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# TWENTY YEARS OF STABILITY AND GROWTH PACT

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Abstract. The year 2017 marked a quarter of a century since the fiscal discipline was embedded in the EU legislation and the 20th anniversary of the Stability and Growth Pact. The figures published by the European Commission in autumn 2016 revealed modest growth in challenging times, budget balance of 2% and gross debt of 86% in the EU. The economic governance framework evolved significantly since its creation in order to accommodate the economic and political developments, as well as the lessons learned: from focus on deficit and debt (in fact more on the deficit) to a larger range of macroeconomic indicators; from strict rules to flexibility and focus on national specificities; again to stricter rules to move afterwards towards growth oriented approach. The results of this framework implementation were limited by the lax implementation and the different developments in Euro Area and Non-euro member states prove not only that one size fits all measures are not suitable, but also that the Economic and Monetary Union needs changes in order to smoothly function in the future. This paper analyses the evolution of the European economic governance framework and its effects on public finance.

## 1. Introduction

The debate on the European Union (EU) economic governance framework intensified since 2009 in the difficult context of the Great Recession. Different views on the way forward were expressed and the debate on austerity versus Keynesian stimulus dominated the agenda. While the USA decided to use fiscal stimulus and quantitative easing since the onset of the crisis, the EU followed the fiscal consolidation path in the first years, moving towards more flexibility and boosting investments afterwards.

After difficult negotiations at European level in the middle of the crisis, the results are: a strengthened Stability and Growth Pact (SGP), the recognition of the specific euro area challenges and of the need for flexibility in order to accommodate the unpredicted events (like security and migration crises, low demand, lack of investments, or ageing population).

But several questions arise if we want to have a better understanding of these developments: How did the economic governance framework evolve? Did the framework influence the developments or the framework has changed taking into consideration the developments? Was the fiscal discipline the cornerstone of the EU member states policies? Did the euro area member states register different developments than the non-euro members? This paper tries to answer this questions. Section 1 looks at the role of the fiscal discipline, as depicted in the economic literature. Section 2 reviews the budget deficit and debt developments, as these two are the main economic indicators used at the EU level when talking about fiscal discipline. Section 3 looks at the economic governance framework changes since its creation and should be read together with section 2 in order to have a better understanding of the cause-effect nature of these

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economic, respectively legislative developments. Section 4 looks at the actual implementation of the framework, and then conclusions are being drawn.

## 2. The role of the fiscal discipline in the economic literature

The fiscal indiscipline (in both private and government sectors) was one of the triggering factors of to the Great Depression, with the negative effects at both economic and social level (as suggested by Stiglitz, Ocampo, Ffrench-Davis & Nayyar, 2006; Krugman, 2012). But more than that, these adverse effects also impacted the potential growth and the economic and financial stability (Stiglitz, Ocampo, Ffrench-Davis & Nayyar, 2006). The macroeconomic costs of a bad financial management can generate excessive volatility, with side effects on the long term economic growth (Fatas & Mihov, 2007).

The fiscal discipline is essential for maintaining the financial stability, reducing vulnerabilities and improving the aggregate economic performance. Of same importance is ensuring the right balance between the short term and the long term objectives, as well as the right balance between flexibility and predictability (Kumar & Ter-Minnesian, 2007).

Even if the need for fiscal discipline is well argued in several papers, implementing the right mix of policies proved to be difficult for several reasons, such as the type and force of the rules that were applied, the institutional framework, the political environment and the actions taken by the decision factors (Alesina & Perotti, 1994; Fatas & Mihov, 2007). A relevant example is the European Union: The Maastricht Treaty included several fiscal rules (such as the deficit or the debt rules, the no-bail out clause, nominal convergence criteria, etc.), still their relaxation in 2005 proved to have significant costs during the crisis. Another example is Hungary, where the policies were not oriented towards fiscal discipline and the internal shocks amplified the external shocks, as well as the potential growth (Matolcsy, 2015).

As regards Romania, the procyclical fiscal measures implemented before the crisis requested adjustments in 2010-2011, that were necessary form a quantitative point of view, but with significant social costs, that generated social tensions (Georgescu, 2016).

