i.e. Germany, France and Greece, failed to reduce their debt levels. Not surprisingly, according to the Commission’s estimates a large part of this negative development in the latter countries can be attributed to their weak performance in terms of primary balance\(^{94}\). Similar conclusion can be drawn from the evidence given in Chapter 2. Negative developments might be noticed also in case of some new Member States. For example, the debt levels in Poland and Czech Republic remain below the Maastricht reference value, nevertheless their dynamics might become a source of concern. In Hungary the debt ratio stabilized below the 60% GDP ceiling in 2004, but it was preceded by a major increase as of the year 2001.

Bearing in mind the distressing evidence of rapidly rising debt levels, one should consider the long-term sustainability threats that might arise in the future. An ample example of such additional burden to the public finance are the costs associated to population ageing phenomenon, i.e. future welfare payments, especially resulting from pay-as-you-go pension schemes. Another example of such financial risks is connected to an implicit government promise to bail-out public or private corporations which are considered “too important for national economy” to go bankrupt. Both categories contain obligations without explicit legal basis, but are likely to arise in the future due to legitimate expectations of the society or pressure of interest groups. Such financial obligations are called *implicit* liabilities.

Another threat for national budgets are *contingent* liabilities\(^{95}\). Those are legal requirements that depend on the occurrence of a specific event, e.g. if the government grants a guarantee for the debt to a private company, it is obliged to repay the debt of the latter in case the original debtor is not able to pay off its own obligations. This type of liabilities is a source of concern especially in the new Member States, where governmental guarantee schemes were a common practice during the transition period. For example in the Czech Republic state guarantees amount to 12%GDP, in Slovakia 12,6%GDP, in Hungary 5,4%GDP, whereas on

\(^{94}\) See: European Commission, *European Economy - Public Finances in EMU*, op. cit. p. 100

\(^{95}\) For more information see: European Commission, *European Economy - Public Finances in EMU*, op. cit. pp. 85-95
Malta as much as 22% GDP. Although it is unlikely that they will have to be covered in full, they should be treated as a source of a long-term budgetary risk. The Member States differ significantly as far as the methods of monitoring budgetary risks are concerned. Therefore, it would be advisable to create European standards dealing with the problem of the definition and methods of estimating the data on contingent and implicit liabilities. Some countries have already introduced legal tools aimed at better control of such liabilities. For example, the Czech Republic and Hungary introduced limits on the volume of state guarantees, while in Sweden the beneficiaries of those have to pay certain fees which makes it more economically rational. In this respect sharing best practice and exchanging ideas with a view to limit the scope of budgetary risks might be beneficial for all the parties.

Having considered some of the main sources of budgetary risks it is important to underline that the uniform application of the deficit and debt criterion to the old and new Member States might be unjustified from the economic point of view. It must be borne in mind that most of the accession countries suffer from severely depleted infrastructure. Taking into consideration the size and nature of the necessary investments, the government should participate to facilitate and accelerate their execution. This might result in higher borrowing needs, consequently larger budget deficits ceteris paribus. However, such investments are justified from both economic and equity perspective. They constitute an indispensable part of the economic development process. Moreover, they will result in higher level of economic activity, fostering the GDP growth. In longer run they will bring profits both to the public and private sector. From the equity point of view, borrowing in order to finance those investments represents a temporal dispersion of costs. Both current and future generations will benefit from current investments therefore, it is justifiable to divide the costs. Of course, there remains a question of how much the new Member States are able to borrow without undermining the stability of public finances. In this respect two things should be kept in mind. Firstly, all the accession countries with the exception of Hungary, Malta and Cyprus record debt levels significantly below the 60% GDP reference value. Thus, there is still some room for additional borrowing that will not result in infringing the Maastricht criterion, which might be regarded as ensuring public debt sustainability. Secondly, during the catching-up phase the new Member States are likely to record significantly higher GDP growth, therefore additional surpluses might be devoted to debt repayment when the most expensive investments are
finished. Moreover, countries characterized by a credible fixed exchange rate against the Euro and a higher long-run growth rate and/or lower long-run real interest rate (e.g. the Baltic States) are able to run higher budgetary deficits, but still keeping the debt level on the sustainable level\textsuperscript{96}.

