stability and growth pact

The Stability and Growth Pact was designed in 1997 and implemented with the inception of the euro in 1999. An innovative tool in essence, it provides, first, a practical definition of the concept of fiscal sustainability by imposing a ceiling of three per cent and 60 per cent respectively on the budget deficit and public debt. Second, it offers guidelines for governments’ public finances. Third, it offers a way to coordinate national public finances to achieve an optimal fiscal–monetary policy mix within the Eurozone. Even before some countries breached the Pact, the economic literature argued about its rationales.

Proposed by Germany in 1995, backed by France, and created by the Treaty of Amsterdam in 1997, the Stability and Growth Pact (SGP) is the European Union’s (EU) answer to concerns about fiscal unsustainability. It consisted initially of three regulations: (a) on the strengthening of the surveillance and coordination of economic policies (Council of the European Union, 1997b), (b) on speeding up and clarifying the implementation of the excessive deficit procedure (Council of the European Union, 1997c, and (c) on the SGP (Council of the European Union, 1997a). The SGP extended fiscal discipline into the Economic and Monetary Union (EMU) after 1 January 1999 in the manner foreseen by the Treaty of Maastricht (1992) for the convergence period 1993–8: budget deficit and public debt must be, respectively, no more than three per cent of GDP and 60 per cent of GDP.

When, in May 1998 the European Union was deciding which of the EU–15 countries would enter into the EMU in light of the Treaty of Maastricht criteria, some countries, including Germany, would have failed to qualify under the debt criterion. Since then, the debt criterion has been interpreted in terms of trend rather than level in the Treaty of Maastricht, and as a consequence in the Treaty of Amsterdam. The nature of the SGP thus changed within a year of its ratification and a year before its implementation. *De facto* the rule was then to abide by the deficit criterion, leaving the debt criterion to be interpreted in trend. The change in the interpretation of the Treaty of Maastricht resulted in a change in the interpretation of the Treaty of Amsterdam, weakening its original double objective.

What happens when a country does not abide by the three per cent rule? If it is a first violation, the country will have to make a non-interest-bearing deposit with the European Commission. The amount of this deposit comprises a fixed component equal to 0.2 per cent of GDP, and a variable component linked to the size of the deficit. Each following year the Council may decide to intensify the sanctions by requiring an additional deposit, though the annual amount of deposits may not exceed the upper limit of 0.5 per cent of GDP. A deposit is converted into a fine if, in the view of the Council, the excessive deficit has not been corrected after two years. After three consecutive years of violation, the country will see its three deposits become a fine. While the three per cent limit might seem tight, the probability that a country will fail to abide by the Pact for three years in a row, and thus be fined, was originally perceived as low. However, revised numbers from Eurostat indicate that Greece has always been above the three per cent deficit ceiling since its entry into the EMU in 2001. Additionally, Portugal’s deficit was greater than three per cent in 2001, 2004 and 2005, Germany’s deficits exceeded three per cent from 2002 to 2005, France’s deficits exceeded three per cent from 2002 to 2004, and Italy, the UK and the Netherlands breached the three per cent rule in 2004. Further the deposit rules were not enforced.
Not only did Portugal not have to make a deposit, but France and Germany were not fined. The credibility of the SGP was dramatically weakened for the second time.

On 20 March 2005 the European Union decided to try to improve the credibility of the Pact: the Council adopted a report entitled ‘Improving the Implementation of the Stability and Growth Pact’ (Council of the European Union, 2005). The report was endorsed by the European Council in its conclusions of 22 March, and is now an integral part of the SGP. On 27 June 2005 two additional regulations amended Regulations 1466/97 and 1467/97 (Council of the European Union, 1997b; 1997c). The European Council unanimously agreed to introduce some flexibility into the SGP, creating a de facto SGP II. This flexibility was particularly introduced via the concept of ‘relevant factors’, which are country-specific. Examples of relevant factors are: (a) budgetary efforts towards increasing or maintaining at a high level financial contributions to foster international solidarity and to achieve European policy goals (notably the unification of Europe if this has a detrimental effect on the growth and fiscal burden of a Member State), (b) structural reforms (for example, pensions, social security), (c) policies supporting R&D, and (d) medium-term budgetary efforts (consolidating during good economic times, a reduction in debt levels, and an increase in public investment). The European Council is the final judge of the relevance of a given factor.

In the meantime, the European Union introduced a ‘code of conduct’ to counterbalance the new flexibility that was introduced. This code of conduct established a country-specific Medium Term budgetary Objective (MTO) that serves as the actual deficit target around which some flexibility is allowed so long as the country abides by the three per cent reference value. To better understand the effects of these amendments, the background economics literature is reviewed, as well as the institutional design of the original SGP and its amended version.

