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Discipline and Flexibility: The Stability and Growth Pact

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ABSTRACT

In "*The economics of the government budget constraint*" Stanley Fischer discusses the negative implications of government deficits and debts and concludes that to achieve stability and growth a state should implement fiscal discipline i.e. keep the budget in balance.

In *"Fiscal policy rules"* George Kopits and Steven Symansky discuss the difficulties for a state to exercise fiscal discipline due to the fact that it is politically challenging to implement the measures needed to balance the budget. Hence the authors argue for the benefits of fiscal policy rules; a set of budget rules for the governing powers to adhere to. According to the authors it is however not enough for the Member States to achieve a balanced budget through tax increases and expenditure cuts. For a fiscal policy rule to be optimal the rule has to provide for structural reforms and give the government the possibility to respond to exogenous chocks affecting the economy.

Stanley Fischers reasoning on fiscal discipline and budget balance is manifested in an EU context through the framework of the Stability and Growth Pact (SGP). The SGP is designed to ensure that the Member States achieves a balanced budget and exercises fiscal discipline.

However the SGP-framework has since long been debated, one of the most significant questions being whether it is really worth appeasing fiscal discipline at a cost of limiting fiscal flexibility.

The aim of this study is to investigate how the governing bodies of the EU have used the SGP to promote stability and growth in the EU. To achieve this aim the author tries to answer the following research question: Have the governing bodies focused on fiscal discipline, fiscal flexibility or both when assessing whether a Member State is following the SGP?

In an effort to answer the research question and reach the aim the author, by looking at the reasoning, and ultimately the decisions, of the Commission and the Council, will evaluate whether they have chosen to use on fiscal discipline, and thus enforced the debt and the deficit criteria by taking disciplinary action or whether they have allowed the Member States to deviate from the debt and the deficit criteria with regard to exogenous shocks to the economy and attempted structural reforms, thus using fiscal flexibility.

In the thesis it is concluded that the Commission and the Council have allowed the Member States to deviate from the debt and deficit targets due to exogenous shocks and attempts at structural reforms. However, they have undertaken disciplinary action when the Member States has failed to meet the targets and the failure has not been due to the above mentioned factors.

TABLE OF CONTENT

ABSTRACT 1

ABBREVIATIONS 3

1. INTRODUCTION 4

 1.1 AIM AND RESEARCH QUESTION 5

2. METHOD 5

 2.1 DELIMITATIONS 6

 2.2 SOURCES 6

 2.3 DISPOSITION 6

3. FISCAL DISCIPLINE, FISCAL FLEXIBILITY AND THE SGP FRAMEWORK 7

 3.1. FISCAL DISCIPLINE AND FISCAL FLEXIBILITY IN MACROECONOMIC THEORY 7

  3.1.1. BUDGET DEFICITS AND THEIR IMPACT ON THE ECONOMY 7

  3.1.2. AVOIDING BUDGET DEFICITS THROUGH FISCAL RULES 9

 3.2 THE DEFINITION OF FISCAL DISCIPLINE AND FISCAL FLEXIBILITY FOR THE PURPOSE OF THIS THESIS 12

 3.3 THE STABILITY & GROWTH PACT AND ITS FRAMEWORK 12

  3.3.1 THE SGP FRAMEWORK – THE DEBT AND DEFICIT CRITERIA 12

4. ANALYSIS 16

 4.1 FRANCE 16

  4.1.1 THE FIRST STEP IN THE EDP – THE COMMISSION REPORT 16

  4.1.2 THE EDP IS ENFORCED 17

  4.1.3 THE RECOMMENDATION AND THE DECISION 17

  4.1.4 FURTHER RECOMMENDATIONS 18

  4.1.5 ASSESSMENT ON ACTION TAKEN 19

  4.1.6 FURTHER RECOMMENDATIONS 20

  4.1.7 ASSESSMENT ON ACTION TAKEN 21

  4.1.8 FURTHER RECOMMENDATIONS 21

  4.1.9 CONCLUDING REMARKS 23

 4.2 ITALY 25

  4.2.1 THE FIRST STEP IN THE EDP – THE COMMISSION REPORT 25

  4.2.2 THE EDP IS ENFORCED 26

  4.2.3 THE RECOMMENDATION AND THE DECISION 26

  4.2.4. ASSESSMENT ON ACTION TAKEN 28

4.2.5 THE ABROGATION OF THE COUNCIL DECISION 28
4.2.6 A NEW COMMISSION REPORT 29
4.2.7 CONCLUDING REMARKS 31
5. CONCLUSION 32
6. REFERENCES 34

ABBREVIATIONS

SGP	Stability and Growth Pact
EDP	Excessive Deficit Procedure
MTO	Medium- Term Budgetary Objective
MLSA	Minimum Linear Structural Adjustment
TFEU	Treaty on the Functioning of the European Union
NRP	National Reform Programme
CSR	Country Specific Report

1. INTRODUCTION

In "*The economics of the government budget constraint"* Stanley Fischer discusses the different implications of government deficits and debts and concludes that these should be avoided if a state aspires to achieve stability and growth. To achieve stability and growth a state, according to Fischer, should instead implement fiscal discipline i.e. keep the budget in balance.[1]

In *"Fiscal policy rules"* George Kopits and Steven Symansky discuss the difficulties for a state to exercise fiscal discipline. The authors argue that for a government relying on discretionary fiscal policy it can be politically challenging to implement the measures needed to balance the budget. Hence the authors argue for the benefits of fiscal policy rules: a set of budget rules for the governing powers to adhere to. Using this particular kind of framework makes it easier for the governing powers to motivate measures needed for holding a balanced budget to the electorate.[2]

According to the authors it is however not enough for the Member States to achieve a balanced budget through tax increases and expenditure cuts. For a fiscal policy rule to be optimal, the authors argue, the rule has to provide for structural reforms and give the government the possibility to handle exogenous chocks affecting the economy. Enforcing fiscal discipline through a fiscal policy rule without taking the need for fiscal flexibility into account will, according to the authors, harm the economy.[3]

Stanley Fischers reasoning on fiscal discipline and budget balance is manifested in an EU context through the framework of the Stability and Growth Pact (SGP) adopted in 1997 by the Member States. The SGP is designed to ensure that the Member States achieves a balanced budget and exercise fiscal discipline.

In 1992, before the adoption of the SGP, the Maastricht Treaty was signed by the Member States of the European Union. The Maastricht Treaty created the premises for the creation of the euro as a common currency of the European Union by limiting the government deficit to 3% of GDP and public debt to 60% of GDP.[4] The SGP was created as a continuation of the criteria underlying the Maastricht Treaty. It was built on the agreement of the Member States of the European Union to strengthen the monitoring and coordination of national fiscal and

[1] *THE ECONOMICS OF THE GOVERNMENT BUDGET CONSTRAINT*. The World Bank Research Observer. Fischer. 1990. vol. 5 issue 2.

[2] *Fiscal Policy Rules*. Kopits, Symansky. Occasional paper/International Monetary Fund: 162, 1998. p. 2.

[3] Ibid.

[4] http://ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm

economic policies enabling the enforcement of the limits set for the deficits and debts of the Member States by the Maastricht Treaty.[5]

The aim of the SGP, as it is expressed in the *Resolution of the European Council on the Stability and Growth Pact,* is to ensure stability and strong sustainable growth through sound government finances.[6]

The SGP-framework has since long been debated. Ever since the Pact was established its real effect has been discussed. The doubts have been many, one of the most significant questions being whether it is really worth appeasing fiscal discipline at a cost of limiting fiscal flexibility.[7]

1.1 AIM AND RESEARCH QUESTION

The aim of this study is to investigate how the governing bodies of the EU have used the SGP to promote stability and growth in the EU.

To achieve the aim stated above I will try to answer the following research question:
Have the governing bodies used fiscal discipline, fiscal flexibility or both when assessing whether a Member State is following the SGP?

