Fiscal Policy in the European Union

This chapter presents the context and the way in which the European Union (EU) institutions monitor the fiscal policies of member states that have adopted the euro, as part of the Economic and Monetary Union (EMU). The monitoring covers also EU members that have not adopted the euro, and still those who wish to join the EU.

The conduct of monetary policy in the euro area countries is the responsibility of the European Central Bank (ECB) and the management of fiscal policy is the responsibility of each national government. However, to avoid jeopardizing the financial stability of the euro, a monitoring scheme of fiscal policies was adopted, including the setting up of budgetary rules. This framework was already defined in the Treaty of the European Union, and a protocol annexed to the Treaty and by means of the Stability and Growth Pact (SGP), the first version dating from 1997, and subsequently revised in 2005 and in 2011.
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The institutions that carry out the monitoring of fiscal policy in EMU are: the European Council, which brings together the prime ministers of EU governments, the European Commission (EC), the Council of Ministers of Economy and Finance (ECOFIN), and the Economic and Financial Committee (EFC).

Fiscal monitoring is based on the SGP and is performed in a preventive manner by requesting information that the member states should provide twice a year to the EU institutions. Such information, among other things, covers past, current and predicted behaviour of several variables relevant to an assessment of the situation of public finances, particularly the general government budget balances and government dent ratios, with reference values of -3% and 60% respectively. On the other hand, there are penalties for countries that do not meet the deficit criterion (on the *excessive deficit procedure*) and can not justify such failure for exceptional reasons (e.g. a significant slowdown in economic activity).

In 1998 the majority of EU15 countries met the 3% limit for budget deficit, with the exception of Italy and Portugal. Already in 2003 the deficit criterion is not fulfilled by Germany, France, Netherlands and the United Kingdom. In 1998 more than half of the Member States had a debt-to-GDP ratio above 60%: Germany, Austria, Belgium, Spain, Greece, Holland, Italy and Sweden. Moreover, in 2003, the debt criterion was not met by six Member States: Germany, Austria, Belgium, France, Greece and Italy.

The original Stability and Growth Pact (1997) established that the medium-term objectives of the overall balance of the general government should be close to balance or in surplus, an objective standard for all countries. To assess whether the criteria of the fiscal deficit and public debt are met, the Member States must send to the EC a report on excessive deficits twice a year, until March 1st and until September 1st, which determines the value of the general government balance and its break down into Central government, State Balance (in Federal countries), Regional and Local Governments and Social Security balances. Participating countries in the euro must submit to the ECOFIN Council and the European Commission, annually, its Stability and Growth Programme (SGProg). Countries not participating in the euro submit its Stability and Convergence Programme (SCP). The SGProg and the SCP are generally medium-term programs for four years, with information on: i) the medium-term objectives to achieve a fiscal position set in the SGP, ii) information on the adjustment path towards the medium-term fiscal goals, iii) information on expected developments in the economy, iv) information on budget measures, structural reforms and other economic policy measures adopted or to adopt in order to achieve these fiscal targets. Additionally, countries that have to present SCP also have to provide information on its medium-term monetary objectives.

The 1997 SGP framework was subjected to several criticisms, namely that of being rigid and of not

considering the specificities of each country; of considering a medium-term budgetary balance or surplus (which would lead to keep the debt-to-GDP ratio converging to zero), of considering the overall balance of general government as a good indicator, and not the cyclically-adjusted balance, and finally for overlooking the fact that countries can adopt special measures to formally, but not substantively, comply with budgetary rules.

In this sense the 2005 SGP revision defines medium-term budgetary objectives different for each country, taking into account their debt ratios and potential growth rates. The indicator used is the cyclically-adjusted budget balance and the medium-term objective is above -1% of GDP, not considering exceptional measures. The aim of balanced or surplus balance is limited to countries that have debt ratios way above 60% of GDP.

The 2005 SGP is enshrined in Regulation No 1055/2005 (amending Regulation No. 1466/97) for the monitoring and coordination of economic policies, and Regulation No. 1056/2005 (amending Regulation No. 1467/97) which explains the process of implementation of the EDP.