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1 The politics of the Stability and Growth Pact

On 25 November 2003, the Economics and Financial Affairs Council (ECOFIN)[1] effectively decided to suspend the Stability and Growth Pact (SGP). What had seemed a set of 'boring', or at least technical, European Union (EU) regulations on budgetary policy coordination and surveillance, suddenly made headline news. It did not grab the attention of the world because of 'successful' European integration, but rather, in the eyes of the press, it marked the end of an era of rapid progress in European economic and monetary integration. France and Germany, the two countries that had been the founders of the SGP, were now the ones seen to dismantle it when confronted with procedural steps that – eventually – could have led to sanctions for their persistent failure to respect the deficit limit. Concerned with that prospect, they lobbied enough Member States so that the required qualified majority, needed to adopt the Commission recommendation to take the procedure one step further, could not be reached. According to many commentators, this decision was by no means in line with the spirit of the Pact and it flew in the face of all those who had been led to believe that the underlying intention of the framework was to enshrine budgetary discipline by automatically imposing fines on delinquents.

Some observers, however, were pleased to see the arrangement abandoned. They argued that Europe's single currency would be fine without it. Others were concerned that the procedural 'abeyance' of the SGP's Excessive Deficit Procedure (EDP) might ultimately mean the beginning of the end of the euro and Economic and Monetary Union (EMU). Seeing that the Germans had been adamant about suspending the SGP in 2003, how can one reconcile that situation with the fact that they had been the

[1] The Economic and Financial Affairs Council is commonly known as the ECOFIN Council, or simply ECOFIN, and is composed of the Economics and Finance Ministers of the Member States. It meets once a month. Budget Ministers join when budgetary issues are discussed. When the ECOFIN Council deals with issues regarding EMU, the representatives of the Member States whose currency is not in the euro do not take part in the vote of the Council.

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main advocates of it in 1995–7 when they demanded much firmer rules? Furthermore, if the rules were so politically sensitive and were infringing on crucial elements of national sovereignty, why were they created in the first place? More generally, why does European integration in the area of economic and monetary policy occur in this manner?

Even though the SGP had seemed to be all about rules and to some extent (quasi-)automatic procedures, in July 2004 the European Court of Justice (ECJ) declared that the EU Council of Economic and Financial Affairs was indeed entitled to hold the EDP *de facto* in abeyance by not adopting a recommendation of the Commission to advance the procedure (see Appendix). The Court only annulled the so-called ‘conclusions’ that the Council had adopted by changing the Commission’s recommendations, as in so doing the Council had infringed on the Commission’s right of initiative. But it did not admit the plea of the Commission that the Council be forced to adopt a decision in this vein. In the months following the Court judgement, the Commission and the EU Member States underwent a painstaking revision of the legal texts of the SGP, which was concluded in March 2005 (see Appendix). Even though the alleged strengthening of the procedural rules was widely perceived as a weakening of the SGP’s substance, not least by the European Central Bank (ECB), the legal nature of the Pact was not substantially altered; it still sought to clarify the EDP of the Maastricht Treaty and impose common rules on the making of national fiscal policies.

Indeed, it is difficult to judge if the reformed SGP will be effective in the long run, particularly given the favourable macroeconomic environment immediately following the reform, in turn replaced by a sudden and dramatic turnaround of the economic climate. Following the reform economic conditions picked up markedly in the latter half of 2005 and especially in 2006, leading to an improvement in the situation of public finances across the EU. The prospect for future growth brightened and the quarrels soon sank into oblivion. In 2007, ten years after the adoption of the SGP at the Amsterdam European Council, none of the euro-area countries were any more in excessive deficit. By 2008, there were only a few Member States falling short of the reference value before the financial crisis worsened in autumn 2008. At the time of writing (2009) the economic outlook was characterised by recession or slow growth in most EU Member States, with the expectation of a few more difficult years to come. As is discussed at some length in Chapter 9, it remains to be seen how the revised SGP will fare in these truly exceptional circumstances.