2. METHOD

In an effort to answer my aforementioned research question and reach my aim I will examine a number of official documents published on the website of the European Commission. The documents consisting of continuous reports, opinions and recommendations concerning the Member States and the abidance by the SGP by the Member States, issued by the Commission. Furthermore the documents consist of continuous recommendations and decisions issued by the Council which constitute steps in the Excessive Deficit Procedure (EDP) under the SGP as well as the steps preceding the EDP and following it.

While the documents deal with the overall state of the economy in the said Member State, the relevant part for this study is the reasoning of the governing bodies when deciding whether a Member State is in breach of the SGP and how this breach is to be handled. I will thus focus on these specific parts of the documents.

While looking at the reasoning, and ultimately the decisions, of the Commission and the Council I will evaluate whether they have used fiscal discipline, and thus enforced the debt

[5] Ibid.

[6] Resolution of the European Council on the Stability and Growth Pact Amsterdam, 17 June 1997. Official Journal C 236 , 02/08/1997.

[7] *Fiscal discipline and flexibility in EMU: The implementation of the Stability and Growth Pact.* Buti, Franco, Ongena. Oxford review of economic policy, vol. 14, No. 3. 1998 Oxford University Press and the Oxford Review of Economic Policy Limited, p. 95.

and the deficit criteria by taking disciplinary action or whether they have allowed the Member States to deviate from the debt and the deficit criteria with regard to exogenous shocks to the economy and attempted structural reforms, thus using fiscal flexibility.

2.1 DELIMITATIONS

Due to the character and the scope of this study I am unable to include all the Member States in the analysis. I will therefore choose two Member States, France and Italy. France and Italy have since the creation of the SGP struggled to meet the debt and deficit criteria and are the most widely discussed Member States in regard to the SGP which makes them representative for this study.[8]

The time frame for this study will be a six year period between the years 2009 and 2015.

2.2 SOURCES

The sources that will be used in this study consist of official documents and information published on the official website of the Commission.

The official documents that I will use will primarily consist of reports, opinions, recommendations and decisions issued by the Commission and the Council under the SGP framework to the concerned Member States.

In addition to the documents mentioned above I will use relevant legal texts, consisting of primary and secondary legislation as well as guidelines regarding the SGP.

2.3 DISPOSITION

In chapter 3 I will investigate the concepts of fiscal discipline and fiscal flexibility and the macroeconomic theories supporting them. Furthermore I will give a brief description of the SGP framework.

In chapter 4 I will analyze whether the Commission and the Council have used a fiscal discipline or fiscal flexibility approach when assessing whether France and Italy is complying with the SGP or not and whether disciplinary action is to be taken.

In the final chapter of this thesis I will provide some conclusions regarding the actions on behalf of the Commission and the Council and whether these actions have been in accordance with macroeconomic theory.

[8] The Guardian, *Brussels defers punishing France and Italy for breaking Eurozone rules,* 28th november 2014. http://www.theguardian.com/business/2014/nov/28/brussels-european-commission-france-italy-eurozone-rules

3. FISCAL DISCIPLINE, FISCAL FLEXIBILITY AND THE SGP FRAMEWORK

3.1. FISCAL DISCIPLINE AND FISCAL FLEXIBILITY IN MACROECONOMIC THEORY

3.1.1. BUDGET DEFICITS AND THEIR IMPACT ON THE ECONOMY

In *The economics of the government budget constraint* Stanley Fischer concludes that:

"Both theory and evidence tell us- and warn us- that large budget deficits pose real threats to macroeconomic stability and therefore, to economic growth and development."[9]

Summarizing the macroeconomic effects of the government budget deficit, illustrated through the use of the national income accounts budget deficit identity, the deficit financing identity, and the dynamic equation for the evolution of the ratio of public debt to gross national product, the author argues that budget deficits should be avoided.[10]

Fischer firstly introduces the national income accounts budget deficit identity that shows the relationship between budget deficits and domestic saving and investment as well as the current account.[11]

Budget deficit = (private saving –private investment) + (current account deficit)[12]

The national income accounts budget deficit identity illustrates, provided a full employment assumption and an assumption that the rate of saving is given, how an increase in the deficit leads to a decrease in investment or an increase in the current account due to what is called the crowding-out effect.[13]

Fischer continues with the deficit financing identity that shows the different macroeconomic imbalances that can occur due to budget deficits.[14]

Budget deficit = money printing + (foreign reserve use + foreign borrowing) + domestic borrowing[15]

The deficit financing identity, as it is expressed above, illustrates the relationship between the deficit and the current account. However constructed differently, i.e. through placing the

[9] *THE ECONOMICS OF THE GOVERNMENT BUDGET CONSTRAINT*. The World Bank Research Observer. Fischer. 1990. vol. 5 issue 2, p. 139.
[10] Ibid. p. 127.
[11] Ibid.
[12] Ibid. p. 128.
[13] Ibid. p. 129.
[14] Ibid. p. 127.
[15] Ibid. p. 130.

parentheses around money printing and foreign reserve use, can also illustrate the relationship between the deficit and domestic credit creation.[16]

Each of the forms of financing illustrated in the deficit financing identity can be associated with macroeconomic imbalances such as inflation caused by money printing, exchange crisis caused by the use in foreign reserves, external debt crises attributed to foreign borrowing, and high interest rates accompanied by an explosively growing debt attributed to domestic borrowing.[17]

Furthermore, Fischer presents the dynamic equation for the evolution of the ratio of public debt to gross national product that shows the long-run constraints on fiscal policy.[18]

*Change in d = (primary deficit/GNP) – (seignorage/GNP) + (real interest rate – growth rate) * d*[19]

The dynamic equation for the evolution of the ratio of public debt to gross national product illustrates the long-term consequences of excessive budget deficits. The ratio of government debt to GNP (Gross national product) is denoted d in the equation. The definition of the debt includes both the net external and domestic debts. Concerning the equation for the deficit financing identity the foreign and domestic borrowing is consolidated and the changes in foreign reserves are considered equivalent to net external borrowing.

The equation illustrates that the primary deficit has to be financed with new debt as long as it exceeds the amount of money creation by the central bank. Additionally nominal interest expenditures will have to be refinanced with new debt as well. However the denominator of the debt ratio is nominal GNP, consequently the debt ratio will decline with inflation or with real GNP growth provided there is no new borrowing[20]

In his conclusion Fischer points out that when it comes to excessive deficits the macroeconomics of the government budget constraint show us that the macroeconomic imbalances induced by excessive deficits not only pose a threat to macroeconomic stability but to economic growth as well.[21]

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[16] Ibid. p. 130-131.
[17] Ibid.
[18] Ibid. p. 127.
[19] Ibid. p. 135.
[20] Ibid.
[21] Ibid. p. 138.

3.1.2. AVOIDING BUDGET DEFICITS THROUGH FISCAL RULES

Due to the negative effects of budget imbalances demonstrated above it is generally considered necessary to achieve budget balance. One of the methods to achieve this balance is through fiscal policy rules.