Concluding, little effort devoted to budgetary consolidation together with the low economic growth triggered rising levels of public debt in some of the Member States. Having in mind the potential scope of the population ageing financial effects and increasing pressures on public finances arising from implicit and contingent liabilities, one should take better account of the long-term sustainability of public finances. The Commission claims that this issue remains a source of concern in most of the EU members, namely Belgium, Cyprus, the Czech Republic, Germany, Greece, Spain, France, Hungary, Italy, Malta, Poland, Portugal, Slovenia, and Slovakia\textsuperscript{97}. The fact that the SGP remains silent on the maximum debt levels and thus treats uniformly the countries with different levels and dynamics of public might be treated as the \textit{Pact’s} weakness, which needs to be promptly corrected.

\textbf{4.1.6 The Pact disregards structural reforms and might be harmful to economic growth}

Most of the European countries suffer from structural problems such as rigid labour markets, inefficient pension and healthcare schemes, a low investment rate and insufficient R&D expenditures. To counter those problems large financial resources are required. One has to bear in mind that some of the Eurozone countries have had problems in balancing their budgets ever since the beginning of the EMU. Simple, numerical constraint contained in the SGP may become a disincentive for those countries to pursue necessary structural reforms, since they might result in even higher deficits. The SGP targets are fixed in the categories of actual budget balance and budget positions “close to balance or in surplus” in a medium-term. Thus, the possibility of spreading the investments cost between current and future generations becomes very limited. This implies that the capital formation should be funded from current revenues, which in turn may act as a disincentive for the authorities to conduct projects entailing significantly deferred benefits. Such investment suspension is most likely to take

\textsuperscript{96} Buiter W., Grafe C., \textit{Patching up the Pact…}, op. cit., p. 41
place during consolidation periods\textsuperscript{98}. The levels of gross fixed capital formation might be treated as a proxy presenting the scale of such effect. Table 16 provides those figures for 4 old and 4 new Member States, which are all currently under the EDP.

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>1.8</td>
<td>1.8</td>
<td>1.7</td>
<td>1.5</td>
<td>1.4</td>
</tr>
<tr>
<td>France</td>
<td>3.2</td>
<td>3.1</td>
<td>3.1</td>
<td>3.2</td>
<td>3.3</td>
</tr>
<tr>
<td>Portugal</td>
<td>3.8</td>
<td>4.0</td>
<td>3.3</td>
<td>3.4</td>
<td>2.4</td>
</tr>
<tr>
<td>Greece</td>
<td>4.1</td>
<td>3.9</td>
<td>3.7</td>
<td>3.9</td>
<td>4.1</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>2.9</td>
<td>3.2</td>
<td>3.7</td>
<td>4.2</td>
<td>4.3</td>
</tr>
<tr>
<td>Hungary</td>
<td>3.2</td>
<td>3.8</td>
<td>4.9</td>
<td>3.4</td>
<td>3.0</td>
</tr>
<tr>
<td>Poland</td>
<td>2.5</td>
<td>3.5</td>
<td>3.6</td>
<td>3.4</td>
<td>3.5</td>
</tr>
<tr>
<td>Slovakia</td>
<td>2.8</td>
<td>3.1</td>
<td>3.3</td>
<td>2.6</td>
<td>2.7</td>
</tr>
</tbody>
</table>