In this book we do not seek to explore whether the SGP is a useful framework to coordinate fiscal policy, as our primary aim is not to offer a normative value judgement of its merits either in its original or its

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reformed version. Instead, our aim is to draw lessons from these twelve years of SGP history as an exemplary case for the European integration process more generally. We examine the origins of the SGP, its execution, its crisis and reform, as well as the implementation of the revised framework until Europe slid into recession in 2009. We do so with a view to understanding what factors determine the outcome of each episode and to derive from that theoretical insights of general value. Before closing, in the penultimate chapter, we seek to reflect on the financial and economic crisis and, based on our insights on the SGP until this point, argue what the crisis might mean for the Pact. Our aim is to give a thorough and theoretically rich analysis of the entire SGP case while making the findings relevant for an audience that is interested in European integration more generally. We seek to offer a study that is both empirically well informed but also exploits the insights that can be obtained from the case for integration theory. This study is premised on the understanding that a well-researched case can be examined in a way that is theoretically interesting beyond the special policy problem at hand and, conversely, that theoretical work needs a sound empirical base. After offering an analysis of the origins of the SGP we look at its implementation, explore the reasons behind the SGP crisis in 2003, the reform of 2005, and assess what might lie ahead in light of the financial and economic crisis of 2008–9. Before entering into this intriguing story, let us first turn to a brief description of the SGP.

The Stability and Growth Pact – in short

The SGP contains a set of rules that aim at securing a low budgetary deficit regime. Legally, it belongs to the body of secondary EU legislation and consists of two Council regulations that operationalise Articles 99 and 104, respectively, of the EC Treaty, including the Protocol on the EDP (see Appendix).[2] Both of these regulations were amended in the course of the revision of the SGP in 2005.[3] They are complemented by texts that are not legally binding but are either of political or procedural value: a resolution of the European Council of 1997,[4] a report of the

[2] The usual notation for these Articles is ‘Article 104 TEC’. We will hereafter drop the term ‘TEC’ and merely refer to ‘Article 104’.

[3] Council Regulation No. 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, O. J. 1997, L 209/1 (as amended by Council Regulation No. 1055/2005 of 27 June 2005); and Council Regulation No. 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, O. J. L 209/6 (as amended by Council Regulation No. 1056/2005 of 27 June 2005).

[4] Resolution of the European Council on the Stability and Growth Pact, O. J. 1997, C 236/1.

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ECOFIN Council to the European Council of 2005,[5] and, finally, a code of conduct.[6]

The SGP stipulates that Member States respect a ceiling on general government budget deficits of 3 per cent of GDP. This 3 per cent reference value was already present in the convergence criteria and in the EDP as laid down in the Maastricht Treaty (Article 104 and the corresponding Protocol).[7] Yet the SGP goes further than putting a permissible maximum on budgetary deficits. It also specifies that Member States should aim for a balanced budget or have budgetary surpluses over the medium term. These objectives are backed up by a multilateral surveillance procedure, the basis of which was also already contained in the Maastricht Treaty (Article 99).

The core of the SGP is the operationalisation of the EDP. It envisages circumstances under which sanctions can be imposed on Member States that are running excessive deficits. From a perspective of European integration theory, the EDP on its own is already puzzling: why would EU Member States agree to sign up to such a far-reaching agreement and limit their sovereignty over budgetary policies? What was the reason for its creation?

The first factor to keep in mind is that the SGP came to the fore in the aftermath of Maastricht. The creation of EMU took place in three stages. Stage I had started prior to the Maastricht Treaty when restrictions on capital markets and financial transactions were lifted, on 1 July 1990. Stage II commenced as soon as the Maastricht Treaty had been ratified, which was on 1 November 1993. It was seen as the preparatory stage in which all legal and institutional arrangements would be set in place for EMU to become operational. Stage III was the irrevocable fixing of the exchange rates of the participating currencies and the transfer of monetary policy-making to the ECB. Stage III was to start any time after 1997 once half of the Member States met the criteria for entry, but no later than 1 January 1999 even if less than half of the Member States qualified.[8] To enter into Stage III, EU Member States needed to meet the so-called

[5] 'Improving the implementation of the Stability and Growth Pact' – Annex II to Presidency Conclusions of the European Council of 22 and 23 March 2005 (document number 7619/1/05).

[6] 'Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of Stability and Convergence Programmes', Opinion of the Economic and Financial Committee. All legal documents are available on: http://ec.europa.eu/economy_finance/about/activities/sgp/edp_legal_texts_guidelines_en.htm, and the most important documents are reproduced in the appendix to this book.

[7] At the time of writing these Article numbers are the correct ones. However, with the Lisbon Treaty ratified the Article numbers will change. Article 104 will become Article 126, for example.