The definition of a fiscal policy rule is a permanent constraint on fiscal policy, this constraint, usually defined in terms of an indicator of overall fiscal performance such as the government budget deficit and debt expressed as a numerical ceiling or target, in proportion to gross domestic product (GDP).[22]

The interest in fiscal policy rules started in the 1980s when a large number of countries experienced a deficit bias, reflected in the deterioration in public finances. A large number of the advanced economies were experiencing fiscal imbalances as the rise in government expenditures was not matched by a proportionate improvement in revenue. The diverging structural trends in revenue and expenditure, in combination with a short-run stabilization aimed fiscal policy, indicated a largely asymmetrical demand management i.e. budget deficits that emerged during recession were not fully offset by equivalent surpluses during economic expansions.[23]

At the time this was mainly addressed through adjustment under discretionary fiscal policy, this in an attempt to firstly initialize a reduction in the fiscal deficit such that would lead to a stabilization of the public debt to GDP ratio at an acceptable level and secondly to keep the debt to GDP ratio at this acceptable level. More generally this was an effort to ensure fiscal discipline, fiscal discipline that would contribute to stability as well as sustained economic growth. However these attempts at discretionary policy would show to be not as successful as expected as this proved to be successful only in a relatively small amount of countries. Instead for the majority of the advanced economies it was adjustment under fiscal policy rules that showed to be successful.[24]

According to George Kopits and Steven Symansky the rationale for fiscal policy rules consists primarily of aspects such as macroeconomic stability, long-term fiscal sustainability and overall policy credibility, objectives possible to attain through the use of discretionary fiscal policy. However one of the main arguments for fiscal policy rules is the political economy factor. The authors argue that democratically elected governments have a tendency towards being biased to deficits, hence redistributing income from future generations to the

[22] *Fiscal Policy Rules*. Kopits, Symansky. Occasional paper/International Monetary Fund: 162, 1998. p. 2.
[23] Ibid. p. 4.
[24] Ibid. p. 4-6.

present generation of their electorate. Due to the sensitivity in these governments towards pressure from the electorate, a correction of the bias, without a higher order constraint on fiscal policy proves to be difficult. This becomes even more difficult in countries with aging populations and rigid social entitlements. Thus, while discretionary fiscal policy may be considered to be theoretically superior, it is difficult to implement due to the shortsightedness of the electorate making fiscal policy rules the best viable alternative to counter the political pressures on fiscal policymaking.[25]

However, according to Kopits and Symansky, for a fiscal policy rule to be effective and credible it is not sufficient to set statutory constraints on key fiscal performance indicators. It is of outmost importance that the rule is underpinned by a widely shared commitment, embraced over time by a succession of governments and observed as intended. Further to be fully credible the authors argue that a fiscal policy rule must have a track record of satisfactory compliance and it must be supported by well specified future policy measures including deep structural reforms where this is needed.[26]

It is, according to the authors, not enough for the Member States to achieve a balanced budget through such measures as cuts in investment expenditures, tax increases and different types of one-off measures. For a fiscal policy rule to be optimal, the rule has to be supported by structural reforms otherwise the fiscal policy rule and i.e. the fiscal discipline it provides for, will not lead to stability and growth.[27]

Thus the authors argue there is an efficiency prerequisite. A balanced budget target can always be met through one-off measures, these are however to be considered as temporary creating time for the preparation and implementation of deep structural reforms in order for the adherence to the rule to be ensured in the future.[28]

The problems associated with mandatory social entitlement programs exemplified in net unfunded liabilities of social security systems, first and foremost exemplified in the ageing of the population, existent in a number of the Member States currently under the SGP, present, according to the authors, great difficulties for said Member States to comply with fiscal policy rules in the future unless major structural reforms are made.[29] It is further argued that it is not fiscal consolidation that should be the main focus of the member states of the EMU but rather

[25] Ibid. p. 6, 17-18, 22.
[26] Ibid. p. 18.
[27] Ibid. p 17, 22.
[28] Ibid. p. 19.
[29] Ibid. p. 18.

the structural rigidities of the European labour markets, an aspect that is considered to negatively affect the economies of the Member States.[30]

Budget rules are often built on current values of debt and deficit. Alan J. Auerbach suggests in *"Budget rules and fiscal policy: Ten lessons from theory and evidence"* that current debt and deficits are insufficient indicators of fiscal stress. Through the illustration of the government budget constraint showing that the stock of government debt from last year plus the present value of primary deficits must equal zero, the author points to the fiscal gap emerging if this relationship is not held. The author explains the reasons for this fiscal gap as being, past deficits, accounted for by the accumulated stock of debt, current deficits, in terms of the of primary deficits to GDP, and the projected growth of deficits as a share of GDP, relative to the present. One of the main flaws with budget rules are according to the author the focus on the first two variables and the ignoring of the third as it is the third variable that is considered by the author to be the most important reason for the fiscal gap for the majority of the advanced economies. Under current policy trajectories deficits are projected to grow substantially faster than GDP. With the growing commitments of unfunded government programs, the author argues, budget constraints built on current values of debt and deficit miss much of the fiscal challenge typical for an advanced economy with an ageing population. This thus suggests that rules that do not take implicit liabilities into account may be hampered in their effectiveness in promoting fiscal sustainability.[31] Thus the need for fiscal flexibility to allow for the implementation of structural reforms addressing the problems associated with an ageing population is evident.

However, fiscal flexibility is not only needed for the implementation of structural reforms, one of the strongest arguments for fiscal flexibility in fiscal policy rules is that flexibility is needed in times of recession otherwise forcing governments into undertaking contractionary fiscal measures when deficits rise as a consequence of falling revenues and growing expenditures.[32]

Thus the flexibility is needed for the accommodation of exogenous shocks that are not in the control of the governing powers.[33]

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[30] *Fiscal discipline and flexibility in EMU: The implementation of the Stability and Growth Pact.* Buti, Franco, Ongena. Oxford review of economic policy, vol. 14, No. 3. 1998 Oxford University Press and the Oxford Review of Economic Policy Limited, p. 95.

[31] *Budget Rules and Fiscal Policy: Ten Lessons from Theory and Evidence.* Auerbach. German Economic Review. Volume 15, Issue 1, pages 84-99, February 2014. p. 91-94.

[32] Ibid. p. 89.

[33] *Fiscal Policy Rules*. Kopits, Symansky. Occasional paper/International Monetary Fund: 162, 1998. p. 19.

3.2 THE DEFINITION OF FISCAL DISCIPLINE AND FISCAL FLEXIBILITY FOR THE PURPOSE OF THIS THESIS

As mentioned above, macroeconomic theory suggests a need for fiscal flexibility within the SGP framework. At the same time, running a budget deficit and accruing debt, thus deviating from fiscal discipline, can negatively affect the stability and growth of the Member States unless the deviation is due to the factors mentioned in section 3.1.2.

When assessing the economy of a Member State which is not in compliance with the debt or deficit criteria, the Commission and the Council can either 1) strictly enforce the debt and deficit criteria by taking disciplinary action or 2) allow the non-compliance due to exogenous shocks to the economy or due to the Member States attempts at structural reform. The former will, for the purpose of this study be considered as a use of fiscal discipline while the latter will be considered as a use of fiscal flexibility.

3.3 THE STABILITY & GROWTH PACT AND ITS FRAMEWORK

"The Stability and Growth Pact (SGP) is a set of rules designed to ensure that countries in the European Union pursue sound public finances and coordinate their fiscal policies."[34]

The primary aims of the SGP are to facilitate and preserve the stability within the economic and monetary unions of the European Union and of the European Monetary Union. This is achieved through fiscal monitoring of the Member States of the European Union by the European Commission and the European Council.[35] The legal basis of the Stability and Growth Pact is primarily consistent of *Article 121*, multilateral surveillance, and *Article 126*, the excessive deficit procedure, of the Treaty on the Functioning of the European Union, TFEU, as well as *Protocol (No12)* of the Treaty which stipulates the details surrounding the EDP, as well as providing an outlining of the reference values on deficit and debt.[36]

Since its foundation the Stability and Growth Pact has been amended and enhanced on several occasions.

