

PAPER FOR THE TREASURY SELECT COMMITTEE ON THE STABILITY AND GROWTH PACT

Introduction

This paper is a contribution from HM Treasury to the Treasury Select Committee's inquiry, "to review the workings of the Economic and Monetary Union since January 1999 with particular reference to the Stability and Growth Pact and the European Central Bank, and examine the implications for United Kingdom membership of the Single Currency; and examine the basis for the Chancellor's current assessment of the five economic tests". It focuses on the Stability and Growth Pact, and supplements the paper submitted to the Committee on 6 September 2002 on HM Treasury's approach to the preliminary and technical work, and the paper submitted by HM Treasury today on the European Central Bank.

EU Fiscal Policy Framework

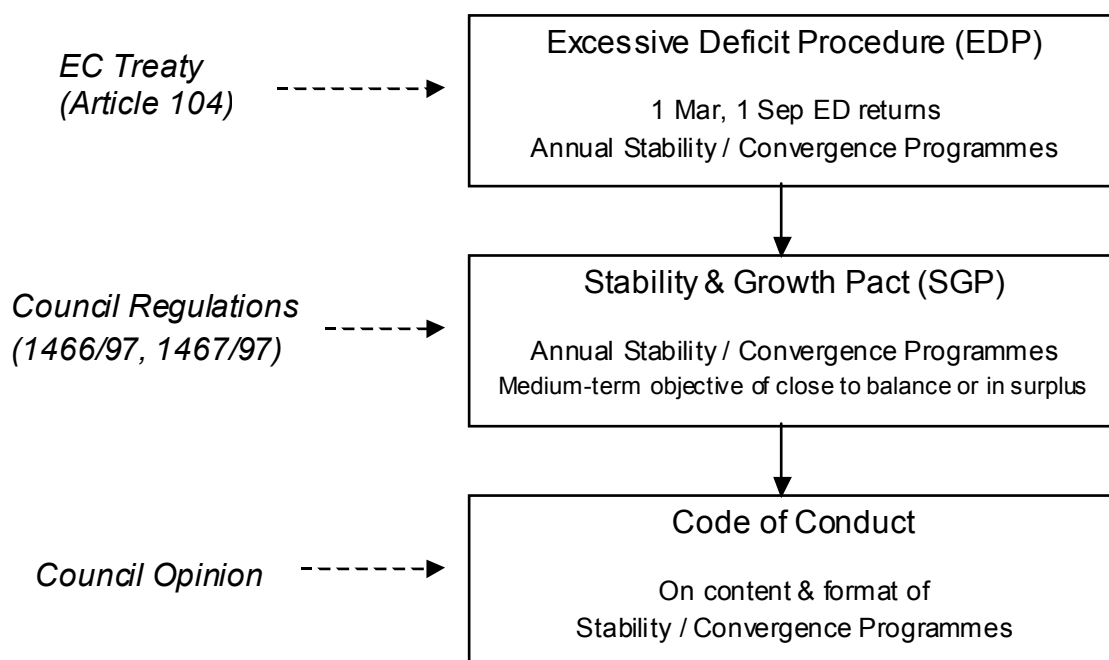
2. Under Article 99 (ex 103) of the EC (Maastricht) Treaty, Member States agree to "regard their economic policies as a matter of common concern and shall coordinate them within the Council"¹. Whether a Member State participates in EMU or not, tax and spending policies remain a matter for Member States. But, subject to that, Member States have agreed a framework for the coordination of fiscal policy, with a view to maintaining sound public finances. Chapter 18 of HM Treasury (2002)² summarises this framework, which is illustrated in Figure 1. The framework consists of:

- The Excessive Deficit Procedure (EDP), agreed as part of the EC Treaty, signed in February 1992;
- The Stability and Growth Pact (SGP) adopted as a Council Resolution and two Council Regulations by the European Council in Amsterdam in June 1997, and building on the EDP;
- The Code of Conduct on the content and format of Stability and Convergence Programmes, agreed as an ECOFIN Opinion, first in October 1998, and revised in June 2001.