We should not forget the banking sector, that benefitted from significant financial help and the nationalization of the losses, losses that were accumulated because of irrational risk taking, deregulation or lack of regimentation.

## 3. Budget deficit and debt developments in the EU

This section aims to assess how the objective of the Stability and Growth Pact, namely keeping the deficit and debt levels below the targets (3%, respectively 60% of GDP), as means to ensure the long term sustainability of public finance, was achieved. In this regard, using Eurostat database, data from 1997 to 2015 was computed in a manner that reflects the changing geometry of both the European Union and the euro area (as the member states had different accession dates in both structures, they were only taken into account when they became members) and represented graphically in Figure 1 and Figure 2 bellow. Two sets of data (euro and non-euro member states) were used in order to underline the role of the monetary policy in dealing with macroeconomic imbalances and shocks to the economy (as the Great Recession was), relevant question in the context of Romania being a member state that, according to the Accession Treaty, has to join the euro area.

One first interpretation of the graphs above is that the starting point (1997) was similar for both euro and non-euro member states, with budget deficits being under the reference value of 3% of GDP, while the public debt was close to, but breaching the Maastricht rule.[1]

[1] Figure 1: Average budget deficits. Source: own calculations using Eurostat database and taking into account for each year the member states that were in the euro area and those outside the euro area.

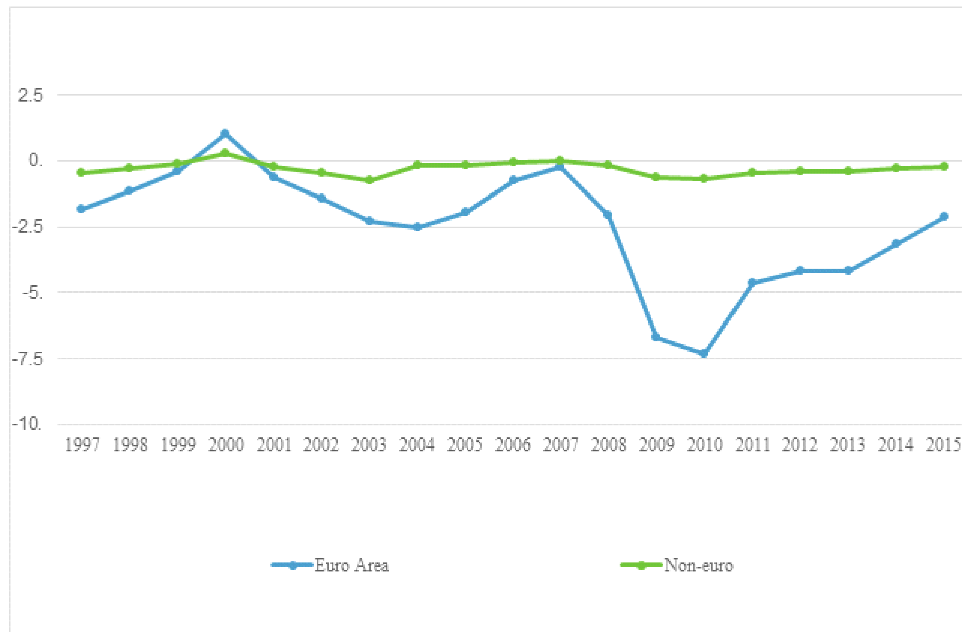


**Figure 1: Average budget deficits**

We can notice that a significant decrease of the public debt for the non-euro took place in 2001, the year Greece joined the euro area (thus having a significant impact on the average of euro area).[2]