3.3.1 THE SGP FRAMEWORK – THE DEBT AND DEFICIT CRITERIA

The Resolution and the Regulations

The Pact is outlined by the *Resolution of the European Council on the Stability and Growth Pact*, adopted on the 17th of June 1997. The Council Resolution as well as two Council Regulations serve as the political basis of the Stability and Growth Pact and account for the

[34] http://ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm
[35] Ibid.
[36] http://ec.europa.eu/economy_finance/economic_governance/sgp/legal_texts/index_en.htm

process and implementation of the SGP as committed to by the Member States, the Commission and the Council.[37]

The first regulation, *Council Regulation 1466/97* on the strengthening of the surveillance of the budgetary positions and the surveillance and coordination of economic policies, serves as the basis for the preventive arm.[38] The second regulation, *Council regulation 1467/97* on speeding up and clarifying the implementation of the EDP, serves as the basis for the corrective arm.[39]

The rules of the preventive arm, which entered into force in 1998, are set to bind the Member States and their governments to their commitments towards sound fiscal policies and coordination through an implementation of budgetary targets for each of the countries involved. These budgetary targets are called Medium- Term Budgetary Objectives, MTOs.[40]

The corrective arm on the other hand consists of the EDP which ensures the correction of excessive budget deficits or excessive public debt levels through a process that reins in excessive deficits and reduces excessive debts. The definitions of an excessive budget deficit and an excessive public debt are given by the EU Treaty and are set to 3% of GDP and 60% of the GDP respectively.[41]

The procedure surrounding an EDP is outlined in *Article 126* of the Treaty. In case of a Member State being incompliant with either one or both of the criteria above, the Commission shall prepare a report. A report may be prepared in case of a risk of an excessive deficit in a Member State as well. Following the Commission report, the Economic and Financial Committee shall formulate an opinion on the report of the Commission. Finding that an excessive deficit in a Member State exists or may exist the Commission shall address an opinion to the Member State as well as notifying the Council accordingly.[42]

Subsequently the Council shall, on a proposal from the Commission, following an overall assessment, decide whether an excessive deficit exists in a Member State. Following the decision the Council shall adopt, based on a recommendation from the Commission,

[37] Resolution of the European Council on the Stability and Growth Pact Amsterdam, 17 June 1997. Official Journal C 236 , 02/08/1997.
[38] 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.
[39] COUNCIL REGULATION (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure.
[40] http://ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm
[41] Ibid.
[42] Ibid.

recommendations addressed to the Member State concerned with a view to bringing that situation to an end within a specified period of time.[43]

After a recommendation from the Commission, the Council shall abrogate some or all of the decisions and recommendations issued by the Council if the Council in its opinion considers the excessive deficit to have been corrected.[44]

"Making the best use of the flexibility within the existing rules of the Stability and Growth Pact"

The latest addition to the evolvement of the Pact was issued in 2015. It is a communication called *"Making the best use of the flexibility within the existing rules of the Stability and Growth Pact"* presented by the Commission. In the communication it is stated that the Commission will henceforth take into account several aspects in the implementation of the legal framework.[45]

It is rigorously emphasized that the communication is not created to serve as an alteration or a replacement of existing rules, it is to be seen as an interpretive communication providing additional guidance on how the Commission will apply its margin of interpretation in the implementation of the existing rules.[46]

The communication is a contribution to a development of a more growth-friendly fiscal attitude in the EMU. However it is also part of the Commission's efforts in reinforcing the effectiveness and the understanding of the intricate rules the Commission itself is responsible for applying.[47]

The aspects mentioned in the communication are investments, structural reforms and cyclical conditions. The structural reforms part is to concern both the Member States not undergoing an EDP as well as the Member States undergoing an EDP. The Member States not in the EDP will be allowed additional flexibility to deviate from the MTO or the path towards it, provided it is temporary. The positive fiscal impact of the structural reforms will be taken into account if the reforms are major, have verifiable direct long-term positive budgetary effects, including raising potential sustainable growth, and are fully implemented. For the Member States undergoing an EDP the existence of a dedicated structural reform plan when

[43] Ibid.
[44] Ibid.
[45] Making the best use of the flexibility within the existing rules of the Stability and Growth Pact (January 2015).
[46] Ibid.
[47] Ibid.

recommending a time limit for the correction of the excessive deficit or the duration of the extension to that time limit will be taken into account by the Commission.[48]

[48] Ibid.

4. ANALYSIS

4.1 FRANCE

Since the establishment of the SGP the economy of France has been far from stable with high government debts reaching an all-time high of 95,8% for the government debt to GDP ratio in 2015. The numbers for the government deficit have been far from low as well with numbers reaching far over the allowed 3% target put forward by the Pact, resulting in a deficit for 2015 of 3,5% of GDP. On account of the persisting deficits and debts France has been under the excessive deficit procedure on multiple occasions the latest starting in 2009.[49]

	1995-2010	2011	2012	2013	2014	2015	2016
Gross public debt (% of GDP)	64,3	85,2	89,6	92,3	95,4	95,8	96,4
Public budget balance (% of GDP)	-3,4	-5,1	-4,8	-4,1	-4,0	-3,5	-3,4
GDP growth (%)	1,8	2,1	0,3	0,3	0,2	1,2	1,3

Economic development-Key figures- France 1995-2016.[50]

4.1.1 THE FIRST STEP IN THE EDP – THE COMMISSION REPORT

On February 18th 2009 a Commission report was issued on the economic situation in France. The Commission report stipulated an excessive government deficit of 3,2% of GDP in 2008, planned to increase further. The deficit was attributed to the severity of the economic recession, to be seen in the context of the unprecedented global financial crisis and economic downturn. However the excessive deficit was considered depending more on the lack of adequate fiscal consolidation at the time when the conditions for the economy were more favorable. Hence if the necessary measures would have been implemented at that time this would have provided France with a safety margin that would have protected the country from

[49] http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/countries/france_en.htm

[50] European economic forecast- Spring 2016- France (DG ECFIN). The figures in the table and the figures in the analysis may differ on account of the figures in the analysis being on most part projections.

breaching the deficit rule when the economic recession was a fact. Thus the excessive deficit was not fulfilling the requirement to be assessed as exceptional leading to the suggestion on behalf of the Commission that the deficit criterion of the Pact was indeed being breached.[51]

The general government debt of the country had been above the reference value for a considerable amount of time and an increase was expected. The debt criterion of the Pact was thus considered to be breached as well.[52]

Although due consideration was given to the relevant factors surrounding the excessive deficit, on their own merit considered favourable, the deficit was after all remaining close to the reference value and the excess was expected to be temporary, however the deficit was not fulfilling the criteria of being exceptional. Thus, the Commission found it necessary to undertake enhanced surveillance under the EDP.[53]

4.1.2 THE EDP IS ENFORCED

On March 24th 2009 the Commission issued a *Commission Opinion on the existence of an excessive deficit in France*. The opinion, based on the budgetary situation in France in regard to the deficit and debt criteria laid down in *Article 126* of the Treaty, as well as the Commission report preceding the opinion, stated that the Commission is of the opinion that an excessive deficit exists in France.[54]

Thus the second step in the EDP process was applied giving way for the recommendations, to end the excessive deficit situation, to come.

4.1.3 THE RECOMMENDATION AND THE DECISION

Following the Commission opinion was a *Commission recommendation for a Council recommendation to France with a view to bringing an end to the situation of an excessive government deficit*. It was issued on March 24th 2009 as well. [55]

In accordance with the greater flexibility in the application of the EDP introduced with the 2005 reform of the Stability and Growth Pact special circumstances were deemed to exist in the case of France. The global financial crisis was considered instrumental to the sharp

[51] Report from the Commission France Report prepared in accordance with Article 104(3) of the Treaty. Brussels, 18.2.2009. SEC(2009) 190 final.

[52] Ibid.

[53] Ibid.

[54] Commission opinion on the existence of an excessive deficit in France. Brussels, 24.3.2009. SEC(2009) 569 final.