In cases of Germany and Portugal the volume of fixed capital formation was significantly decreasing during the period concerned. In France the value remained almost constant, while in Greece it was falling until 2002 and then the tendency reversed, probably due to the organization of the Olympic Games. As far as the new Member States are concerned, only the Czech Republic recorded a systematic increase in capital formation, whereas in Hungary and Slovakia it decreased significantly between 2002-2004. In case of Poland, after the large increase of 1\%GDP in 2001, it remained stable around 3.5\%. Following this evidence it might be suspected that the countries facing significant problems in balancing their budgets, notably Germany, Portugal and Hungary decided to lower the level expenditures devoted to capital formation. A positive aspect is that, for example, the Czech Republic is trying to accelerate the catch-up process by increasing investment expenditures. In this vein it might be argued that one of the Pact’s shortcomings lies in the fact that it does not distinguish between current and investment spending. Such uniform treatment of budgetary expenditures may be regarded as too simplistic and not taking into account the financial effort undertaken to reform the economy. Furthermore it has to be stressed that investments are one of the sources of long-term GDP growth. Consequently, lack of such differentiation might become a disincentive to invest and imply lower levels of economic activity. An interesting exercise in this area was

\textsuperscript{98} Buti, M., Eijffinger, S., Franco, D., *Revisiting the Stability and Growth Pact: Grand design or internal adjustment?*, CEPR discussion paper no 3692, 2003
conducted by Savona and Viviani\textsuperscript{99}. The authors found statistic support for the claim that automatic, uniform treatment of deficits, not focused on the expenditure nature might have a negative influence on the Eurozone growth. Moreover, they claim that public investment has a significant favourable effect on GDP growth. Those two observations indicate it would be advisable that while assessing the budgetary stance more focus should be put on the nature of expenditure positions.

By way of conclusion, the above analysis shows that the Pact’s focus on respecting the deficit criterion might become a disincentive for the authorities to undertake necessary structural reforms. A similar conclusion might be drawn with regard to government investments whose costs need to be borne now while the benefits are deferred in time. This implies that in order to improve the Pact’s economic rationale, one should take better account of what the sources of budget deficit are, e.g. excessive governmental consumption expenditure should be treated in different manner than spending on large scale structural reforms.

4.2 Suggestions on how to improve the Pact – an overview

The Pact has been criticized ever since its adoption in 1997. When the EDP was initiated against two largest European economies, namely France and Germany, the pressure became even stronger. The academic debate resulted in several proposals for remedying the Pact’s shortcomings, which are shortly overviewed in Figure 7.

<table>
<thead>
<tr>
<th>Critical issue</th>
<th>Reform proposals</th>
<th>Institutional Implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>Numerical rules do not tackle at source the budgetary misbehaviour; SGP needs a more credible and nonpartisan enforcement</td>
<td>Improve rational budgetary procedures; create independent Fiscal Policy Committee. Strengthen financial market discipline</td>
<td>Reform the Treaty, abolish Excessive Deficit Procedure. Amend Large Exposure Directive.</td>
</tr>
<tr>
<td>The SGP pays too much attention to the deficit, not to the quality of public finance.</td>
<td>Introduce expenditure rule; move to golden rule.</td>
<td>The golden rule requires changes in the Treaty and the SGP. It is only in a soft version that it is not inconsistent with them</td>
</tr>
<tr>
<td>Sustainability depends on the stock of debt, not on the deficit.</td>
<td>Introduce a Debt Sustainability Pact; move to a country-by-country articulation of the close-to-balance target.</td>
<td>The Debt Sustainability Pact requires changes in the Treaty. For some countries it replaces the SGP.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Critical issue</th>
<th>Reform proposals</th>
<th>Institutional Implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>The 3% and the close-to-balance target are arbitrary and inconsistent with an appropriate fiscal stance.</td>
<td>Move to structural balance; introduce the notion of Permanent Balance Rule.</td>
<td>Abolishing the close-to-balance requires changes in SGP; abolishing the 3% requires changes in the Treaty.</td>
</tr>
<tr>
<td>The SGP does not address the issue of the appropriate fiscal stance for the euro area.</td>
<td>Agree on the aggregate budget balance. Market solution via deficit permits.</td>
<td>Within the 3% ceiling, it is not incompatible with the current rules.</td>
</tr>
</tbody>
</table>

Source: M. Buti, S. Eijffinger, D. Franco, *Revisiting the Stability and Growth Pact: Grand design or internal adjustment?*, CEPR discussion paper no 3692, p. 13

