17 February 2005

A NEW INTERPRETATION OF THE STABILITY AND GROWTH PACT

UNICE POSITION PAPER

EXECUTIVE SUMMARY

It is essential to close the debate on the Stability and Growth Pact as soon as possible in order to restore confidence in an **essential coordination mechanism** of the European Monetary Union. UNICE strongly expresses its attachment to a transparent and clear rules-based system. No reform should water down the system, notably by reviewing the reference values of 3% GDP for the budget deficit and 60% for public debt and its initial objectives in terms of macroeconomic stability and sustainable growth.

UNICE warns European policy-makers against doing more harm than good in accepting some of the proposals that are being formulated in the current debate.

- European business **opposes the proposed revision of the "exceptional circumstances"** for slow-growing countries, as an entitlement for them to run deficit in excess of 3% GDP. Such a change will provide incentives for bad performers to slow down the necessary Lisbon reform process and will penalise the good performers.

- **Excluding certain expenditure** categories such as research, infrastructure or even net contributions to the EU budget and defence equipment procurement will virtually mean the end of the Pact.

Improvements in the application of the Stability and Growth Pact are nevertheless welcomed

- UNICE supports measures aimed at taking greater account of **debt level and dynamic**. Focusing further on debt sustainability makes strong economic sense particularly given the demographic challenge in Europe.

- UNICE has long advocated for the need to strengthen fiscal consolidation in the expansionary phase of the economic cycle. European businesses are therefore in favour of promoting **contra-cyclicality of fiscal policy**. **Peer pressure and early warnings** could be adequately strengthened in economic good times to cope with the current asymmetrical nature of the Pact.

- Regarding the definition of the **medium-term deficit objective and the corrective path** to be followed in case of Excessive Deficit Procedure, specific conditions could pave the way for more differentiated prescriptions. However, objective criteria should be applied to ensure equal treatment. The Stability and Growth Pact should **not be transformed into a "Pacte à la carte"** where political discretion would replace clear-

cut rules. Any greater specificity in the assessment of budget situation should be based on pre-defined criteria that will equally apply to all countries.

1. Background

The Stability and Growth Pact (SGP) has been under increasing pressure following the non-compliance of some Member States. Tension mounted when the Commission took legal proceedings against the Council at the European Court of Justice in January 2004. Since the Court's ruling, a more fruitful dialogue has been opened with a view to reforming the SGP. On 3 September 2004, the European Commission adopted a Communication on EU economic governance following more than one year of debate[1]. We call upon European policy-makers to take final decision as soon as possible, as the current discussion on the subject does not always serve the credibility needed for its full application.

Four main elements of the revised approach are described in the new Commission Communication[2]:

i) Placing more focus on debt sustainability in the surveillance mechanisms (debt level and dynamic) could lead to a definition of the "satisfactory pace of debt reduction".

ii) The medium-term objective of budget "close to balance or in surplus" could be shaped according to specific situation of public finance and in particular of public debt sustainability. "Factors such as potential economic growth, inflation, the existing implicit liabilities related to ageing populations, the impact of structural reforms, and the need for additional net investment could be considered".

iii) Considering economic circumstances and developments in the implementation of the Excessive Deficit Procedure could be translated into two major changes. First, "exceptional circumstances" under which a country breaking the 3% reference value would not be put in the Excessive Deficit Procedure, could include a situation of "protracted period of sluggish growth". Second, the adjustment time to full compliance might vary according to country-specific economic conditions (point in the economic cycle) and debt levels[3].

iv) Ensuring earlier actions to correct inadequate budgetary developments, particularly in economic good times. This could be achieved through peer pressure and the ability of the European Commission to issue early warnings.

In order to improve economic governance in the EU, changing the timetable of the preventive part of the Stability and Growth Pact and improving the quality of statistics collection is being considered.

Following the Commission Communication, the Economic and Financial Affairs Council expressed its attachment to a transparent and simple rules-based system and to the numerical criteria of the 3% deficit and the 60% debt-to-GDP ratio. Finance Ministers appeared to support enhancing contra-cyclical fiscal policy, taking into account debt and sustainability in the definition of the mid-term objective, and placing more focus on the debt

[1] See COM(2002) 668 on 27 November 2002; COM(2004) 425 on 24 June 2004.
[2] COM(2004) 581 on 3 September 2004.
[3] So far, deficit has been considered as exceptional if real GDP decreased by at least 2% over one year while the adjustment time has been one year (with the exception of six new Member States).

criteria. Moreover, a majority of Finance Ministers seemed to agree on not excluding specific expenditure categories from the calculation of public deficit.

2. Keep the objectives of the SGP in mind

Sound fiscal policy is a necessary condition for macroeconomic stability and sustainable growth. No economy could grow in a sustainable manner without this stability, which limits uncertainty for economic agents. Therefore, **policy-makers must stick strictly to the rules of the Stability and Growth Pact**. For UNICE, the reference values of 3% GDP for the budget deficit and 60% for public debt should be absolutely preserved.

Excessive budgetary deficits have the detrimental consequences to raise the debt burden at the expense of future generations, increase future taxes, give wrong signals to the financial markets and weaken the ECB's capacity to formulate an adequate monetary policy. In a highly integrated economic area, such binding rules also reduce the risks of spillovers through trade and capital flows.