**The rationales for a supra-national fiscal rule**

One of the major goals of the SGP was to make fiscal discipline a permanent feature of the EMU. Safeguarding sound government finances was regarded as a means to strengthen the conditions for price stability in the Eurozone. However, it was also recognized that the loss by individual countries of the exchange rate instrument in the EMU must be offset by automatic fiscal stabilizers at the national level to help economies adjust to asymmetric shocks. The three per cent deficit limit was calculated under the assumption that the long run average nominal GDP growth rate is five per cent, whereas the long-run inflation rate is two per cent.

Beetsma (2001) provided a summary of the different arguments in favour of a fiscal rule. Arguments in support of a Europe-wide fiscal rule are of three types: benefits to domestic governments; benefits to other governments; and collective benefits.

**Benefits to domestic governments**

The main benefit to domestic governments, namely, public finance sustain-ability, has been studied by several researchers, including Amador (2000), Ballabriga and Martinez-Mongay (2005), Bohn (1995), Mongelli (1999), Nielsen (1992), and Perotti, Strauch and von Hagen (1998). The SGP aims at
ensuring the sustainability of EU public finances, and hence is supposed to prevent governments hampering growth through unsustainable fiscal policies. For illustration purposes, it should be noticed that the primary balance as a percentage of GDP is close to zero or even positive (a surplus) for most of the euro area members. Thus, what pushes countries like France, and Germany above the three per cent deficit ceiling seems to be, primarily, interest payments on debt.

Does Europe really need a fiscal rule to prevent unsustainable domestic public finances? If the answer is ‘yes’, it is because financial markets do not work properly. If government bond yields include risk premia, increasing indebtedness may cause bond yields to rise, thus raising the cost of borrowing and imposing discipline on governments. Market discipline of this kind may be especially relevant and important in the EMU, in which governments of the Member States can issue debt but do not have the possibility to monetize and inflate away excessive debt. Spreads between European bonds have narrowed considerably since 1991 for the Eurozone members. Bernoth, von Hagen and Schuknecht (2004) explain that, for Deutschmark/euro denominated bonds, EMU membership reduces the linear effect of debt on default risk premia. Accordingly, EMU members enjoy a lower risk premium than before, but this benefit declines with the size of public debt compared with Germany’s. This is consistent with the view that markets anticipate fiscal support for EMU countries in financial distress unless these countries had previously been highly undisciplined. Thus, the disciplinary function of credit markets still exists. If the domestic benefit provided by the SGP to governments is not striking, does the SGP discipline governments in their relationships with others, or ease the coordination of fiscal policies between governments?

Benefits to other governments

A first issue is the likelihood of free-riding behaviours: the fear that governments would run higher deficits in a monetary union. Indeed, under the uncovered interest parity assumption, the understanding was that countries would run deficits that would be financed partly by the Eurozone through an overall rise in the Eurozone bonds interest rate. Undeniably, a country not belonging to a monetary union and running a high deficit will have to face a rise in its domestic interest rate. In a monetary union and integrated capital market, a country running a high deficit will face a much lower rise in its interest rate since it is now equalized at the European level. This may create the incentive for some countries to free-ride on others. If every country behaves this way, on the one hand the overall interest rate rises, and on the other hand the Eurozone faces a greater risk of public finance unsustainability. In the extreme scenario, Eichengreen and Wyplosz (1998) argue that the financial turmoil triggered by a default on the debt of any member country would have significant cross-border effects. In this context, focusing his discussion of free-riding and the SGP on the effects of centralized monetary policy combined with decentralized fiscal policy, Uhlig (2002) regards the SGP as necessary in preventing free-riding in the form of excessively high deficits.

The second issue is moral hazard, which differs from free-riding to the extent that it is ‘post-contractual opportunism’. In other words, once countries belong to the EMU, countries’ loss functions change: without the SGP, governments could weigh more the use of fiscal policies to increase the likelihood of a re-election rather than keeping their public finances in line with
the Maastricht guidelines. Dixit (2001) and Dixit and Lambertini (2001) demonstrate that fiscal discretion leads to equilibrium levels of output and inflation very different from Pareto-optimal choices. The SGP should thus prevent countries from changing their attitudes once within the Eurozone.