It follows from the overview that the proposals touch upon most of the **Pact’s** shortcomings as described in the paper. However, there are two problems concerning their introduction. First of all, each of them tackles only a part of the SGP shortcomings. Therefore, in order to correct all the SGP weaknesses it would be inevitable to propose a reform that would take account of most of the proposals. This could in turn lead to a solution that would be impossible to apply due to its complexity and data requirements. Secondly, all of the proposals with the exception of the last one require a change in the Treaty and the SGP itself. The Member States recently managed to agree on the European Constitution. It replaces all the Treaties and it is unfeasible that the negotiations will be reopened before the ratification. It is more likely that the countries would be able to reach a consensus on the changes of the SGP rules. However, if one recalls the fierce negotiations in 1996-1997 and the threat of undermining the **Pact’s** credibility that might result from a grand redesign, incremental adjustments in the SGP interpretation become the most plausible way of reforming the **Pact**. Bearing those arguments in mind, the Commission made some suggestions on how to improve the **Pact’s** economic rationale and efficiency without recourse to legal changes. It is noteworthy that those proposals partly reflect the concerns and problems identified by academics during the debate on the SGP.

In September 2004 the Commission issued a Communication to the Council and the European Parliament\(^{100}\) which summarized the Commission’s ideas on possible improvements regarding the SGP implementation. The proposed changes cannot be called a revolution, but represent a rather evolutionary adjustment of the approach towards the SGP, whose aim is to “enhance its economic underpinnings of the existing framework and thus strengthen the credibility and enforcement”\(^{101}\). The proposed improvements include:

- a) increasing focus on debt levels and sustainability,
- b) allowing for more country-specific assessment.

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\(^{100}\) European Commission, *Communication from the Commission*, op. cit.,

\(^{101}\) Ibidem, p. 2
c) putting more emphasis on other economic variables and strengthening the correlation between SGP and economic objectives set in BEPG,

d) enhancing the SGP efficiency and credibility by reorganizing its timetable.

First of all, the Commission suggests that more attention should be devoted to the issue of the government debt and sustainability. The reason for such a proposal follow the concerns presented in 4.1.5. This does not mean that the deficit criterion should be abandoned, but that the assessment of budgetary positions should consist of the evaluation of both factors. Moreover, not only the values are important, but also it is essential to examine the dynamics of debt developments to gauge the medium and long-term risks to the sustainability of public finance. Since the Pact does not explicitly mention the debt criterion, the Commission suggests that a better approach would be to redefine the medium-term objective enshrined in the Pact, so that it would take into account also the individual countries’ debt levels. This would allow for more country-specific evaluation under the surveillance mechanism and thus introduce a less mechanistic approach. Bearing in mind that various countries record significant differences in the initial levels of debt, threats associated with contingent liabilities and potential for debt reduction, such an assessment would have a more sound economic rationale.

Furthermore, the Commission argues that the countries with low debt levels could be allowed to run somehow higher deficits (over 3%GDP), which would constitute a kind of prize for countries with a sound public finance situation\textsuperscript{102}. Another advantage of such an approach stems from the fact that putting more emphasis on long-term sustainability of public finance assessed in terms of debt developments is likely to reduce the bias for short-term planning.

Another adjustment results from the observance that capital expenditure should not be treated in the same manner as current consumption since the former is likely to promote growth, and the Pact should not be a disincentive for undertaking investments. Therefore, the Commission suggests that the medium term objective could be considered as the deficit excluding the net capital expenditure. In similar vein, it might be argued that other pro-growth spending such as R&D and education expenditures should also be excluded while evaluating