[8] Strictly speaking, monetary policy in the euro area is conducted by the ECB and the national central banks (NCBs) of the participating Member States, as NCB presidents vote on the ECB Governing Council. The system is formally called the 'Eurosystem',

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'convergence criteria' defined in Article 121.[9] In contrast to monetary policy, which was transferred to the ECB, a new supranational institution, fiscal policies were to remain in the hands of national authorities and no final arrangements were incorporated into the Treaty.

During Stage II of the EMU process, the SGP was inspired by a memorandum for an intergovernmental stability treaty, proposed by the German Ministry of Finance under Theo Waigel in November 1995. Waigel used the idea to create a Stability Pact for Europe to fend off domestic political pressures. The other countries initially reacted favourably to the idea to create clearer rules on budgets, which had already been defined as one of the priority areas for the drafting of secondary legislation during Stage II. They were opposed, however, to renegotiating the Maastricht Treaty or to concluding an intergovernmental agreement outside the EU Treaty framework. Therefore, Member States prompted the Commission to propose a solution within the framework of the Treaty.

Negotiations on the possible draft text took place in the Monetary Committee (MC). The MC consists of representatives of NCBs and the Ministries of Finance.[10] In the case of the SGP, the formative discussions took place from January 1996 throughout the remainder of that year. The Commission's draft legislative text turned out much closer to the Maastricht Treaty than to the Waigel proposal. It did not include some of the controversial elements that the Germans had proposed, such as purely automatic fines under the supervision of a newly to be established independent 'Stability Council'. Instead, it reduced the sanctions to a discretionary measure of the ECOFIN Council. The Commission's proposal also included innovations on multilateral surveillance and economic policy

whereas the European System of Central Banks (ESCB) contains the ECB and all NCBs of the EU. In this book we use ECB as shorthand for the more complex functioning of monetary policy within the decentralised 'Eurosystem', consisting of the ECB itself and the national central banks of those EU Member States that have adopted the single currency.

[9] The convergence criteria stipulate entry conditions for Stage III in the form of economic parameters that the Member States needed to comply with. While Article 121 defines the criteria in qualitative terms, a Protocol lays down precise definitions and numerical values, including those for specific reference levels on deficits (3 per cent of GDP) and public debt (60 per cent of GDP). Member States were required to stay below these reference values or show that the levels were continuously declining and coming close to the reference values. These reference values were annexed to the Treaty in a Protocol. The other convergence criteria stated that Member States should have an inflation rate within 1.5 per cent of the three EU countries with the lowest rate. Long-term interest rates had to be within 2 per cent of the three lowest interest rates in the EU. Finally, exchange rates would have to be kept within 'normal' fluctuation margins of the ERM of the EMS. In addition, a legal convergence criterion requires national legislation to be compatible with the TEC, for instance with regard to central bank independence.

[10] With the start of Stage III of EMU, on 1 January 1999, the Monetary Committee was renamed the Economic and Financial Committee (EFC).

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coordination. As of then, the SGP has consisted of two parts: a 'dissuasive' or 'corrective' arm, centred on the EDP and Article 104; and a 'surveillance' or 'preventive' arm, centred on the annual submission of so-called 'stability programmes' based on Article 99.

The bulk of the SGP discussions were completed in the MC. Only very few open questions needed to be referred to the political level, i.e. the ECOFIN Council. Yet one issue in particular developed into a major controversy. Germany was isolated in its request for automatic sanctions to be imposed on a Member State with excessive deficits. Waigel demanded nothing less than a GDP contraction of 2 per cent or worse before he would accept an exemption. A political compromise was reached in the morning of 13 December 1996 after dramatic negotiations.

The Maastricht Treaty had provided a restrictive environment for the experts and politicians to operate within. Short of changing the Treaty, it was impossible to alter the functioning of the EDP. For instance, it was legally impossible to replace the political decision-making process on each EDP step with 'automaticity' as demanded by Waigel. The appearance of 'automaticity', which was important domestically for Waigel, was then salvaged through a solemn resolution by which all parties involved subscribed to a self-commitment to apply the EDP in a strict and timely manner. In practice, however, that – not legally binding – resolution turned out to be not very authoritative at all. It was of a purely declaratory nature, as became dramatically clear on 25 November 2003, when the EDP was *de facto* held in abeyance for France and Germany.