¹ In this context, the Council adopts the annual Broad Economic Policy Guidelines (BEPGs). The BEPGs are the central economic policy document of the EU, and provide the framework for the definition of economic policy objectives and orientations for the Member States and the Community. They are adopted each year by ECOFIN on the basis of QMV, following conclusions by the European Council. They are non-binding on Member States.

² *Reforming Britain's Economic and Financial Policy, Towards Greater Economic Stability*, HM Treasury, 2002 (eds Ed Balls and Gus O'Donnell)

Figure 1: Fiscal policy coordination in the EU



EC Treaty: The Excessive Deficit Procedure

3. The Excessive Deficit Procedure is set out in Article 104 (ex 104c) of the EC Treaty. Under the EDP, “Member States shall avoid excessive government deficits”, as defined in Article 104 and Protocol No 20 (ex No 5) on the EDP, annexed to the EC Treaty. The criteria are:

- Whether the ratio of the planned or actual government **deficit to GDP** exceeds **3 per cent**, unless:
 - either the ratio has declined substantially and continuously and reached a level that comes close to 3 per cent of GDP;
 - or, alternatively, the excess over 3 per cent of GDP is only exceptional and temporary and the ratio remains close to 3 per cent.
- Whether the ratio of government **debt to GDP** exceeds **60 per cent**, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

4. In line with Article 116(4) (ex 109e(4)) of the EC Treaty, Member States in the second stage of EMU, like the UK, “shall endeavour to avoid excessive deficits”, rather than be obliged to “avoid excessive deficits”.

5. Surveillance of Member States’ deficit and debt positions under the EDP is partially fulfilled through the submission, under Council Regulation

(EC) 3605/93, of Excessive Deficit (ED) returns by Member States to the European Commission, on 1 March and 1 September each year³. For the UK, the ED returns are based on Budget figures for the 1 September return, and Pre-Budget Report figures for the 1 March return. Parliament gives approval for the submission of such data to the Commission via Section 5 debates in both Houses, in accordance with the European Communities (Amendment) Act 1993.

6. Under Article 104(3) of the EC Treaty, if the European Commission believes that a Member State has exceeded, or is at risk of exceeding, the Treaty reference values for government deficit and / or government debt, it should prepare a report. Such reports were quite common when many countries were in the second stage of EMU. More recently, such a report was adopted by the Commission on the Portuguese economy on 24 September 2002⁴, and on the German economy on 19 November 2002⁵. Following consideration by the EU's Economic and Financial Committee (EFC), the Commission then prepares its official Opinion on whether an excessive deficit "exists or may occur" in the Member State. In line with Article 104(5), this is addressed to the ECOFIN Council of EU Economic and Finance Ministers. Such an Opinion was prepared by the Commission on the Portuguese economy on 16 October 2002⁶, and on the German economy on 8 January 2003⁷.

7. The Council then decides, by a qualified majority (including the Member State concerned), whether an excessive deficit exists. Where an excessive deficit is judged to exist, ECOFIN will make recommendations to the Member State concerned with a view to bringing the situation to an end within a given period of time. If no effective action has been taken in response to these recommendations, the Council can decide whether to make its recommendations public⁸. On 5 November 2002, ECOFIN adopted a Decision on the existence of an excessive deficit in Portugal, and made a Recommendation to Portugal with a view to bringing an end to the situation⁹. Portugal agreed that its Recommendation be made public.

³ This procedure has been in operation since 1994. Since the adoption of the SGP, it has been supplemented by the multilateral surveillance that takes place under the SGP. See paras 12-19 of this note.