\textsuperscript{102} So far the Pact contains only a penalty for non-conformity, but does not include any incentive to act better than required, which is also a source of critique
the level of budgetary deficit. This would, however, bring about the problem of differentiating between growth promoting and growth neutral measures. For the time being it would require designing a special taxonomy and framework for conducting such an assessment. Yet in long-term, it would shift the focus onto budget quality, i.e. not only how much is spent, but also what the funds are devoted to. This in turn would create an incentive to pursue expensive structural reforms and investments as it would not aggravate the budgetary positions in SGP surveillance. This line of thinking has already found some support among some Member States. For example, in January 2005 German Chancellor Gerhard Schröder put forward some proposals on reforming the Pact. He suggested that a country should be allowed to breach the 3%GDP threshold if it was undertaking structural reforms or facing “specific burdens” such as high level of contribution to the EU budget, economic stagnation or in case of Germany, large sums paid to the former East Germany. Those proposals were strongly criticized by the EU presidency, German Bundesbank and some other Member States, notably Austria which is a strong defender of the Pact. The case of Germany or France, however, indicates that somehow more flexible approach could be followed if a Member State faces the consequences of a protracted economic slowdown. Such a situation is not covered by the SGP “exceptional clause”, but might result in significant problems in balancing the budget, the same as an abrupt economic downturn. Therefore, long-lasting stagnation might be a good rationale for extending the deadlines for correcting the excessive deficit situation. Such deferred deadlines have already been granted to the new Member States owing to their special economic characteristics.

Another postulation states that strengthening the focus on budget quality and growth considerations could enhance the coherence between economic coordination in form of the BEPG and budgetary surveillance. The empirical evidence suggests that the SGP is characterized by an overly narrow perspective on other economic variables which may hamper the efforts of executing the economic objectives of the BEPG. A higher correlation between the surveillance mechanism and the economic objectives set in the BEPG might follow from the reorganization of the SGP timetable. The Commission argues that ex-post assessment of

103 For more detailed account of this problem see: European Commission, European Economy - Public Finances in EMU, op. cit., p. 163
104 Honor Mahony, Schröder’s reform plans meet opposition, www.euobserver.com, 18.01.2005
105 Honor Mahony, Juncker rebuffs Schröder’s stability pact calls, www.euobserver.com, 24.01.2005
the Stability/Convergence Programmes is characterized by low efficiency. This stems from the fact that Council opinions are adopted in the early months of a year, which is too late for the budget just adopted and too early for the coming one. Therefore, the Commission suggests moving the surveillance process to a real ex-ante procedure which would allow the governments to plan their budgets with greater attention devoted to BPEG and induce the authorities to more strategic planning\textsuperscript{106}. Such an adjustment is also likely to increase the efficiency of the early warning procedure.

Concluding, at first sight the Commission’s proposals constitute a reasonable set of improvements that can be introduced into the \textit{Pact’s} implementation without changing the Treaty. Those are likely to strengthen the SGP economic rationale and its efficiency. On the other hand, one has to bear in mind that moving towards country specific assessment may bring about the problem of unequal treatment of the Member States. It has been argued above that large Member States might be able to get off the hook of the EDP thanks to their large bargaining power. Taking account of the country specificity might even aggravate this problem. Moreover, many technical and methodological problems are likely to arise while introducing those adjustments, e.g. defining the notions of a protracted slowdown, pro-growth expenditures or sustainable level of public debt and ensuring that wider interpretation of the rules will not induce creative accounting. All in all, if applied with necessary caution, the Commission’s proposals together with the changes included in the European Constitution should be regarded as a step in right direction.

\textsuperscript{106} European Commission, \textit{European Economy - Public Finances in EMU}, op. cit., p. 114
Conclusions

The fiscal safety net demanded by some of the EU Member States before the creation of the monetary union exists in the form of surveillance mechanism and excessive deficit procedure enshrined in the Maastricht Treaty. In 1997 those notions were clarified and made easier to apply by the introduction of a set of legal acts called – The Stability and Growth Pact. Since then, the *Pact* has been subject to criticism for both its desirability and enforceability.

The paper briefly touches upon the economic rationale for rules ensuring fiscal prudence within a monetary union. The main objective is an overall analysis of the Pact’s construction and evaluation of the first years of functioning. Special focus was given to presenting empirical evidence arguing that the *Pact* was not efficient in pursuing the goals it aimed at. Consequently, it is claimed that the SGP contains some shortcomings which confronted with economic reality and the political bargaining system present in the EU may result in efficiency and enforceability problems.