Ageing population in Europe makes more relevant than ever a framework not only promoting disciplined fiscal policy but also promoting its long-term sustainability in terms of debt burden and interest costs. In this context, fiscal consolidation should be accompanied by a budget restructuring allowing the financing of competitiveness-enhancing investment.

The current debate should not draw our attention away from one of the fundamental objectives pursued by the SGP. The Pact contributes to promote a stable macroeconomic environment which is a prerequisite for achieving the Lisbon goals. Its contribution to the growth strategy could be strengthened by considering its medium-term orientation further.

3. The risks to be avoided

UNICE would like to draw policy-makers' attention to the importance of avoiding some risks in revising the Stability and Growth Pact. The current rules might not be theoretically perfect but it should be ensured that the **rules will remain sufficiently stable and transparent** to be applied effectively.

The **revision of the "exceptional circumstances"** which entitle a country to run a deficit in excess of 3% GDP would be a bad signal.

- Exempting from the Excessive Deficit Procedure countries with a "protracted period of sluggish growth" will give the wrong incentives for bad performers to slow down the necessary reform process. Most of the time, a protracted period of sluggish growth is not a cyclical phenomenon but the result of too slow a pace of structural reforms aimed at expanding the growth potential of an economy.

- Such an exemption would also penalise the good performers that have successfully implemented the growth-enhancing Lisbon reforms. They would suffer from the detrimental spillovers of higher (allowed) budget deficits in other countries on interest rates and inflation rates.

- We could also wonder what the Commission means by a "protracted period of sluggish growth". Regarding the fact that in some Member States potential growth is estimated to fall to a range of between 1.25% and 1.75%, we wonder whether, say, a 1%-2% growth rate - as an average over three years - could be considered as either

an exceptional situation that entitles countries to run a deficit in excess of 3% GDP or as most will argue, the normal result of the slow pace of structural reforms.

Excluding certain expenditure categories such as defence, development policy, infrastructure, net contributions to the EU budget and research will **virtually mean the end of the Pact.** Besides the risk of ending up with a Pact without substance, it opens the door to innovative accounting to classify current spending as an excluded category of investment. It will also become an excuse for not improving the quality of public spending and consequently, will not necessarily increase financial means in the targeted investment category. Such a change will also modify the opportunity cost of one public investment and discriminate against other investment included in the deficit calculation, even if this investment is more relevant for tailor-made implementation of the Lisbon Strategy in a particular country.

Regarding determination of the medium-term deficit objective, the way to achieve it, and the corrective path if an Excessive Deficit Procedure is opened, **a more specific analysis** should avoid transforming the SGP into a framework with a possibility of political assessment, instead of clear-cut rules. Ex-ante determination of the objective parameters to be taken into account should be specified to respect the principle of equal treatment. Avoiding transforming the current rule-based system into a “Pacte à la carte” requires that criteria are equally applied but might lead to different prescriptions according to the specific circumstances of the countries concerned.

4. Towards a better interpretation

Focusing further on **debt level and dynamic** makes economic sense. However, this proposal should not unduly soften the SGP for low-indebted countries, as the demographic challenge will also constitute a heavy constraint on the long-term sustainability of their public finances.

We recognise that diversity of national macroeconomic conditions has increased in the enlarged EU, especially as far as debt sustainability, growth potential, the ageing burden, the need for infrastructures and position in the economic cycle are concerned. In accordance with the principle of equal treatment as stated above, **the adjustment time and the medium-term objective** could be fine-tuned accordingly. A protracted period of sluggish growth might be taken into account only for that purpose.

The Commission regards **peer pressure and early warnings** as useful channels through which the Stability and Growth Pact could be strengthened in economic good times. Promoting contra-cyclicality of fiscal policy is a valuable objective. Countries should speed up the consolidation of public finances and achieve surpluses in good times in order to create sufficient room for dealing with economic slowdowns. In this context, the initiative possibilities of the Commission could also be strengthened as foreseen in the future Constitution for Europe and possibly backed up by independent forms of external scrutiny.

5. Economic Governance: Some ways forward

It cannot be denied that there is a problem of economic governance in the sense that countries with excessive deficits could not be compelled to comply with the rules agreed by all Member States. Furthermore, it has been too easy for national governments to stigmatise the EU as a scapegoat instead of tackling internal obstacles that stand in the way of competitiveness. Therefore, the Commission has usefully widened the debate on the SGP to the whole economic governance in the EU.

The Commission proposal to **change the economic policy calendar** could help to close the gap between the relative consensus at the EU level on the need to implement structural reforms and political resistance at national level to do so. National Stability and Convergence Programmes as well as Broad Economic Policy Guidelines could also be taken into account in national parliaments when entering in the annual budgetary procedure.

Communication between the Eurogroup and the ECB could be promoted. The appointment of a President of the Eurogroup for two years will improve economic governance by enhancing dialogue with the ECB and providing a greater visibility to this group both internally and in international fora. However, this should not jeopardise the necessary independence of the monetary authorities and the important role of the ECB President.

There is certainly a **scope to improve supply-side policy coordination**. Sustained structural reforms are a necessary accompanying policy to budgetary consolidation. The Eurogroup decision to discuss further structural issues such as rising health care expenditure, lagging labour market participation, rising labour costs and implications of ageing population is therefore welcomed. This initiative could give more room for manoeuvre to the ECB, by pushing down inflationary pressure and improving the channels for transmission of monetary policy.

* * *