[55] Recommendation for a Council recommendation to France with a view to bringing an end to the situation of an excessive government deficit. Brussels, 24.3.2009. SEC(2009) 571 final.

deterioration of the economy in France thus creating the basis for the existence of special circumstances.[56]

The report concluded that budgetary consolidation measures would lead to a reinforcement of the growth potential of the economy as well as leading to durable improvement in the general government balance.[57]

It was further stated that in accordance with the existence of special circumstances the French authorities were allowed for a correction of the excessive deficit at a slower pace and should hence put an end to the present excessive deficit situation by 2012 as well as ensuring that the government gross debt ratio is put on a sufficiently declining path approaching the reference value at a satisfactory pace.[58]

On the basis of the documents above the Commission simultaneously issued a *Commission recommendation for a Council decision on the existence of an excessive deficit in France*.[59]

On April 27th 2009 a *Council decision on the existence of an excessive deficit (2009/414/EC)* was issued in which it was stated that having regard to the recommendation from the Commission as well as to the observations made by France the Council considers an excessive deficit to exist in France. No account was taken to relevant factors in the steps preceding the decision as the *double condition*, of the deficit being close to the reference value as well as being temporary, was considered not to be met by France.[60]

Founded on the preceding documents by the Commission a *Council recommendation to France with a view to bringing an end to the situation of an excessive government deficit was issued at the same time as the Council decision*. The Council recommendation stated that the French authorities should put an end to the excessive deficit situation by 2012.[61]

This concluded the steps leading up to the EDP and France was officially once again found under the corrective arm of the SGP forcing the country to enforce the set out measures and position its economy on a balanced path towards the limits set out by the Pact.

4.1.4 FURTHER RECOMMENDATIONS

On November 11th 2009 the Commission came out with a new *Commission recommendation for a Council recommendation to end the excessive deficit situation* stating that assessed

[56] Ibid.
[57] Ibid.
[58] Ibid.
[59] Recommendation for a Council decision on the existence of an excessive deficit in France. Brussels, 24.3.2009. SEC(2009) 570 final.
[60] Council decision of 27 April 2009 on the existence of an excessive deficit in France. (2009/414/EC) 27 April 2009.
[61] Council recommendation to France with a view to bringing an end to the situation of an excessive government deficit. 27 April 2009.

against the economic forecast underlying the initial Council recommendation, adopted on April 27th 2009, unexpected adverse economic events affecting the budget in an unfavorable way had occurred in France. The action taken by France, taking into account the economic developments compared to the outlook in the forecast underlying the Council recommendation, were assessed to be adequate, the governing powers of France had implemented the fiscal measures according to plan but would not be able to reach the set out targets within the time limit put forward in the preceding Council recommendation due to the aforementioned unexpected adverse economic events.

Mentioning these factors it was thus considered that the target date set in the Council recommendation on April 27th 2009 should be revised and extended by one year. It was however stated that the consolidation efforts should be strengthened compared to that projected by the French authorities. Furthermore, a specification of the necessary measures, created to achieve the correction of the excessive deficit by 2013, should be done by the French authorities. Concluding the Commission recommendation was an outline for a new Council recommendation based on the new circumstances underlying the new recommendation stipulating the new target date to 2013.[62]

Following the Commission recommendation was subsequently a *Council recommendation to France with a view to bringing an end to the situation of an excessive government deficit*, specifying the new conditions put forward in the Commission report and consequently extending the deadline by one year setting the time limit to the year 2013.[63]

4.1.5 ASSESSMENT ON ACTION TAKEN

A Commission communication on action taken was issued on June 15th 2010. The Commission assessed adequate progress on behalf of France towards the correction of the excessive deficit within the time limits put forward by the Council in the renewed Council recommendation. France was credited with having implemented the deficit-reducing measures as planned in 2010. France was credited with having outlined the details for the strategy required to progress towards the correction of the excessive deficit by 2013 as required by the Council recommendation. However France was once again urged to take further steps specifying the consolidation measures for the years to come in order to make sure a correction

[62] Recommendation for a Council recommendation to France with a view to bringing an end to the situation of an excessive government deficit. Brussels, 11.11.2009. SEC(2009) 1550 final.

[63] Council recommendation to France with a view to bringing an end to the situation of an excessive government deficit. 02.12.2009.

of the excessive deficit in time. Nevertheless further steps in the EDP were not considered to be needed.[64]

4.1.6 FURTHER RECOMMENDATIONS

On May 29th 2013 the Commission issued a *Commission recommendation for a Council recommendation with a view to bringing an end to the situation of an excessive deficit in France* for a third time. The recommendation emphasized the deterioration in the budgetary position due to an overall weakening of the position of the general economy, not least effected by the economic crises, suggesting revised recommendations under *Article 126(7)* TFEU for France with an extension of the time limit by the Council for the correction of the excessive deficit by 2015. The circumstances underlying the 2009 Council recommendation were considered to have altered to such an extent that a revised recommendation was considered justified under the rules of the SGP.[65]

An extension of the time limit by only one year, although the rule according to *Council Regulation (EC) No 1467/97*, was considered to be inadequate and unreasonably pressuring, implying targets well above the ones recommended for the period of 2010-2013, by the Council in the renewed Council recommendation issued on December 2nd 2009, as well as considered hampering on the projected economic recovery for the year to come. A two- year extension was argued for, primarily on the grounds of the possibility of bringing down the excessive deficit below 3% of the GDP in 2015 in addition of having a minimal effect on growth in 2014 and 2015.[66]

For the budgetary targets to be achieved the importance of a full implementation of the already adopted measures for 2013 was stressed. Furthermore a specification, adoption and implementation of further measures for the years 2014 and 2015 were underlined.[67]

The Commission continued by stating that all the conditions for an extension of the deadline for correcting the excessive general government deficit, as stated in Article 3(5) of *Regulation (EC) No 1467/97* on speeding up and clarifying the implementation of the EDP were fulfilled.[68]

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[64] Communication from the Commission to the Council Assessment of the action taken by Belgium, the Czech Republic, Germany, Ireland, Spain, France, Italy, the Netherlands, Austria, Portugal, Slovenia and Slovakia in response to the Council Recommendations of 2 December 2009 with a view to bringing an end to the situation of excessive government deficit. Brussels, 15.6.2010. COM(2010) 329.

[65] Recommendation for a Council recommendation with a view to bringing an end to the situation of an excessive government deficit in France. Brussels, 29.5.2013. COM(2013) 384 final.

[66] Ibid.

[67] Ibid.

[68] Ibid.

Thus on June 21st 2013 a third *Council recommendation with a view to bringing an end to the situation of an excessive government deficit in France* was therefore issued. It was issued on the basis of the Commission recommendation from May 29th 2013.[69]

4.1.7 ASSESSMENT ON ACTION TAKEN

On November 15th 2013 the action taken by France was once again assessed in a Commission communication this time based on the action taken in consideration to the new Council recommendation issued on June 21st 2013. At the time France was considered making sufficient progress with no further steps in the EDP needed.[70]

However as early as on March 5th 2014 a *Commission recommendation regarding measures to be taken by France in order to ensure a timely correction of its excessive deficit* was issued due to fears from the Commission that France would not meet the targets set out in the recommendation issued on June 21st 2013. The Commission urged France to undertake the measures needed to correct the excessive deficit in the country in a timely manner. In the communication it was clearly stated that there was a significant risk of non-compliance with the recommended fiscal effort in 2013 as well as in 2014. Accordingly France was urged to make efforts to ensure full compliance with the Council recommendation of June 21st 2013.[71]

4.1.8 FURTHER RECOMMENDATIONS

On February 27th 2015 the Commission issued a *Commission recommendation for a Council recommendation with a view to bringing an end to the excessive government deficit in France*, for a fourth time, stipulating that the budget deficit in France according to the Commission 2015 forecast is expected to exceed the target set in the Council recommendation of June 21st 2013 and thus the 3% of the GDP benchmark required in the SGP by reaching a figure of 4,1% of the GDP in 2015. This despite, what are considered to be, significant efforts undertaken on the behalf of the Member State to rein in the increase in public expenditures. Thus the evidence did not allow for the conclusion that no effective action had been undertaken. However due to low inflation those measures were not sufficient to reach the budgetary targets. Thus the significant decline in the position of the budget due to a weakening of the economy in the country as a whole was considered to have substantially