Collective benefits

Collective benefits of the SGP are at least threefold: the coordination of domestic fiscal policies; the policy-mix argument; and the reinforcement of the ECB's credibility. First, there is the question of fiscal coordination among member countries. A lack of coordination could lead to asymmetric economic shocks on both the aggregate demand and aggregate supply in every country due to large differences in fiscal policies. The coordination of fiscal policies is intended to eliminate those large differences in fiscal policies across countries, and thus implicitly create a Europe-like fiscal policy. The coordination argument is different from the policy-mix argument in the sense that it addresses only the coordination of fiscal policies, whereas the policy-mix argument addresses the question of the coordination of the European monetary policy to a European-like fiscal policy.

Second, Beetsma (2001) and Issing (2002) analyse the policy-mix argument and claim that the advent of a central monetary authority was important in establishing the correct mix of fiscal and monetary policy within the Eurozone. Article 99(3) of the Treaty establishing the European Community stipulates: 'In order to ensure closer coordination of economic policies and sustained convergence of the economic performances of the Member States, the Council shall, on the basis of reports submitted by the Commission, monitor economic developments in each of the Member States’ (Treaty establishing the European Community, 2002). Beetsma and Uhlig (1999) build a model of centralized monetary policymaking and decentralized fiscal policymaking and find that a monetary union combined with an appropriately designed fiscal rule will be strictly preferred to fiscal autonomy, as there are benefits to coordination of a Europe-wide monetary policy with a Europe-wide fiscal policy.

The third reason is the maintenance of the credibility of the European Central Bank (ECB) through insuring its primacy as a monetary authority. As noted by Buti and van den Noord (2004, p. 6), the EMU is, ‘[commonly] seen as a regime of monetary leadership where fiscal policy is to support the central bank in its task to keep inflation in check’. This power is drawn from the following European Council resolution which accompanies the Pact: ‘[it] is also necessary to ensure that national budgetary policies support stability oriented monetary policies’ (Buti and van den Noord, 2004, p. 6). Around the time that the Maastricht Treaty was drafted, Beetsma and Bovenberg (1999) showed that the European budgetary situation could undermine the credibility of the future European Central Bank. If a country’s fiscal situation becomes unsustainable, other countries might be forced to bail out the insolvent national government. Alternatively, the European Central Bank could be forced to monetize national debts, and thereby create additional inflation in the EU although this would be forbidden in theory by the statutes of the ECB. In this regard, the SGP is a secondary safety device.
Institutional design

Formally, the SGP consists of three elements: a political commitment, a preventive element, and a dissuasive element.

The political commitment

Peer support and peer pressure are an integral part of the Stability and Growth Pact: the Council and the Commission are expected to motivate countries to adhere to the pact, and make public their positions and decisions at all appropriate stages of SGP procedure. The idea is to make the SGP more transparent. Member States may also establish a committee of experts to advise them on the main macroeconomic projections, a notion that has roots in the economic literature (Wyplosz, 2005). With this aim, Council Regulation 1466/97 reinforces the multilateral examination of budget positions and the coordination of economic policies.

The SGP foresees the submission of all Member States to stability and convergence programmes. Stability and convergence programmes must present information on the adjustment path and the expected path of the general government debt ratio, as well as the main assumptions made about expected economic development. New to SGP II and in line with the recommendations of the literature, structural reforms are encouraged by the possibility of taking them into account on the path towards adjustment.

The preventive arm of the SGP

The preventive arm of the Pact was, for the first time, given real substance with the implementation of the Medium Term budgetary Objective (MTO). In the 1997 version of the SGP, the MTO was the same for every country: a close-to-balance or surplus budget. Since 2005 the MTO has been given a new definition and is part of a broader new addition to the SGP: the code of conduct. Member States have to define a specific MTO in cyclically adjusted terms. Thus, cycles are now taken into consideration. As recommended by the literature, country specificities must be taken into account. This new device means that surpluses from periods of economic growth are required to be used for debt and deficit reduction.

The goals of the MTO are threefold. The first is to provide a margin with respect to the three per cent of GDP deficit ceiling. This margin is calculated by taking into account the past output volatility and budgetary sensitivity to output fluctuations of each Member State. The second goal is fiscal sustainability, for instance, taking into account the economic and budgetary impact of aging populations. Influenced by the economic literature (Blanchard and Giavazzi, 2004; Buti, Eijffinger and Franco, 2003; Fatas, 2005), the third goal is to take into account the need for public investment and represents the structural side of the SGP. The MTOs are revised every four years or whenever a major reform is implemented.

The Council also has the leeway to issue an ‘early warning’ to Member States before an excessive deficit has occurred. Articles 6(2) and 10(2) of Council Regulation 1466/97 state that

In the event that the Council identifies significant divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, it shall, with a view to giving early warning in order to prevent the occurrence of an excessive deficit, address, in
accordance with Article 103 (4) a recommendation to the Member State concerned to take the necessary adjustment measures.

