EU Economics: Fiscal Policy

University College Dublin

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Fiscal policy and the Stability and Growth Pact

Among the 28 members of the European Union there is an agreement to facilitate and maintain the stability of the European Monetary Union. Recall that in order to join the EMU a country has to behave according to a number of entry conditions, including:

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- Having a budget deficit no more than 3% of GDP
- A public debt less then 60% of GDP

But what are the rules once a country joined the EMU? Practical details concerning fiscal discipline were set out in

One of the three principles of the EMU treaty

- the Stability and Growth Pact (SGP)
- the Excessive Deficit Procedure (EDP)

The EDP is part of the SGP (corrective arm) and was adopted in 1997 and meant to be strictly enforced, there have been some issues with this however. Currently 11 of 28 member states are subject to and EDP

The Stability and Growth Pact

The SGP was established in 1997 to improve coordination and monitoring of the fiscal and economic policies of the member states, and to enforce the deficit and debt limits established by the Maastricht Treaty. The SGP has three main elements:

1. Prevention
    - Bind EU governments to their commitment towards sound fiscal policy and coordination by setting each one a budgetary target
    - The budget deficit targets are defined in structural terms, this means that they take into account the business cycle and filter out one-off or temporary measures
    - Each member state has to write an annual budget outlining how they intend to reach the targets, which are assessed by the European Commission and the EU governments
    - Entered in force July 1998

This is known as the Medium-Term Budgetary Objective (MTO).

Recall that these rules apply to both Eurozone countries and all other EU member states.

2. Correction
    - Here enters the EDP to ensure the correction of excessive budget deficits or excessive public debt levels

From the website of the European Commission; "the EU Treaty defines an excessive budget deficit as one greater than 3% of GDP. Public debt is considered excessive under the Treaty if it exceeds 60% of GDP without diminishing at an adequate rate (defined as a decrease of the excess debt by 5% per year on average over three years)".

- The EDP is a step-by-step procedure. Basically the European Commission, via Eurostat, examines the issues and sets deadlines to the member country to reach the target level as defined in the MTO.
- Entered in force January 1999

3. Enforcement

- When countries fail to respect the preventive and corrective rules of the SGP, sanctions may follow
- For the eurozone countries these could be fines such as
  - 0.2 % of GDP, if they fail to abide by either the preventive or the corrective rules
  - 0.5 % of GDP, if they repeatedly fail to abide by the corrective rules
- For all member states the penalty could be a suspension of commitments or payments the EU's Structural and investment funds

Strangely, the UK is excluded from these penalties. In general, one criticism is that the rules are hardly ever enforced on Germany and France, who were much in favour for the SGP.

Adjustments to the Stability and Growth Pact

With the aim to make the SGP more comprehensive and predictable, and likely more efficient, the economic governance rules were adjusted , following the sovereign debt crisis in 2012, with a collection of new laws that are known as the Six Pack. These rules stipulate that EU governments must

1. Operate public accounting systems that comprehensively cover all areas of income and expenditure
2. Make the fiscal data publicly available (monthly basis for central and state governments, quarterly for local governments)
3. Ensure their fiscal planning is based on realistic macroeconomic and budgetary forecasts, using the most up-to-date data
4. Operate specific fiscal rules to help ensure the overall government budget complies with European rules
5. Establish a credible, effective medium-term budgetary framework that includes a 3 year fiscal planning horizon
6. Ensure consistency and coordination of all accounting rules and procedures across all areas of government activity

These must be subject to internal control and independent audits

The scope of this set of additional rules was to enhance macroeconomic surveillance and subsequently improve the procedures to address macroeconomic imbalances and address public deficits.

For the Eurozone members and additional set of rules was implemented in 2013, which are known as the Two Pack, basically these regulations required member states to increase the reporting frequency to enhance surveillance.

The Excessive Deficit Procedure

As mentioned, the EDP is a step-by-step procedure for correcting excessive debt levels or deficits. It proceeds in the following manner

So it is initiated when deficit exceeds 3% of GDP or when debt exceed 60% of GDP and is not sufficiently diminishing.

1. European Commission reports on whether to open the EDP
2. The European Council decided whether an excessive deficit exists, and if so opens an EDP
   - At this stage recommendations are made followed by deadlines and targets
   - In some cases sanctions can be issues
3. The member state has 3-6 months to comply with the recommendations
4. The Commission assesses if the member state has taken effective action and informs the council
   - Member state has taken effective action and the targets are met $\rightarrow$ Council takes note
   - Member state has taken action but targets aren't met $\rightarrow$ council revises recommendation, extend deadlines $\rightarrow$ Back to 3
   - Member state has not taken effective action $\rightarrow$ Council gives new recommendations etc. $\rightarrow$ Back to 3
   - In the case the the member state is also part of the Eurozone, additional sanctions follow when no effective action is taken
5. European Commission proposes EDP abrogation, Council takes final decision