It is also noteworthy that sanctions cannot be enforced by legal means. A Member State government or a Community institution can only enforce formal adherence to the sequence of decision-making. It could thereby 'call the bluff' if the Commission or the Council failed to play their part in the process. However, such an appeal for failure to act could not force a positive decision, for instance to initiate sanctions. This happened when the Commission asked the ECJ to review the events of 25 November 2003.[11] The ECJ ruled on 13 July 2004 that the Council had the right *not* to adopt the Commission's recommendation but that it did not have the right to adopt its own conclusions instead of revising the Commission's proposal. Thus the Court ruled the single-handed Council conclusions void – but not the Council's decision not to adopt the Commission recommendations (which, effectively, had placed the EDP in abeyance).

The above discussion shows that the SGP suffers from inherent legal weaknesses. Due to the politicised nature of the EDP, the essence of the

[11] On the basis of Article 230.

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Pact seems to be not so much a mechanism of 'quasi-automatic sanctions'[12] but rather the institutionalisation of a political pledge to aim for low deficits. Following a period of reflection in 2004, the SGP underwent a painstaking reform until a deal was reached in March 2005. By then, all parties involved were ready to put the quarrelling behind them and make a fresh start. The political leaders in particular were aware that the credibility of the framework could not be overstretched and that it was important to come to an agreement on the revised SGP. Their fate was helped subsequently by a strong economic upturn. In 2006 public finances improved substantially. In fact, during this year most EDP cases could be abrogated and everything seemed in order, with the revised SGP functioning reasonably.

In 2007 the budgetary situation improved further for all countries, but by the autumn of 2007 the fall-out of the subprime mortgage crisis in the USA was starting to affect the market for interbank loans. By autumn 2008, the full crisis reached Europe, activating an adverse feedback loop between the financial and real sectors of the economy. As we shall see in Chapter 9, at the time of writing the SGP is not being implemented in such a way that it restricts Member States to contain their budgetary deficits to 3 per cent of GDP in the midst of the crisis. Deficits above the reference value will, however, trigger the EDP, which means that down the road, once an upturn supersedes the crisis, the SGP may well make headlines again. After all, the SGP will structure the way in which EU Member States will need to work their way out of an era of potentially very large deficits. Throughout its history European integration has been typically a process with ups and downs.

By studying the history of the SGP we hope to draw conclusions that may enable us to learn more about how the general European integration process is to be understood.

Why create the SGP? Various theoretical explanations

If one is to examine the reasons for the creation of the SGP, one could look at a range of explanations, touching on economic, legal and political issues.

Economics literature stresses the fact that EMU could not operate without some degree of coordination in the area of fiscal policy. Member States could perhaps rely on the market as one source of discipline, but the risk would still be that some would benefit ('free-ride') on

[12] Waigel introduced the term 'quasi-automatic sanctions' after the Dublin summit, whereas Chirac declared that the compromise entailed no automaticity (*Handelsblatt*, 14 December 1996).

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the availability of credit and extend their deficits to the detriment of others. Political leaders and economists have argued that EMU would need either further fiscal and political integration or have reasonably strict rules on budgetary and fiscal policies. The Maastricht Treaty was perceived as having an 'open fiscal flank'.

The legal dimension stresses that the Maastricht Treaty contained Articles and Protocols on the EDP and on economic policy cooperation, but it did not safeguard that Member States would produce the desirable behaviour. Seen that the arrangements were all intricately linked, it would not be possible to make provisions substantially outside the Treaty framework. It was clear that matters could still be decided on details, but stepping outside the existing framework altogether was not an option. It was also not possible to assume that any change to the Treaty text would be acceptable to all Member States.

Political science integration theories focus on the logic of the integration process itself. These approaches deal with issues such as why do states transfer sovereignty? What is their domestic motivation to do so? What is the role of experts in the process of integration? When and how do intergovernmental bargains become crucial? What is the logic behind the creation of European rules? Once they are in place, how are they followed and implemented? How does a crisis build up that can eventually even lead to the suspension of these rules?

In the following we offer an overview of the political science integration theories that offer the most useful possible explanations of European integration in particular regarding the case of the SGP.

Integration theories

For many years studies in the area of European integration have struggled with the question of how to explain European integration phenomena. International relations (IR) scholars typically stress the puzzling fact that national governments give up national sovereignty over policy-making and transfer power to the European level. Through the process of European integration, Member State governments subsequently accept European rules and laws that are enforced by the ECJ. In the case of EMU, for example, they have transferred their monetary sovereignty to a new European supranational institution, the ECB.