The dissuasive element

If a country breaches the three per cent value for three consecutive years, it is considered to be in violation of the SGP. In order to dissuade countries from excessive deficits, Council Regulation 1467/97 establishes the Excessive Deficit Procedure (EDP). When the council decides that an excessive deficit exists, it makes recommendations to the Member State and establishes a deadline of six months (raised from four) for corrective policies to be implemented. If a Member State fails to implement the policies based on the Council’s decisions, the Council imposes sanctions (deposits, and then fines), which are levied within ten months of the first report of an excessive deficit. A country cannot avoid the deposits, and ultimately the fine, unless the Council decides to abrogate some or all of the sanctions. Abrogation depends on the significance of the progress made by the participating Member State concerned in correcting the excessive deficit, if the breach has resulted from an unusual event or a major economic decline (that is, an annual decline in real GDP of at least two per cent), or if the country’s deficit is due to ‘relevant factors’. Any fines already imposed are not reimbursable. Interest on the deposits lodged with the Commission, and the yield from fines, are distributed among Member States without an excessive deficit, in proportion to their share in the total GNP of eligible Member States.

Assessing the Pact

The economic literature and the Pact

Before the creation of the SGP, the economic literature reflected on the need of a fiscal rule for Europe. In 1997 this fiscal rule materialized into the SGP. Since then, the literature has addressed criticisms to the scientific justifications of the specific design of the SGP, as well as the proposed alternatives. Most of the justifications covered by the literature are inscribed in the following notions: sustainability of public finances; free-riding and moral hazard; coordination and policy mix; and finally the credibility of the ECB.

As for sustainability, the literature is divided with respect to the actual effects of the SGP. Prior to the SGP, financial markets played an active role in disciplining governments, and this still holds true (Bernoth, von Hagen and Schuknecht, 2004). Moreover, some authors challenge the arbitrariness of the definition of sustainability implicit in the SGP (the 3 per cent–60 per cent rule). On the one hand, since budget composition is different across countries, De Grauwe (2003) argues that countries should be able to choose their own debt target instead of the 60 per cent ceiling, and as a consequence have different deficit targets. On the other hand, Coeure and Pisani-Ferry (2005) call for a better concept of sustainability, including, for example, pension regimes. This is something that has been addressed in the amended version of the SGP through the notion of ‘relevant factors’, one of them being the change in pension expenditures.
As for free-riding, the SGP may prevent it (Warin and Wolff, 2005), but it seems not to prevent moral hazard. Indeed, although included in the definition of the Pact, the dissuasive arm seems to malfunction due to moral hazard behaviours: De Haan, Berger and Jansen (2003) explain that this is, likely, one of the reasons why some countries – Germany and France, for instance – decide to put more emphasis on solving their internal troubles by relaxing their fiscal policies instead of strictly abiding by the letter of the SGP. The SGP should prevent countries from changing their attitudes once within the Eurozone, but a recent literature on the political budget cycle (PBC) and the SGP explains that incumbent governments within the Eurozone display an inclination to raise public expenditure, and thus deficits, before an election, although they have to abide by the SGP (Mink and de Haan, 2005). Buti and van den Noord (2003) analyse the fiscal policies over the 1999–2002 period and find some evidence of expansionary fiscal policies motivated by near-term elections. This result is confirmed by von Hagen (2003) who concludes that there is evidence that fiscal policies were used during the period 1998–2002 before elections. Those results mean that the SGP does not seem to prevent moral hazard behaviours.

As for coordination, the SGP may not represent the optimal means of dealing with this problem. Eichengreen (1990), Cohen (1990), and Branson (1990) study the necessity for a federal budget to augment national budgets. MacDougall (1977), De Grauwe (1990), Italianer and Vanheukelen (1993), and Bryson (1994) analyse the need for a centralized budget as a way of establishing automatic stabilizers with income transfers from better-off to worse-off countries.

As for the ECB’s credibility, every EMU member enjoys a lower risk premium than before the creation of the euro, which can be explained by many reasons, such as the liquidity of the market and the improved credibility for the central bank in charge of the European monetary policy. Did the SGP play a role? Since Germany and France did not abide by the SGP for some years, it is difficult to grant this benefit exclusively to the SGP.

In this context, the SGP has had mixed results. The amended version of 2005 embodies some of the changes called for by the economic literature. The lack of flexibility was one of the main criticisms. For instance, Cooper and Kempf (2000) call for some flexibility at the fiscal level, as the ECB lacks the tools necessary for stabilization in the presence of country-specific shocks. The new definition of the MTO based on country specificities seems to go into this direction, although this is misleading. Indeed, the MTO in SGP I was ignored by the countries which considered only the three per cent of GDP reference value. Its new definition, based on country specificities, is now at the core of the assessment of countries’ fiscal policies. In other words, it seems that for national policies what matters is no longer three per cent but their specific medium-term objectives, by definition lower than three per cent. In this regard, the new preventive arm seems to be tighter than the original SGP, and hence less flexible.