[69] Council recommendation with a view to bringing an end to the situation of an excessive government deficit in France. Brussels, 18 June 2013.
[70] Communication on action taken. Assessment of action taken by Spain, France, Malta, The Netherlands and Slovenia in response to the Council Recommendations of 21 June 2013 with a view to bringing an end to the situation of excessive government deficit, and by Belgium in response to the Council Decision to give notice of 21 June 2013. Brussels, 15.11.2013. COM(2013) 901 final.
[71] Commission recommendation of 5.3.2014 regarding measures to be taken by France in order to ensure a timely correction of its excessive deficit. Brussels, 5.3.2014. C(2014) 1498 final.

changed the premise on which the Council recommendation of June 21st 2013 was founded therefore calling for a revised recommendation under *Article 126 (7)* TFEU for France, setting a new time limit to correct the excessive deficit.[72]

The public debt in France is expected to rise and to reach 97,1% of GDP in 2015 and 98,5% of GDP in 2016, targets estimated by the Commission in its 2015 forecast.[73]

On November 21st 2014 the French authorities notified the Commission with a letter stating that the country had committed to several growth- enhancing structural reforms implementing the country specific recommendations (CSRs) issued by the Council on July 8th 2014. On December 12th 2014 a reform agenda was published by the government of France stating the reform priorities until 2017. The reform agenda was confirmed in a communication on the National Reform Programme (NRP) made public on February 18th 2015. With this information the government of France also provided a quantification on the expected macroeconomic impact of the reforms already initiated. The main reforms expected to contribute to growth and the sustainability of public finances were a reduction in the cost of labour and additional reductions in the social security contributions aimed at the employer, however considered in need of further strengthening by complementary reforms addressed at reducing wage rigidities. Further reforms expected to contribute to growth and the sustainability of public finances in the long-term were the 2014 pension reform, measures aimed at reforming the local authorities, reforms improving the business environment and measures aimed at increasing competition in services. However the Commission pointed to the lacking response on the behalf of France in regard to previous recommendations aimed at improving macroeconomic imbalances and would hence take into account the level of ambition provided in the upcoming National Reform Programme and other commitments before deciding whether there was need for further recommendations on account of the existence of an excessive imbalance and recommending that France take corrective action.[74]

The commitments on the behalf of France in regard to structural reforms were however considered adequate and on the right path taking into consideration the latest communication *"Making the best use of the flexibility within the existing rules of the Stability and Growth Pact"* and thus, under this premise, an extension of the deadline for the correction of the excessive deficit by more than one year was considered to be in order.[75]

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[72] Recommendation for a Council Recommendation with a view to bringing an end to the excessive government deficit in France. Brussels, 27.2.2015. COM(2015) 115 final.
[73] Ibid.
[74] Ibid.
[75] Ibid.

The rules of the Pact dictate only a one- year extension for correction. However this was, for the second time, considered too demanding considering the weak economy of France. According to the Commission 2015 forecast the economic adjustment needed, if only one year was granted, would have a damaging effect on growth in the country, as well as being significantly above the annual average effort for 2013-2015 recommended by the Council in the Council recommendation to end the excessive deficit situation issued on June 21st 2013. Consequently, the commission, on these grounds as well as taking into account the announced reform plans, found it suiting to extend the deadline to bring an end to the excessive deficit by two years. However the French authorities were expected to ensure full implementation of both the adopted as well as planned reforms, which, if required, were expected to be reinforced. If France were to fail the reform plans put forward by the country the Commission would find it aggravating and to a disadvantage for the country when assessing the effective action taken in response to the recommendation put forward by the Commission on February 27th 2015.[76]

The Commission insisted on full implementation of the already announced measures for 2015 and a specification, adoption as well as implementation of additional measures needed to achieve the budgetary targets set for 2015, 2016 and 2017. Furthermore France was expected to report on the reform plan presented in the communication on February 18th 2015 which was expected to be further complemented in the NRP. The NRP was to be implemented in a strict manner so as to improve the growth of the economy in the country and to contribute to the long- term sustainability of the public finances. It was further expressed that it is important that the fiscal consolidation is strengthened by the implementation of comprehensive and ambitious structural reforms.[77]

4.1.9 CONCLUDING REMARKS

The financial crisis of 2008 is considered by the Commission and the Council to have affected France throughout the investigated timeframe. It is considered to be a mitigating factor for France's failure to meet the budget targets in all investigated documents, resulting in a two year extension of the deadline for the correction of budgetary targets rather than the ordinary one year limit in 2013 and 2015. However, France has, according to the Commission and the Council, been lacking in the implementation of measures to ensure budget stability before, as well as during the financial crisis. France failure to implement the necessary measures prompted the Commission and the Council to take disciplinary action against the Member

[76] Ibid.
[77] Ibid.

State despite the exogenous shock to the economy on two occasions, on February 18th 2009 with the opening of an EDP and on March 5th 2014 with the issuing of an extraordinary recommendation for France to implement the necessary measures to reach the deficit and debt targets.

Thus the factor of exogenous shocks to the economy has influenced the decisions of the Commission and the Council but has not been decisive on every occasion. Fiscal discipline has on two occasions been considered as more important, resulting in disciplinary action by the Commission and the Council.

Beginning with the Commission recommendation issued on February 27th 2015 France is, on the basis of the implementation of growth-enhancing structural reforms, granted the possibility to deviate from the set out targets. This is due to the communication on *"Making the best use of the flexibility within the existing rules of the Stability and Growth Pact"*. The Commission and the Council have since the issuing of the aforementioned communication added the factor of attempts at structural reform when assessing whether disciplinary action is to be taken towards a Member State that does not meet the debt and deficit criteria. This creating a stronger basis for fiscal flexibility within the SGP framework.

Addressing the aforementioned research question, the Commission and the Council have allowed France to deviate from set targets due to exogenous shocks and attempts at structural reforms. However, they have also criticized France for not undertaking sufficient measures and undertaken disciplinary action when France has failed to meet the targets and the failure, according to the Commission and the Council, has not been due to exogenous shocks or attempts at structural reforms.

The actions of the Council and the Commission has thus been in line with the macroeconomic theory behind fiscal discipline and fiscal flexibility. France was allowed to deviate from the debt and deficit targets due to exogenous shocks and attempts at structural reform. When France did not meet the targets due to the Member State not undertaking necessary measures and due to the failure to undertake necessary measures to make the economy more resilient to exogenous shocks prior to the financial crisis the Council and the Commission took disciplinary action and enforced fiscal discipline.

4.2 ITALY

The Italian economy has since the introduction of the SGP been experiencing high debts on occasion accompanied by high deficits. With debt to GDP ratios reaching over one hundred percent the Italian debt to GDP ratio was recorded at an all-time high in 2015 at 132,7%. Granted that the Italian deficit for 2015 was at 2,6% of GDP the deficit ratios of the Member State has on multiple occasions reached far over the allowed 3% target put forward by the Pact. Accordingly Italy has been under an excessive deficit procedure on several occasions, the latest starting in 2009.[78]

	1995-2010	2011	2012	2013	2014	2015	2016
Gross public debt (% of GDP)	107,1	116,4	123,1	128,5	132,5	132,7	132,7
Public budget balance (% of GDP)	-3,6	-3,5	-3,0	-2,9	-3,0	-2,6	-1,9
GDP growth (%)	1,0	0,6	-2,8	-1,7	-0,3	0,8	1,1

Economic development- Key figures- Italy 1995 -2016[79]

4.2.1 THE FIRST STEP IN THE EDP – THE COMMISSION REPORT

On October 7th 2009 the Commission issued a report assessing the economic situation in Italy especially with an emphasis on the deficit and the debt criterion of the SGP. The planned government deficit for 2009 was 5,3% of GDP with a growth of real GDP estimated to -4,8%. The deficit was considered exceptional, especially as Italy´s economy had been adversely affected by the 2008 financial crisis which had resulted in a severe economic downturn. However the deficit was not considered to satisfy the two further criteria, the double condition. The deficit was forecasted to remain above the reference value until 2011 and to go