⁴ *Commission adopts report on government finances in Portugal as a first step in the Excessive Deficit Procedure*, European Commission Press Release (IP/02/1360), 24 September 2002

⁵ *Commission adopts report on government finances in Germany as a first step of the Excessive Deficit Procedure*, European Commission Press Release (IP/02/1705), 19 November 2002

⁶ *Commission considers that an excessive government deficit exists in Portugal*, European Commission Press Release (IP/02/1476), 16 October 2002

⁷ *Commission considers that an excessive government deficit exists in Germany*, European Commission Press Release (IP/03/12), 8 January 2003

⁸ In line with Article 104(12), should the Council decide to make its recommendations public, it must also, on the basis of a recommendation from the Commission, make a public statement when the excessive deficit ceases to exist.

⁹ *Implementation of the Excessive Deficit Procedure for Portugal*, ECOFIN Press Release, 13490/02 (Presse 333), 5 November 2002

8. If a Member State persistently fails to put in place the Council's recommendations, the Council may give notice to the Member State concerned to take the measures necessary to remedy the situation.

9. During the third stage of EMU only (that is, for EMU members), under Article 104(11), as long as the Member State fails to comply with the Council's notice to take the measures necessary to remedy the excessive deficit, the Council may decide to apply (or intensify) one or more of the following measures:

- To require the Member State concerned to publish additional information, to be specified by the Council, before issuing bonds and securities;
- To invite the European Investment Bank to reconsider its lending policy towards the Member State concerned;
- To require the Member State concerned to make a non-interest bearing deposit of an appropriate size with the Community until the excessive deficit has, in the view of the Council, been corrected¹⁰;
- To impose fines of an appropriate size¹¹.

10. Such sanctions cannot be applied to Member States, such as the UK, in the second stage of EMU.

11. In line with Article 104(12), when the Council believes the Member State concerned has corrected the excessive deficit, the Council abrogates the excessive deficit, and can abrogate some or all of its decisions made under Article 104(11), outlined above. Once it has been decided that an excessive deficit exists in a Member State, that Member State is excluded from all subsequent decisions related to its excessive deficit.

Council Regulations: The Stability and Growth Pact

12. Member States agreed to strengthen the framework for fiscal policy coordination across the EU, building on the EDP set down in the Treaty, via the Stability and Growth Pact (SGP), adopted at the Amsterdam European Council in June 1997. Under the Resolution of the European Council on the SGP, of 17 June 1997, Member States commit themselves to maintain sound and sustainable government finances through the medium-term objective of "close to balance or in surplus" (CTBOIS). This commitment is operationalised in the form of two Council Regulations:

¹⁰ In this situation, the first deposit will be a fixed component of 0.2 per cent of GDP, plus a variable component equal to one tenth of the difference between the deficit as a percentage of GDP in the preceding year and the reference value of 3 per cent. Each year thereafter, until the situation is corrected, the sanctions will be intensified by one tenth of the difference between the deficit and the reference value, unless the Member State has complied with the Council notice. Any single deposit is restricted to a maximum of 0.5 per cent of GDP.

¹¹ Deposits will normally be converted into fines, if, two years after the decision to require a deposit to be made, the deficit has not been corrected.

- Council Regulation (EC) No 1466/97 of 7 July 1997, 'on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies';
- Council Regulation (EC) No 1467/97 of 7 July 1997, on 'speeding up and clarifying the implementation of the excessive deficit procedure'.

Regulation 1466/97

13. Regulation 1466/97, which has Article 99 of the EC Treaty as its legal base, provides for the regular surveillance of Member States' budgetary positions, in the form of annual Stability (for Member States participating in EMU) and Convergence (for Member States not participating in EMU) Programmes. In these programmes, Member States are required to detail their adjustment path towards meeting the medium-term budgetary objective of the SGP, and the expected path of the general government debt ratio.

14. Member States are required to submit updates of their programmes no later than 1 December each year¹². The Pre-Budget Report forms the basis for the information sent to the Commission by the UK. The UK Parliament gives its approval for the submission of such data via Section 5 debates in accordance with the European Communities (Amendment) Act 1993. A copy of the UK's latest Convergence Programme¹³, submitted to the Commission, and placed in the Library of the House on 19 December 2002, is attached to this note.