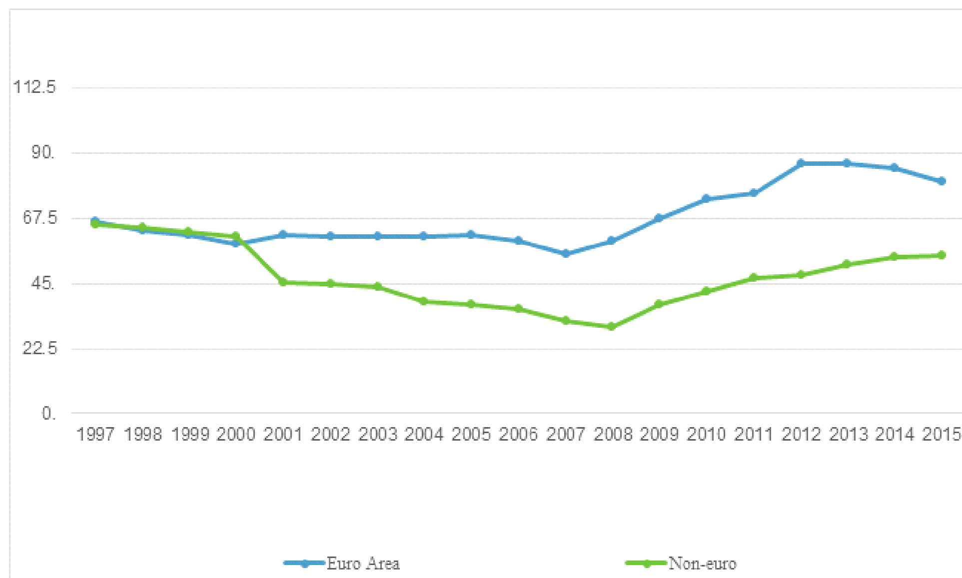


**Figure 2: Average governments gross debt**

Then different developments took place:

[2] Figure 2: Average governments gross debt. Source: own calculations using Eurostat database and taking into account for each year the member states that were in the euro area and those outside the euro area.

- euro area average budget deficit had a sinusoidal path: it decreased from 1997 to 2000, then increased from 2000 to 2004, when again started decreasing until 2007. After 2008 it had a sharp increase up to 2010 when the trend reversed. It must be mentioned that until 2009, the budget deficit average was within SGP limits (where it returned in 2015).
- euro area average public debt was on a decreasing path until 2008, when is started to increase. The Maastricht Treaty reference value for the public debt was respected only from 2006 to 2008, but with values close to 60% of GDP (59.8 %, 55.2%, respectively 59.4% of GDP).
- the non-euro average budget deficit had a more constant development and was within the SGP limits in all 20 years.
- the non-euro average public debt was well below the reference value of 60% of GDP after 2001.

We can conclude that the non-euro, on average, had better performances in the first 20 years of the SGP and the rules had a better impact on the deficit than on the debt figures. This is one finding that could be used in assessing the implications of joining the euro area for the member states that are currently outside (of course, this being just a piece of a very complex puzzle). But let's have a look at the legislative piece of the puzzle.

## 4. The developments of the economic governance framework in the EU

4.1. **1992 - The beginnings.** The year 1992 marked an important development in the EU economic governance framework. The perspective of adopting Euro, the high levels of public expenditures, public deficits (5% of GDP) and public debt (60% of GDP) determined the 12 member states at that time to agree within the Maastricht Treaty the basic rules for fiscal discipline: the deficit can no longer be financed by the central banks, the government does not have a privileged access to financial institutions, the government cannot be bailed out, the public deficit should be limited to 3% of GDP and the public debt should be limited to 60% of GDP (as revealed also by Schuknecht, Moutot, Rother & Stark, 2011). Also, the 5 nominal convergence criteria are being established.

All these provisions were adopted by the 16 member states that joined the EU at a later stage.

In 1997, the Maastricht Treaty provisions on fiscal discipline were detailed and operationalized within the SGP (15 member states now). Thus, the fiscal discipline is monitored in the preventive arm (the provision is that the budgets must be balanced or in excess and the concept of MTO[3] is introduced) and any deviation is corrected within the corrective arm (the excessive deficit procedure provides for the member state to take corrective measures and in case of failure sanctions can be imposed).

4.2. **2005 - The first reform - more flexibility.** From 1992 to 1998, there is an improvement on the fiscal stance, but starting with 2000 the budget deficit in the Euro Area is worsening. Several member states go beyond the reference value of 3% of GDP (Portugal in 2001, France and Germany in 2002, Netherlands and Greece in 2003, Italy in 2004). We should notice that 2000 is the year when the Euro is introduced so the Euro Area member states remain without the monetary policy tools.