[78] http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/countries/italy_en.htm

[79] European economic forecast- Spring 2016- Italy (DG ECFIN).The figures in the table and the figures in the analysis may differ on account of the figures in the analysis being on most part projections.

down to 2,7% of GDP in 2012 in combination with returning positive real GDP growth. The deficit criterion in the Treaty was thus not considered to be fulfilled.[80]

The general government gross debt was set to 115,3% of GDP in 2009 exceeding the reference value put forward by the Treaty. The planned deficit levels over the period of 2009-2010 and the growth projections for the years implied that the government debt-to-GDP ratio would indeed move away from the set out reference value. The debt-to-GDP ratio was thus not considered as sufficiently diminishing and approaching the reference value at a satisfactory pace as expressed in the Treaty and the SGP, consequently leaving the debt criterion of the Treaty unfulfilled as well.[81]

The relevant factors, examined by the Commission, presented a mixed picture. The complexity of the economic situation in the country was clearly demonstrated by the fact that the real GDP in Italy, impacted by a weak productivity growth, had been quite low for a substantial amount of time, hence the global economic downturn when it hit the country, also hit a weak economy. Thus while potential growth was strongly influenced by the economic downturn in 2009, the structural weaknesses underlying the slow productivity dynamics in the country were, in the opinion of the Commission, to continue to have a negative effect on growth, making the recovery process very slow. The Commission concluded that the opening of an EDP was necessary.[82]

4.2.2 THE EDP IS ENFORCED

Following the report, a *Commission opinion on the existence of an excessive deficit in Italy* was issued on November 11th 2009. The opinion, based on the budgetary situation in Italy in regard to the deficit and debt criteria laid down in *Article 126* of the Treaty as well as on the Commission report preceding the opinion, stated that the Commission is of the opinion that there exists an excessive deficit in Italy.

Thus the process of the EDP was started and the recommendations, to end the excessive deficit situation, were to come.

4.2.3 THE RECOMMENDATION AND THE DECISION

In addition to the release of the opinion, two additional documents were issued consisting of a *Commission recommendation for a Council recommendation to Italy with a view to bringing an end to the situation of an excessive government deficit* and a *Commission recommendation for a Council decision on the existence of an excessive deficit in Italy*.

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[80] Report from the Commission Italy Report prepared in accordance with Article 104(3) of the Treaty. Brussels, 7.10.2009. SEC(2009) 1271 final.
[81] Ibid.
[82] Ibid.

In the Commission recommendation the Commission emphasized the fact that special circumstances apply in the case of Italy and thus a greater flexibility would be used in the application of the EDP according to the 2005 reform of the SGP. The financial crisis was, as before, considered having a damaging effect on the Italian economy, creating the premise on the behalf of the Council to allow for the correction of the excessive deficit situation at a slower pace thus setting the deadline for the correction of 2012. In addition the importance of achieving the MTO was stressed, this, to ensure the convergence of the debt ratio towards a suitable level, taking into account the implicit liabilities related to ageing, and ensure that the budgetary consolidation undertaken towards the MTO, after the correction of the excessive deficit, is sustained as well. Further specification of the budgetary consolidation measures needed for the improvement of the general government balance reinforcing the growth potential of the economy were stressed.[83]

On the basis of the documents above, the Commission issued the Commission recommendation for a Council decision.[84]

Following the preceding documents was consequently a *Council decision on the existence of an excessive deficit in Italy (2010/286/EU)*, in which it was stipulated that Italy was indeed not fulfilling the deficit criteria and not the debt criteria either. It was however also said that the deficit planned for 2009, 5,3% of GDP, considered exceeding and not close to the 3% of GDP reference value, was nonetheless considered as exceptional, in particular due to the fact that it was resulting from a severe economic downturn, within the meaning of the Treaty and the SGP. The general government gross debt however had been exceeding the target of 60 % of GDP for a long time and planned to reach 115,1% of GDP in 2009 with a forecast predicting further increase. Thus the debt ratio was not considered diminishing sufficiently and approaching the reference value at a satisfactory pace in the sense of the Treaty and the SGP.[85]

At the same time the Council issued a *Council recommendation to Italy, with a view to bringing an end to the situation of an excessive government deficit*, in which the special circumstances surrounding Italy's deficit were once again mentioned. The special circumstances were once again stressed especially in the context of the EDP and the greater

[83] Recommendation for a Council recommendation to Italy with a view to bringing an end to the situation of an excessive government deficit. Brussels, 11.11.2009. SEC(2009) 1525 final.

[84] Recommendation for a Council decision on the existence of an excessive deficit in Italy. Brussels, 11.11.2009. SEC(2009) 1524 final.

[85] Council decision of 19 January 2010 on the existence of an excessive deficit in Italy. (2010/286/EU) 02.12.2009.

flexibility, introduced with the 2005 reform. In particular the global financial and economic crisis and the strong adverse effect it had had on the Italian economy was emphasized. The widening deficit in 2009 was attributed mainly to the automatic stabilizers preventing a further deterioration of public finances especially given the high gross debt but in the end raising the deficit. A fiscal effort was recommended considering the circumstances.[86]

Moreover the Italian authorities were requested to seize all opportunities possible beyond the fiscal effort, to accelerate the reduction of the gross debt ratio towards the 60% of GDP reference value.[87]

The documents above confirmed the excessive deficit in the country and Italy was found not abiding by the rules set out by the Pact.

4.2.4. ASSESSMENT ON ACTION TAKEN

On June 15th 2010 the Commission presented a communication to the Council assessing the action taken by Italy in response to the recommendation from the Council. The assessment stated that Italy was recommended by the Council to put an end to the deficit situation by 2012. Italy was considered making adequate progress towards the correction of the excessive deficit, in line with the set out targets and the time limit. The Commission especially brought forward the implementation of the consolidation measures for 2010, implemented as recommended by the Council. It was nevertheless stressed that in order to achieve the correction of the excessive deficit in time, a strict implementation of the planed measures had to be ensured, as well as ensuring that the debt ratio gets on a downward path by 2012. Thus the procedure surrounding Italy was considered not in need of any further steps being implemented, consequently closing the communication on a positive note.[88]

4.2.5 THE ABROGATION OF THE COUNCIL DECISION

On May 29th 2013 a *Commission recommendation for a Council decision abrogating the former Decision 2010/286/EU on the existence of an excessive deficit* in Italy was issued by the Commission.[89]

It was considered that based on the fact that Italy had corrected the deficit, although the debt was still excessive and forecasted to rise to 131,4% of GDP in 2013 (being at 127, 0% in

[86] Council recommendation to Italy with a view to bringing an end to the situation of an excessive government deficit. 2009.12.02.

[87] Ibid.

[88] Communication from the commission to the Council Assessment of the action taken by Belgium, the Czech Republic, Germany, Ireland, Spain, France, Italy, the Netherlands, Austria, Portugal, Slovenia and Slovakia in response to the Council Recommendations of 2 December 2009 with a view to bringing an end to the situation of excessive government deficit. Brussels, 15.6.2010. COM(2010) 329.

[89] Recommendation for a Council decision abrogating Decision 2010/286/EU on the existence of an excessive deficit in Italy. Brussels, 29.5.2013. COM(2013) 385 final.