15. Once the programmes are submitted, the Commission produces assessments of each programme, following which, in the first quarter of the calendar year, ECOFIN Ministers agree on and publish Opinions on each Member States' programme. The UK plays a full part in this peer review process.

Early Warning Mechanism

16. Articles 6(2) (in the context of Stability Programmes) and 10(2) (in the context of Convergence Programmes) of Council Regulation 1466/97 note 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) [now Article 99(4)], a recommendation to the Member State concerned to take the necessary adjustment measures".

17. Thus, in addition to the EDP set out in the Treaty, Regulation 1466/97 also provides for the Council, on the basis of a recommendation from the Commission, to issue an 'early warning' to a Member State before an

¹² ECOFIN has agreed that, because of our different fiscal year, the UK should submit our Convergence Programme as close as possible to the PBR, generally by end December.

¹³ *Sustainability for the Long Term, Convergence Programme for the United Kingdom*, HM Treasury, December 2002

excessive deficit has occurred. The legal basis for such 'early warnings' is Article 99(4) of the EC Treaty, which allows for the Council, acting by a qualified majority on a recommendation from the Commission, to address a recommendation to a Member State if they "risk jeopardising the proper functioning of economic and monetary union". Acting by a qualified majority of all Member States (including the Member State concerned), the Council may decide to make its recommendation public.

18. The Commission proposed to ECOFIN on 30 January 2002 to give an early warning to Portugal and Germany¹⁴. In light of commitments made by the respective Governments, the Council decided not to pursue the early warning procedure in either instance¹⁵. The Commission recommended to ECOFIN on 19 November 2002¹⁶ to address an early warning to France. No decision has yet been taken by the Council on this matter.

Regulation 1467/97

19. Regulation 1467/97 builds on the EDP as set out in the Treaty, and on Council Regulation (EC) No 3605/93 of 22 November 1993, on the application of the Protocol on the EDP (the ED returns). For example, Regulation 1467/97 gives greater detail on the definitions contained in the EDP – including what is meant by "exceptional and temporary" in Article 104 – and sets out a timetable for applying sanctions to Member States which fail to take action to correct an excessive deficit, as identified under the terms of the Treaty. It has Article 104 of the EC Treaty as its legal base.

Code of Conduct: Content and Format of Stability and Convergence Programmes

20. In addition to the Treaty and Council Regulations, Member States have further developed the framework for the coordination of fiscal policy in the EU in the form of a Council Opinion on the content and format of Stability and Convergence Programmes, the 'Code of Conduct'. In this Opinion, first agreed on 12 October 1998 (and subsequently revised by ECOFIN on 27 June 2001) Member States agreed more detail on the interpretation of the Stability and Growth Pact, as operationalised in the Commission and Council assessments of Member States' annual Stability and Convergence Programmes.

¹⁴ *Commission assesses updated stability programme of Portugal (2002-2005)*, European Commission Press Release (IP/02/165), 30 January 2002, and *Commission assesses the German Stability Programme update (2001-2005)*, European Commission Press Release (IP/02/164), 30 January 2002

¹⁵ *Statement by the Council (ECOFIN) on the budgetary situation of Portugal (SN 1383/1/02 REV 1)*, 12 February 2002, and *Statement by the Council (ECOFIN) on the budgetary situation of Germany (SN 1382/1/02 REV 1)*, 12 February 2002

¹⁶ *Commission recommends to the Council to address an early warning to France*, European Commission Press Release (IP/02/1704), 19 November 2002

Latest developments

21. As noted above, the Code of Conduct was revised by ECOFIN on 27 June 2001¹⁷. As the Chancellor said at Treasury Orals on 28 February 2002 (Column 839), “The important point is that last summer, when the stability pact code was rewritten, account was taken of the economic cycle for perhaps the first time in the Council’s deliberations in this matter.”¹⁸

22. More recently, on 27 November 2002, the Commission issued a Communication to the Council and the European Parliament¹⁹, which included proposals on ways to further develop the interpretation of the SGP. The Commission proposals respond to the Conclusions of the 2002 Barcelona Council on the need to reinforce existing fiscal policy co-ordination mechanisms, and for the Commission to, “... present proposals to reinforce economic policy coordination in time for the Spring European Council”. An Explanatory Memorandum (EM)²⁰, submitted by HM Treasury to the European Scrutiny Committees of both Houses, summarises the proposals made by the Commission in their Communication. This EM is attached to this note.