A key turning point was the Councils decision in November 2003 to reject Commissions proposal to sanction France and Germany for breaking the deficit rule. Even though in July 2004 the Court of European Justice canceled the Councils decision, the discussions for a reform of the SGP was already on the way and 2005 brought some important changes in the economic governance framework, making it more flexible:

[3]MTO – the medium - term budgetary objective is a target, defined in cyclically adjusted terms, net of one-off and other temporary measures. It is calculated according to a formula defined in the Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes (http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf).

- preventive arm: a differentiated MTO for each member state is being introduced (and this can now deviate from the balance or excess rule); a minimum structural adjustment of 0.5% if GDP is required for the euro area and ERM II member states that do not comply with the deficit rule; the structural reforms with positive impact on the long term sustainability of the public finance are being taken into consideration (including the pensions reforms).
- corrective arm: a new definition of severe economic downturn is being decided upon and the relevant factors that are assessed within the process are clarified; more time for reaction is being given to the member states not complying with the deficit rule and the deadlines for correction are being extended; the euro area member states are required to improve the structural deficit by 0.5% of GDP.

4.3. **2011 - The second reform - strengthening the SGP.** The second reform took place in the context of the Great Recession and its effects: since 2008 the budget deficits started increasing (in 2010, 23 out of 27 member states were placed in excessive deficit procedure), the public debt goes well beyond 60% of GDP (especially within the euro area). Moreover, in 2010 Greece gets the first financial assistance package and the European Financial Stability Fund is being created (until then, only the non-euro member states could get financial assistance through the balance of payments facility). The next step was the creation, in 2012, of the European Stability Mechanism, the permanent instrument for euro area member states in financial difficulty.

This second reform meant more attention to economic policy coordination, to the public debt and to the macroeconomic imbalances. More specific, the so called 'Six Pack' (5 regulations and a directive: Regulation No 1173/2011 on the effective enforcement of budgetary surveillance in the euro area – sanctions regulation, Regulation No 1174/2011 of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area, Regulation No 1176/2011 of 16 November 2011 on the prevention and correction of macroeconomic imbalances, Council Regulation No 1177/2011 of 8 November 2011 amending Regulation No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, Regulation No 1175/2011 Of The European Parliament And Of The Council of 16 November 2011 amending Council Regulation No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies and Directive 2011/85/EU on requirements for budgetary frameworks of the Member States) adopted in 2011 meant:

- introducing the European Semester - the economic policies of the member states are being coordinated within the annual budgetary cycle. Policy orientations are proposed by the European Commission, discussed at the Council of European Union level and endorsed by the heads of states and governments at European Council level. Then, based on the member states Stability/Convergence Programs and the National Reform Programs, the Council adopts country specific recommendations in order to feed the national budgetary process.
- introducing the macroeconomic imbalances procedure (including the excessive imbalances procedure) - 14 economic indicators assess the risk of internal and external imbalances, competitiveness and social developments, then the economic judgement is used to establish the existence of imbalances and to propose measures within the country specific recommendations.
- operationalization of the debt rule within the SGP - the excessive deficit procedure may be launched in case of the breaching the debt rule as well.
- introducing the expenditures rule in the preventive arm - the growth path of the government expenditure is being assessed against a reference medium term rate of potential GDP growth, in order to ensure the achievement of the MTO or the adjustment path towards it.
- defining the significant deviation from the MTO (0.5% of GDP per year or 0.25% of GDP in 2 subsequent years).
- introducing financial sanctions for the Euro Area member states in both preventive and corrective arms (we have to mention that the non-euro member states are not subject to

financial sanctions, but they may be penalized by partial or total suspension of commitments or payments of the EU funds)

- requirements for the budgetary frameworks - fiscal rules, medium term budgetary frameworks, more transparency, using more prudent forecasts in the budgetary process, the creation of fiscal councils.
- using the reverse majority voting rule - the decisions are now being adopted if the majority of the member states does not oppose. Thus, the decisions are being taken in a semiautomatic manner.

Even if not part of the EU acquis (it is an intergovernmental treaty), we have to mention here the Treaty on Stability, Coordination and Economic Governance within the Economic and Monetary Union, signed in 2012 by all but 3 member states (namely Great Britain, Czech Republic and the newest member state, Croatia) that provides for more fiscal discipline: the signatories commit to keep the budget in balance or in excess, to limit the structural deficit to 0.5% of GDP (except for the member states with a low and sustainable public debt, that are allowed to have a structural deficit of 1% of GDP). Also, automatic correction mechanisms must be in place in all the member states for the cases when there is a significant deviation from the MTO or the adjustment path towards it.