First shortcoming lies in the SGP asymmetric construction. The history shows that during an economic upswing the SGP did not induce some of the Member States to pursue extra consolidation. This in turn resulted in major problems with balancing their budgets during a protracted economic slowdown. The inability to prevent the Member States from pursuing pro-cyclical policy which was one of the *Pact’s* main aims is not directly remedied by the Commission’s reform proposals and thus it should be still regarded as a source of concern.

Secondly, the numerical targets of the SGP are regarded to simplistic and mechanistic approach to the budgetary developments evaluation. On the one hand, there are cases in which the Member States managed to escape from the EDP mainly due to the use of one-off measures and not long-term consolidation. On the other hand, the countries pursuing expensive structural reforms or engaged in large investment projects cannot expect any exemption under the SGP rules. Those consideration call for a more country-specific assessment under the SGP rules and putting more emphasis on the quality of budgetary positions. Such suggestions are the even more valid, as after the enlargement the EU is composed of countries characterized by significantly diverse economic structures.

Thirdly, the *Pact* disregards the level of public debt and presents only a limited scope for the long-term sustainability of public finance. This results in a bias towards short term
budgetary planning. Bearing in mind the potential burdens for public finance arising from population ageing or contingent/implicit liabilities, it should be regarded as an important source of concern. In this vein it might be claimed that another shortcoming of the SGP lies in the fact that it does not take proper account of the initial level of debt and its dynamics. As presented in the paper some of the Member States managed to reduce their debt levels while others let their debt rise considerably. All in all, according to the Commission assessment, long-term sustainability is currently secured in only a part of the Member States, i.e. Austria, Finland, the Netherlands, Luxembourg, Sweden, Denmark, the UK, Latvia, Lithuania and Estonia. It is noteworthy that in eight out of the twelve Eurozone Members the long-term sustainability remains an distressing issue, which might undermine the stability of the Monetary Union in longer-term. Therefore, it is crucial to take due account of the debt issues under the budgetary surveillance mechanism.

Furthermore, some shortcomings were identified in the legal construction of the surveillance and enforcement procedures. For example, in some cases the early warning mechanism was not executed, although the situation clearly indicated that it should have been. Moreover, the dissuasive part of the Pact has been so far characterized by a mixed implementation history. The situation of proceedings under the EDP in November 2003 explicitly showed that the Council can suspend the procedure, even if it consents with the Commission’s evaluation of the underlying economic factors that suggests proceeding to the next step of the EDP. This in turn, supports the academic arguments that the Council might not be capable of impartial and consistent enforcement of the SGP rules.

Last, but not least the paper gives evidence on the technical and methodological problems related to the SGP. On the one hand, some important improvements have already been made, e.g. the introduction of the Code of Conduct or the use of CAB while assessing medium-term budgetary positions. On the other hand, some issues call for a refinement, such as the data collection requirements or the SGP timetable. Besides, it would be advisable to prepare a consistent taxonomy for that would allow to capture the issues related to long-term sustainability and budget quality.

Summarizing, it must be stressed that the SGP has resulted in higher budgetary prudence as compared to a situation of its non-existence. However, the empirical evidence shows that the performance of individual Member States is diverse and while some countries
strived to reduce budgetary imbalances, other seemed to show only limited efforts in this respect. Therefore, following the above-mentioned sources of concern a heavy debate has been taking place in both academic and political circles on how to reform the Pact. Most of the academic postulations require a change in the Treaty which does not seem feasible. Consequently, the Commission proposed a set of improvements that aims at remedying the identified shortcomings of the Pact. Although those proposals call mostly for the rules reinterpretation and more flexible approach, it seems plausible that together with the changes arising form the introduction of the European Constitution they will enhance the SGP economic rationale and improve its enforceability. One should however keep in mind that in face of increased pressures on the public finance that are likely to arise in the future the debate on how to ensure budgetary prudence within the EMU should be continued.
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