Conclusion

23. As the Government stated in the 2002 Pre-Budget Report²¹, fiscal sustainability is a pre-condition for macroeconomic stability and the Government agrees with the principle of a strong SGP founded on sensible fiscal policy coordination as set out in the EC Treaty.

24. At Treasury Orals on 28 February 2002 (Column 833), the Chancellor set out the position that the Government has consistently taken towards the SGP, namely that, “the United Kingdom believes that a prudent interpretation of the disciplines of the stability and growth pact should take into account the economic cycle, sustainability of debt and the important role of public investment.” As noted in HM Treasury’s EM of 16 December 2002, “the Government believes that a prudent interpretation of the Pact would provide a long-term solution and strengthen fiscal discipline.”

¹⁷ *Opinion on the content and format of stability and convergence programmes* (EFC/ECFIN/404/01 – REV 1), 27 June 2001

¹⁸ The relevant text from the Code of Conduct reads as follows, “It is therefore clear that the assessment of the appropriateness of Member States’ medium-term objectives and the examination of their fulfillment have to take explicit account of the cyclical position and its effect on the budget. Cyclically-adjusted balances should continue to be used, in addition to nominal balances, as a tool when assessing the budgetary position ... The medium-term budgetary position which respects the dose-to-balance-or-in-surplus rule of the SGP has to take account of several elements, such as the possibility to deal with adverse cyclical developments ...”

¹⁹ *Strengthening the co-ordination of budgetary policies*, Communication from the Commission to the Council and the European Parliament (ECFIN/581/02-EN REV 3), 27 November 2002

²⁰ *Explanatory Memorandum 14997/02*, HM Treasury, 16 December 2002

²¹ *Steering a steady course: Delivering stability, enterprise and fairness in an uncertain world*, Box 2.5, HM Treasury, November 2002

25. The 2002 UK Convergence Programme gives further detail on the three elements of the UK's prudent interpretation of the SGP. The Convergence Programme also shows that the Government's public finance projections, as presented in the 2002 Pre-Budget Report, comfortably meet the EU Treaty reference values for general government gross debt (60 per cent of GDP) and general government net borrowing (3 per cent of GDP) throughout the projection period. The projections are consistent with the Government's prudent interpretation of the SGP, which takes into account the economic cycle, sustainability and the important role of public investment (as specified in Article 104 of the EC Treaty).

26. In addition, the programme shows that, based on cautious assumptions and consistent with the Government's fiscal rules, the cyclically-adjusted deficit is projected to remain at or below 1.6 per cent of GDP throughout the projection period. Against a background of low and stable debt levels that remain consistently well below the 60 per cent reference value – ensuring the public finances are sustainable – and taking into account prudent borrowing for investment as specified in the Treaty, this is consistent with meeting the objective of the Stability and Growth Pact of achieving a budgetary position of close to balance or in surplus over the medium term.

27. HM Treasury's EM of 16 December 2002 sets out the Government's position towards the recent Commission proposals, noting that the Government's "principled approach will govern the UK's stance towards the Commission's proposals, and in EU surveillance procedures. To the extent that the Commission's proposals could represent a strengthening of the economic underpinnings of the Pact, the Government sees them as a useful contribution to the debate on the reform of the SGP." However, as noted in the EM, the Government remains very concerned about the Commission's ideas for institutional change on the SGP, which they are pursuing through the Convention on the Future of Europe, which would increase the role of the Commission in enforcing the disciplines of the Pact, at the expense of Member States.

**HM Treasury
January 2003**