4.4. **2013 – The Two Pact adopted.** The so called "two pack" means the two regulations for the euro area member states aiming to increase the transparency on their budgetary decisions, stronger coordination of the budgetary cycles and the recognition of the special needs of euro area Member States under severe financial pressure (Regulation No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area and Regulation No 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability). These legislative pieces should be seen in a larger context of the efforts taken to reinforce the Economic and Monetary Union.

4.5. **2015 - The reinterpretation of the Stability and Growth Pact.** The Great Recession left the EU member states with high public deficits and debts and low to modest economic growth, in a global environment of low demand. Thus, the government's fiscal space reduced significantly in times of high unemployment, difficult security environment and also migration crisis. The austerity path did not seem to represent the right answer to the macroeconomic and social problems and could not fuel the economic engines. We should mention here that the Euro Area member states were in a more difficult situation as they could not balance their economies using the monetary policy.

In this context, the beginning of 2015 brought the European Commission Communication on the SGP flexibilities, thus a reinterpretation of the existing legislative framework and not a reopening of the difficult negotiations on a sensitive issue where different opinion exists within the member states. We can see now that the fiscal discipline must be preserved, but not with the cost of structural reforms and investments. The new concept, as the Annual Growth Survey reveals in several editions is 'growth friendly fiscal consolidation'. The need for investments gets into the spotlight and the Juncker Commission undertakes several strong decisions in this regard: The Investment Plan for Europe (with its European Fund for Strategic Investments) is being launched and the one of the priorities of each European Semester are the investments.

The flexibilities mentioned above refer to the investment clause, the structural reform clause and the matrix of fiscal adjustment requirements depending on the economic cycle. Another flexibility generated by special circumstances was also activated in the context of the migration crisis.

The *investment clause*: a temporary deviation of maximum 0.5% from the MTO or the adjustment path towards it is allowed in order to cover the incremental costs for co-funding the

projects financed by the European Structural and investment Funds, the Connecting Europe Facility, European Fund for Strategic Investments and Trans-European Networks. In order to ensure that this flexibility does nor prejudge the fiscal discipline, some conditions must be fulfilled by the member state requiring the activation of this clause: the GDP growth is negative or the GDP remains well below potential (output gap greater than 1.5% of GDP) and the reference value of 3% of GDP for the budget deficit must be preserved.

The *structural reform clause*: a temporary deviation of maximum 0.5% of GDP from the MTO or the adjustment path towards it is allowed for major structural reforms that have a direct long term positive budgetary effects. In order to ensure that this flexibility does not prejudge the fiscal discipline, some conditions must be fulfilled: the maximum initial distance from the MTO is 1.5% of GDP and the reference value of 3% of GDP for the budget deficit must be preserved. In 2016, Latvia and Lithuania benefited of the clauses (for pension and healthcare reforms, respectively for pensions reform).

The cumulative temporary deviation granted for structural reforms and investments does not exceed 0.75 % of GDP. (Italy benefited of this cumulative clauses in 2016).

The *matrix for specifying the annual fiscal adjustment towards* the MTO was drafted to ensure that larger fiscal effort is to be undertaken during better times and a smaller fiscal effort to be undertaken during difficult economic conditions.

*Special circumstances generated by the migration crisis.* In 2016, Belgium, Slovenia, Austria and Finland benefited of this clause.

4.6. **2016 - Stronger focus on an expenditure-based indicator.** In October 2015, the European Commission presented within the Communication on strengthening the Economic and Monetary Union its intention to create a single indicator for setting and assessing the fiscal policies, in both the preventive and the corrective arm. The aim was to reduce the complexity in the fiscal surveillance framework and to provide more transparency.

After intense negotiations, the ECOFIN Council in December 2016 agreed on a stronger focus on the expenditure based indicator, while the structural balance indicator remains an essential part of the surveillance framework. “The indicator involves setting an upper limit for the growth rate of government expenditure. This is considered an operational and easy-to-measure target that will guide member states in the preparation and monitoring of their budgets.” (ECOFIN Council Conclusions, December 2016).