Flexibility refers to the idea of an optimal fiscal policy even though it can be above the three per cent deficit limit. In order to target this optimal fiscal policy and prevent at the same time the existence of a political budget cycle, authors such as Wyplosz (2005), Beetsma and Debrun (2005), Annet, Decressin and Deppler (2005), and Marinheiro (2005) argue for the strong version of institutional reform – the creation of an independent Fiscal Policy Committee (FPC), and a reconfiguring of the debt targets so that they are established, country by country, on a basis of the starting position. This would not automatically mean the end of a fiscal rule in Europe, but it would mean the end of the SGP. However, SGP II seems to go in this direction.
Indeed, it allows countries to decide whether they need an independent committee to scrutinize their domestic fiscal policy. In fact, this independent committee is not the same as the FPC: the FPC could decide an optimal fiscal policy above the three per cent deficit limit, which is not the case with a national independent committee.

Another solution to introduce some flexibility without renegotiating the Treaty of Amsterdam, as well as giving some weight back to the debt criterion, is proposed by Pisani-Ferry (2002): allowing countries to opt out of the Excessive Deficit Procedure based on the deficit, and abide by the 60 per cent of GDP debt criterion. In this spirit, a country can have a deficit greater than three per cent as long as its debt is below 60 per cent. But before we consider other amendments, what is the future of the Pact from an institutional perspective?

The future of the Pact

The changes produced by SGP II to SGP I are twofold and concern both the preventive and dissuasive arms of the Pact. First, there is new definition of the medium-term objective (preventive arm). However, it is acceptable if countries do not abide by the medium-term objective as long as they do not go over the reference value of three per cent: regulation 1466/97 explains,

[in] order to enhance the growth-oriented nature of the Pact, major structural reforms which have direct long-term cost-saving effects, including by raising potential growth, and therefore a verifiable impact on the long-term sustainability of public finances, should be taken into account when defining the adjustment path to the medium-term budgetary objective for countries that have not yet reached this objective and in allowing a temporary deviation from this objective for countries that have already reached it.

This amendment does not relax the reference value of three per cent, but relaxes the constraint imposed by the definition of the medium-term budgetary objective. The amendment adds: ‘in order not to hamper structural reforms that unequivocally improve the long-term sustainability of public finances, special attention should be paid to pension reforms introducing a multipillar system that includes a mandatory, fully funded pillar, because these reforms entail a short-term deterioration of public finances during the implementation period.’

The second change was to the dissuasive arm and deals with exceptional circumstances. The dissuasive arm is looser than it was. The European Commission is asked to prepare a report in case of a breach of the deficit reference value by a Member State. If the breach is not justified by an economic downturn (a recession of at least two per cent of GDP) or an exceptional external event, countries have to make deposits to the European Commission that will be transformed into fines in the third consecutive year if a country could not abide by the reference value for three years in a row. The amended regulation loosens the constraint by introducing the notion of relevant factors. Moreover, before asking for deposits when a country breaches the deficit reference value for the first or second time, the Commission should look at the medium-term economic position of a country, at relevant factors, and at the overall quality of public finances.

In the long run, the most important question in assessing the effects of SGP II versus SGP I is to know whether the preventive arm – tighter than
under SGP I – will outweigh the loosening of the dissuasive arm. The answer is in the hands of national governments. In retrospect, the SGP does not seem to provide an ideal answer to the branches of the literature studying the potential need for a fiscal rule. This is not surprising, since the SGP is, by its nature, as much a politically designed rule extending the Treaty of Maastricht as an economically designed one.

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See also

- European Central Bank;
- European economics;
- fiscal federalism.

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**Index terms**

bonds  
budget deficits  
business cycles  
default risk premia  
Economic and Monetary Union (EMU)  
European Central Bank  
Eurozone  
fiscal rules vs. discretion  
fiscal–monetary policy mix  
free-rider problem  
Medium Term budgetary Objective (EU)  
monetization  
moral hazard  
optimal fiscal policy  
political budget cycles  
public debt  
public finance  
Stability and Growth Pact  
stabilization  
Treaty of Amsterdam (EU)  
Treaty of Maastricht (EU)  
uncovered interest parity

**Index terms not found:**

business cycles  
fiscal rules vs. discretion  
free-rider problem  
monetization