2012), the decision should, in the opinion of the Commission, be abrogated. Part of this decision was contributed to the fact that the rise in the debt level was mostly contributed to Italy having made a substantial contribution to financial assistance to the Member States of the European Monetary Union [90]

However starting in 2013, the year following the correction of the excessive deficit, Italy was obliged to continue towards the medium-term objective set out for the country, making satisfactory progress towards compliance with the debt criterion in accordance with *Council Regulation (EC) 146/97*.[91]

The *Council decision abrogating Decision 2010/286/EU on the existence of an excessive deficit in Italy (2013/314/EU)* repealed the former decision on the existence of an excessive deficit, on the grounds presented by the Commission, and so the EDP for Italy was closed.[92]

4.2.6 A NEW COMMISSION REPORT

On February 27th 2015 the situation of Italy was once again assessed, this time in a new Commission report. The *Commission report* was prepared in accordance with *Article 126(2)* TFEU where it was specified that the Commission has within its task the obligation to monitor the compliance with budgetary discipline on the basis of two criteria, the first being whether the planned or actual government deficit exceeds the reference value of 3% and the second one being whether the government debt exceeds the reference value of 60%.[93]

The report continued by stating that the report indicated the first step in the EDP and analyzed the question whether Italy was compliant with the debt criterion. It stipulated that following the amendments to the Pact in 2011, the debt requirement had been put on equal footing with the deficit criterion. It was stated that the transition period in the case of Italy was set between 2013 and 2015.[94]

Italy was considered not making sufficient progress towards compliance with the debt criterion thus not reaching the set out targets for the country. According to the report Italy was not making sufficient progress towards compliance with the debt reduction target for 2014 and 2015, falling short of the required MLSA. It was thus assessed that *prima facie* there was

[90] Ibid.
[91] Ibid.
[92] Council decision of 21 June 2013 abrogating Decision 2010/286/EU on the existence of an excessive deficit in Italy (2013/314/EU). 21.06.2013.
[93] Report from the commission Italy Report prepared in accordance with Article 126(3) of the Treaty. Brussels, 27.2.2015. COM(2015) 113 final.
[94] Ibid.

a risk of the existence of an excessive deficit, in the sense of the SGP. However if all factors were indeed taken into account there appeared to be a different picture.[95]

The deficit criterion was forecasted to be respected in the sense of the SGP. However the debt criterion appeared not to be respected on account of the planned measures not being sufficient to meet the requirements set out for the debt reduction benchmark, thus not reaching the MLSA targets set out for it. The assessment of the compliance with the debt criterion thus showed that *prima facie* the debt criterion in the sense of the SGP was not complied with. However, taking into account all relevant factors, as required by *Article 126(3)* of the TFEU, especially important in the case of a breach of a debt criterion due to the influence the factors outside the control of the government tend to have on the government debt, it was clear that the currently unfavorable economic conditions, with particularly low inflation, created particularly demanding conditions for Italy under which it was considered exceptionally hard to respect the debt rule. However the MTO and the expectations that compliance with the required adjustment towards the MTO was going to occur was broadly ensured, and the implementation of ambitious growth-enhancing reforms alongside with the commitment of the Italian authorities advocated for the debt, defined in the Treaty and in *Regulation (EC) No 1467/1997*, to be considered as complied with at the moment.[96]

In addition the report stated that respecting the MLSA in 2014 and 2015, required by the debt rule, would call for targets significantly over the countries MTO targets. It was considered that the necessary additional measures in the current economic environment would eventually lead to negative effects on growth and hence further aggravate the deflationary trends in the economy, consequently working in the opposite direction of the intended.[97]

Moreover the Communication on flexibility issued by the Commission on January 13th 2015 was highlighted together with the fact that the implementation of growth-enhancing structural reforms was to be considered when analyzing all relevant events regarding the economic, budgetary and debt position. Thus the commitment, on the behalf of Italy, to an ambitious structural reform agenda and a rapid implementation of it was emphasized as an important contribution to the process of bringing down the debt-to-GDP ratio on a satisfactory reduction path.[98]

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[95] Ibid.
[96] Ibid.
[97] Ibid.
[98] Ibid.

The reforms expected in the structural reform plan submitted by Italy were supposed to concern public administration and judicial system, competiveness and product markets, the labour market, education and the taxation system.[99]

Among the reforms considered to in the future have a positive impact on growth were first and foremost the reform concerning the labour market, the Jobs Act law. This reform had been adopted with the expectation of further adoption and implementation of several legislative decrees in this area. Taxation was addressed through a sizeable reduction in the labour tax wedge for 2015. The issues concerning the institutional and administrative efficiency, considered having a hampering effect on the business environment and growth, were addressed through the ongoing legislative process on institutional reform as well as the parliamentary adoption process on the enabling law on public administration reform. Concerning the reforms for the improvement of the judicial system, several measures were still pending while a number of the provisions had been converted into final law. The reforms on competition were considered to be on their way as the draft law had been adopted by the government however it still had to be approved by the parliament. The reform of the school system was expected to get underway in 2015 through the announcement of a decree law on this reform plan.[100]

All things considered and all relevant factors taken into consideration Italy was thus for now considered to be in compliance with the SGP due to the attempted structural reform and the unfavorable economic conditions.[101]

4.2.7 CONCLUDING REMARKS

As in the case of France, the financial crisis of 2008 is considered by the Commission and the Council to have affected Italy throughout the investigated timeframe. The financial crisis is considered to be a mitigating factor for Italy's failure to meet the budget targets in all investigated documents, resulting in the abrogation of an EDP in 2013 and in the Commission not recommending the initiation of an EDP in 2015. However, as Italy had failed to implement the necessary measures before the financial crisis, the Member State was put under an EDP in 2009, despite the crisis adverse effects on the economy.

Furthermore, since the introduction of the communication *"Making the best use of the flexibility within the existing rules of the Stability and Growth Pact"* the Council and

[99] Ibid.
[100] Ibid.
[101] Ibid.

Commission have allowed Italy to deviate from the debt and deficit targets due to the Member State's attempts at structural reform further emphasizing the use of fiscal flexibility.

In answer to the research question stated above it can be assessed that in regard to Italy the Commission and the Council have accepted deviation from the budget targets when the deviation is due to exogenous shocks and efforts at structural reform. When the deviation was due to factors considered as being within Italy's control, the Commission and the Council took disciplinary action.

The actions of the Council and the Commission have thus been in line with the macroeconomic theory behind fiscal discipline and fiscal flexibility. Italy has only been allowed to deviate from the debt and deficit targets due to exogenous shocks and attempts at structural reform. When Italy failed to reach the targets due to the failure to undertake necessary measures to make the economy more resilient to exogenous shocks prior to the financial crisis the Council and the Commission took disciplinary action and enforced fiscal discipline.

5. CONCLUSION

Both attempts at structural reform and exogenous shocks have been considered as mitigating factors by the Commission and the Council which is consistent with the macroeconomic theories behind fiscal policy rules. It was, however, not until 2015 that attempts at structural reform was considered as a mitigating factor. It can thus be argued that before 2015, the SGP framework was not consistent with macroeconomic theory in this aspect and might have hindered the Member States from undertaking much needed structural reforms. This aspect is particularly interesting as the Commission and the Council, before 2015, stressed the need for structural reform in the Member States. By allowing attempts at structural reform as a mitigating factor when assessing whether a Member State has reached the targets, the Member States are no longer hindered by the SGP and positive effects of the fiscal policy rules might have been strengthened.

When the Member States have failed to reach the debt and deficit targets due to exogenous shocks, the Commission and the Council have on several occasions stated that, if the Member States would undertake the necessary measures to meet the debt and deficit targets, the damage due to the contraction of the economy caused by the efforts needed for the targets to be met would be severe. It can therefore be concluded that the Commission and the Council have taken into account the possible negative effects by strictly following fiscal rules

mentioned in the theory and avoided to take measures that might be harmful to the economy but would have enforced fiscal discipline among the Member States.

It can further be concluded that Italy and France have received similar treatment from the Commission and the Council during the investigated timeframe when assessing the debt and deficit criteria. A study including more Member States might have reached a different conclusion as both the investigated countries are among the largest economies of the EU which might have influenced the decisions of the Commission and the Council. A study including some of the smaller Member States might have produced another result.

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