## 5. 20 YEARS OF THE CORRECTIVE ARM IN FIGURES

In 20 years, the EU member states spent altogether 169 years in the excessive deficit procedure (the corrective arm of the SGP). An average of 6 years per member state, so 30% of the time. Of course, the member states had different developments, and we can see in the table above some member states (Estonia, Luxemburg, Sweden) were never placed in excessive deficit procedure (even though Commission reports were drafted, so there was a risk), while other member states spent half of this time in the corrective arm. We have to mention here that many procedures were launched after 2009, in the context of the Great Recession (24 out of 38 launched procedures).[4]

[4]Figure 3: Number of years spent in excessive deficit procedure by the EU member states. Source: own calculations based on the information published on the European Commission web site. EE – Estonia, LU – Luxemburg, SE – Sweden, BG – Bulgaria, FI- Finland, HR – Croatia, BE-Belgium, DK – Denmark, RO – Romania, Li – Lithuania, LV – Latvia, Au – Austria, IT – Italy, IE – Ireland, SI – Slovenia, NL – Netherlands, ES – Spain, CY – Cyprus, DE – Germany, MT – Malta, SK – Slovakia, CZ – Czech Republic, HU – Hungary, EL – Greece, PT – Portugal, PL – Poland, UK – Great Britain, FR – France.

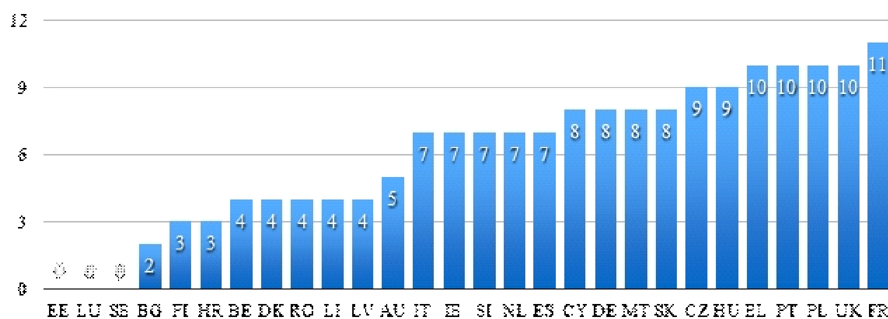


**Figure 3: Number of years spent in excessive deficit procedure by the EU member states**

It is interesting to have a look at these developments separately for the euro area member states, respectively the non-euro member states.[5]

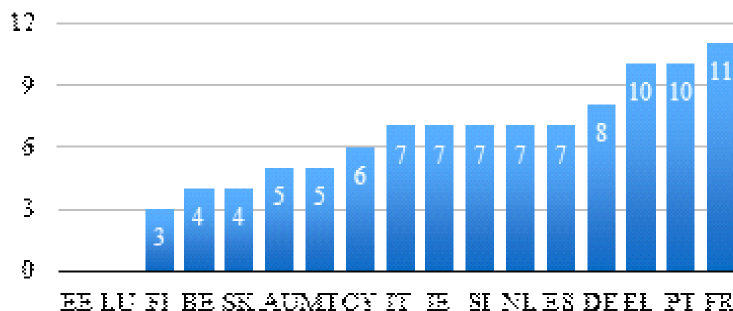


**Figure 4: Number of years spent in excessive deficit procedure by the Euro Area member states**

Even if the average number of years spent in excessive deficit procedure is similar (5.94 years for the Euro Area member states versus 5.23 years for the non-euro member states), we can easily notice that if we exclude the best performers (EE, LU, SE) and the worst performers (EL, PT, FR, CZ, HU, PL, UK), the average number of years spent in excessive deficit procedure is higher in the Euro Area member states than in the case of non-euro member states.[6]

