

**INQUIRY BY THE HOUSE OF LORDS ON:  
THE REVISION OF THE STABILITY AND GROWTH PACT**

**UNICE POSITION**

- 1) *The inflexibility of the current Stability and Growth Pact: Is there a sound basis for the existence of EU-wide restrictions on the public borrowing of Member States? Why is the current Stability and Growth Pact deemed to be too inflexible? Have the current problems arisen because the rules are too rigid? Or is it rather because of the budgetary actions and fiscal policy decisions of individual Member States? Is the current Pact restrictive on growth?*

a) Economic rationale:

The Stability and Growth Pact (SGP) was concluded in 1997 in order to avoid members of the Eurozone accumulating excessive debts and deficits, the economic costs of which the Eurozone as a whole would have to bear. In the current discussion about the “flexibility” of the rules of the SGP it is important to notice that the goal of the Pact has always been a medium-term one: to consolidate public finances so that budgets are close to balance or in surplus over the business cycle.

This rule underpins the policy assignment within the Economic and Monetary Union: with the single monetary policy responding to Eurozone-wide economic developments, it is the national fiscal policies that should take care of asymmetric shocks within the Eurozone and country-specific developments. With the limits of discretionary fiscal fine-tuning of the economy encountered painfully in the 1970s and 1980s, the main stabilising instrument of fiscal policy are automatic stabilisers. With the starting point of a budget ‘close to balance or in surplus’, the rules of the SGP provide enough room for manoeuvre so that the automatic stabilisers can fulfil their role. Their work should be symmetric, i.e. they should be allowed to function both during the upturn and during the downturn of the business cycle.

Thus, the SGP is needed to ensure that fiscal policy can be effective in the EMU. Inserting a degree of fiscal rectitude to Member States’ budgets, it creates a room for manoeuvre for the single monetary policy and ensures that it can play its role in the policy-mix. Besides, a strong SGP strengthens the currency by sending a signal to the markets that no excessive budget deficits will emerge in the Euro-area thus also providing room for manoeuvre for the ECB. Only sound public finances can keep interest rates low and lead to the crowding-in of private investments.

Re-directing the design of public finances to medium-term also prepares national budgets for the threatening time bomb of an ageing population in Europe, one of the major economic threats of our time.

Therefore, the SGP is a necessary condition for macro-economic stability and for raising the medium- and long-term growth potential of the Eurozone.

b) The “inflexibility” of the SGP:

The European business community does not share the view that the rules of the SGP are too inflexible. Without fulfilling the prerequisite of a balanced budget, there is no place for fiscal flexibility, as the interest bearing state debt would increase. Especially in view of the ageing problem in Europe, all governments must now bring their budgets under control.

When evoking the recent fiscal plan for stimulating the US economy as an example for “flexible” fiscal policy, the comparison with the European situation does not hold. In contrast to the Eurozone, important economic fundamentals like the public debt ratio or the age structure of the population do not pose a problem in the US.

If the SGP is applied correctly over the business cycle, its rules are not restrictive. As a matter of fact, overall the SGP has proven very successful. Most EU Member States are now in a much better budgetary position than they were before the Pact was installed.

Neither are the rules restrictive for the Member States that did not undergo the necessary fiscal reforms in good economic times. Only if governments try to keep within the 3% limit by raising taxes, as is currently the case in Germany, and thereby applying a false budget “discipline”, counterproductive effects may occur. Instead, the reform should mainly concentrate on consumptive expenditure. By doing so, economic effects will be positive.

- 2) *The specifics of the design of the current Stability and Growth Pact: What are the criteria in the present Pact that pose the greatest problems to Member States? How does the Stability and Growth Pact compare in this respect to the Code for Fiscal Stability that forms the British budget framework?*

In contrast to most Member States of the Eurozone, the governments of several large Member States applied the Pact selectively and did not conduct prudent fiscal policies during the times of high economic growth. As a consequence, the budgetary situation in these economies is worrying. Excessive deficit procedures have been opened for Germany and Portugal that did breach the 3% budget deficit limit. France and Italy are not only approaching the 3% limit, but do not show the determination that would be appropriate to reach balanced budgets any time soon, invoking an unfavourable economic environment. The goal of reaching reach the medium-term-target of a budget in balance or in surplus by 2004 (which is not enshrined in the SGP but to which the Heads of State and Government committed themselves during the Barcelona Summit in March 2002) had to be postponed. This makes it all the more important that the 3% ceiling of the budget deficit is respected.