Comparative politics and political economy stress that the EU polity increasingly resembles the situation of a nation state (Hix 1994). They argue that one should not overemphasise the transfer of sovereignty. Instead one should look at the specific arrangements that have been made and explain the novel institutional design as well as the policy

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content. The puzzle is to understand exactly what policy or institution was created and why. They suggest applying theories that are based on domestic factors and political economy and examining differences among Member States.

What do theories of European integration tell us about the causes of integration? Let us turn to a short review of the various integration theories and start with the two traditional approaches, intergovernmentalism and neofunctionalism. Though often discredited as being old-fashioned, they continue to represent polar opposites of the types of explanations given.

Intergovernmentalism (Hoffmann 1966; Moravcsik 1998) stresses that integration occurs when the outcome is in the interest of the Member States. This approach disputes the idea that there is automaticity and some sense of intrinsic direction in the process. Instead, it stresses the importance of the actions of Member State governments, in particular those of the larger Member States. Hoffmann's original intergovernmentalist approach assumed state interests as given. Moravcsik's innovation over Hoffmann's original formulation is that the former offers an explanation of the preferences of national governments, namely that they are determined by domestic economic actors.

Neofunctionalism (Haas 1958, 1964, 1968) expects integration to occur when various domestic actors can no longer solve a particular policy problem at the domestic level and they then turn to the European level for a European solution. In so doing, they prepare to transfer policy-making to supranational actors and transnational elites in order to enable them to work out policy solutions at that level. This process of integration is understood to be the result of spillover, and at the same time the cause for further spillover. The spillover mechanism assumes that integration in one policy area requires progressively more cooperation and ultimately integration in adjacent fields, too. Because of this understanding of the spillover mechanism, one could say that there is a certain degree of automaticity and direction in the integration process according to the neofunctionalist approach. Recent authors have incorporated contemporary criticism and have amended the approach so that the automaticity is not necessarily present all the time (Rosamond 2005; Schmitter 2004).

Besides these two classical theories, the field of European integration has enjoyed a recent upsurge in theoretical developments. However, often the approaches are differently labelled but are not significantly distinct from each other or from one of the two classic approaches. We focus on two further approaches that in substance are distinct from the classical approaches and offer additional insights into the understanding of our case.

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Perspectives under the heading of domestic politics stress the importance of domestic actors and structures in influencing the policies that national governments pursue when they bargain for European solutions (Bulmer 1983; Huelshoff 1994; Martin 1995). These approaches also explain why governments sometimes do not aim at a European solution. The domestic situation is the key factor in determining Member State government interests, political actions and timing (including sensitivity to the electoral cycle). Attention is placed on various domestic actors, structures and events.

Approaches focusing on experts and ideas look at the cognitive dimension and stress the role of ideas, paradigms, knowledge and experts for the policy-making process (*inter alia* Marcussen 2000; McNamara 1998; 1999; Radaelli 1995; Risse 2000). These approaches are often referred to as being 'constructivist' (Christiansen *et al.* 1999). They examine more subtle forces behind the formulation of interests (Finnemore 1996) and explain how experts hold certain ideas and formulate policy objectives accordingly. So-called 'epistemic communities', i.e. groups of transnational experts, can be called upon to enable a compromise. They are typically called upon when national governments wish to find an international policy solution to a particular problem (Haas 1992). These epistemic communities do more than merely redefine intergovernmental bargaining. Their own expertise and convictions play a role in framing policy options and driving the process of integration.

There are many more theoretical approaches that are similar in one way or another to the four mentioned above. Some theories seem to be in the same group, roughly speaking, because they share similar notions of the most important actors and mechanisms that determine the outcome of the integration process. For example, the fusion thesis (Wessels 1997), policy networks (Peterson 2003) and advocacy coalitions (Sabatier and Jenkins-Smith 1993) can be seen as close to a functionalist or ideas approach (see also Verdun 2002a, chapter 2).

In recent years, governance approaches have gained in popularity. Multilevel governance (Hooghe and Marks 2001) and other governance approaches (Jachtenfuchs 2001; Kohler-Koch and Eising 1999; Tömmel and Verdun 2009) emphasise the role of state and non-state actors at various levels of governance (i.e. European, national, regional and local as well as in various network settings) as well as the modes of governance used by these actors to coordinate or to create new policies. Given the importance of subnational levels, they emphasise that one can no longer look at integration from a purely IR perspective. One needs to examine the process by looking 'inside' the so-called 'black box' of

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