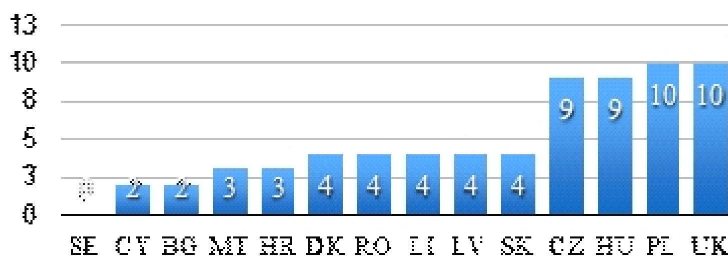


**Figure 5: Number of years spent in excessive deficit procedure by the Non-euro member states**

As regards the number of excessive deficit procedures, most member states (46%, or 13 member states) had only one procedure, most of them in the context of the Great Recession;

[5] Figure 4: Number of years spent in excessive deficit procedure by the Euro Area member states. Source: own calculations based on the information published on the European Commission web site.

[6] Figure 5: Number of years spent in excessive deficit procedure by the Non-euro member states. Source: own calculations based on the information published on the European Commission web site.

only Hungary has been in the excessive deficit procedure since 2004). 39% (11 member states) had 2 procedures (out of which one in the context of the Great Recession).[7]

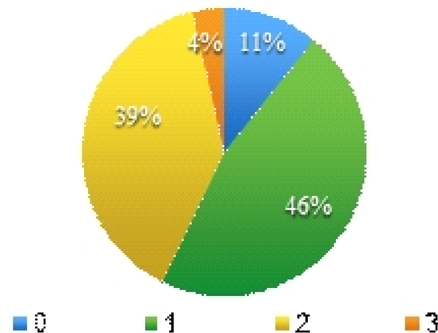


**Figure 6: Number of excessive deficit procedures**

Even if the SGP provides for sanctions and there were several cases where the member states did not take effective action (not taking the effective action means not complying with the recommendations issued by the Council), no sanction was actually ever imposed. We should mention here the case of Hungary in 2012, when the finance ministers approved the freezing of €495 million of Hungary's EU funds, in an unprecedented application of the EU's Excessive Deficit Procedure. Still, as the sanction would have been applied in the year following the Council decision, Hungary took the necessary measures and the measure was cancelled.

The most recent cases where the sanctions were not applied in the excessive deficit procedure are in 2016 for Spain and Portugal. Both countries failed to take effective actions, but the decisions on imposing fines were formal only, as they were cancelled. Of course, UK's decision on BREXIT played its role in the decision making process, as any decision at the European level sends a strong signal to the markets and people.

## 6. Concluding remarks

The economic governance framework played a role in improving the sustainability of public finances, but the lax implementation diminished the potential positive effects, as the member states were not that incentivized to obey the rules if this came with high internal political costs (see Greece or France). An important role in defining and implementing the rules is played by the political factors (at both the national and at European level). In the same time, the deficit and debt developments (of course, together with other relevant factors, as the investment needs during the Great Depression) influenced the economic governance framework, so we can talk about a bidirectional effect.

The latest developments indicate that the need for transparency, predictability and continuity of the rules must be balanced by flexibility in order to accommodate both the unpredicted events and the national specificities, and important steps in this direction were taken in the last few years (as for example using the flexibilities of the SGP, putting more emphasis on investments, recognizing the Euro Area need for a different approach or trying to solve the negative spillovers by a better coordination between member states).

The Great Recession revealed also that a focus on the 2 basic macroeconomic indicators used within the SGP (namely de budget deficit and the public debt) are not enough to prevent economic slippages. As Reinhart and Rogoff (2012) proved, assets price developments are an important trigger for crises. And the macroeconomic imbalances procedure came to correct this weakness of the SGP by assessing 14 macroeconomic indicators (including house price index).

[7] Figure 6: Number of excessive deficit procedures. Source: own calculations based on the information published on the European Commission web site.

Moreover, several steps were taken to tackle the risk in the financial sector (strengthening the Economic and Monetary Union or the creation of the Banking Union).

Also, the risks related to the public debt that were not considered before are now better monitored by operationalization of the debt criterion within SGP.

In terms or public debt and deficit, euro area member states and non-euro members had different performances in these first 20 years of SGP implementation, the monetary policy tools seeming to play an important role: non-euro members spend less years in the excessive deficit procedure, had lower deficits and debt levels.

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