Compared with national Codes or laws on fiscal stability, it is to be stressed that the SGP is a policy co-ordination tool and designed to make macro-economic policy among EU Member States work in the long run. Therefore it must create trust and maintain political credibility.

- 3) *The Commission's Proposals: Do the Commission's proposals address the deficiencies in the current Pact? Will the Commission's proposals help to resolve the budgetary problems of the Member States that are currently having difficulties staying within the terms of the Pact? Are there any inconsistencies in the Commission's proposals? Is it appropriate that structural budget deficits should be reduced by at least 0.5% of GDP a year? How should cyclically adjusted budget balances be calculated? Is it possible for them to be calculated in a sufficiently unambiguous way for them to be used as the trigger for sanctions? Should the 3% reference value for the deficit/GDP ratio be set in cyclically adjusted rather than current terms? What would constitute a 'satisfactory pace' of debt reduction towards the 60% of GDP reference value? Is it helpful to impose tighter restrictions on high-debt countries and allow greater flexibility to low-debt countries? Should the pact be amended to allow more flexibility for dealing with longer-term changes in needs for public spending, such as a bulge in public pension obligations? In such a situation is the pact flexible enough to allow the tax burden to be spread widely enough? If not, should it be amended so that it is? Would you wish to make proposals different from those of the Commission?*

The main objective of the Commission's proposals of 27 November 2002 is to assure budgetary commitment of Member States. The core rules of the SGP are left unchanged: the main goal remains the achievement of sound public finances in the medium-term. However,

those Member States that prove they can keep their budgets under control will be able to undertake structural reforms in the framework of the Lisbon Strategy. This strengthening of interaction between structural reform and macro-economic policy is an important new element, which is also emphasised in the Commission's Synthesis Report of 14 January 2003. However, the application of allowing exceptional budget deficits in order to push structural reforms must be watched carefully in order not to incite governments to launch public expenditure programmes and thus re-introduce discretionary fiscal policy through the back door.

On the other hand, Member States with difficulties in controlling their deficits or their debt ratio are still restricted to budget discipline. The clear commitment to the 3% ceiling in that context is necessary to the credibility of European budgetary co-ordination and beneficial to the long-term growth potential of Europe.

The Commission's proposals put a new emphasis on driving down structural deficits. The proposal to have Member States with excessive deficits lower their structural deficits by 0.5% per year goes in the right direction as the excessive deficits of Member States are, in fact, to a large extent structural and not caused by the economic downturn.

Balanced budgets are the safest way to prepare the economy to deal with periodic changes in the business cycle and asymmetric shocks. That implies that underlying structural deficits are targeted and reduced, which necessitates continued restraint in government spending.

In order to avoid devastating fiscal situations such as the ones observed today in big Member States, the Commission wants in future to be able to sanction a pro-cyclical loosening of the budget in good times as a violation of the SGP. This measure of providence is also welcomed by UNICE.

- 4) *Enforcement: By what method should a revised Pact be enforced? Are the current provisions on excessive deficit procedures and the early-warning mechanism working effectively? What criteria should be used when deciding whether to activate the early-warning mechanism? Are the arrangements for decisions on penalties functioning successfully? If not, how should they be revised? Is there scope for simplifying the institutional procedures of the SGP. Should the Commission be given the authority to issue early-warnings directly to Member States without recourse to a Council vote?*

Today's situation illustrates a more general problem in EU policy-making, namely that the Member States find it difficult to implement at the national level policy solutions which they have agreed on at the European level. This delivery gap undermines the effectiveness of economic policy coordination.

In the past, the danger of Member States questioning the enforcement of the SGP when it is applied against them has emerged, e.g. when the Council decided not to issue a formal early warning to Germany in 2002 although their devastating budget situation would have largely justified it. More generally, any lack of commitment to the SGP by Member States has damaging consequences for the credibility of the EMU and undermines the ability to stabilise the economy through budgets. Therefore, UNICE supports the strengthening of the Commission's role in the surveillance and enforcement procedure.

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