

# DOES THE EUROPEAN UNION HAVE A FISCAL POLICY?

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## 1. INTRODUCTION

If one were to ask a first-year undergraduate student as well as a senior economist what are the major macroeconomic policies, I think that 99% would answer: monetary and fiscal (i.e. budgetary) policies.

Yet, surprisingly enough, while the former benefits from a large space in the existing (consolidated version of the) Treaty Establishing the European Communities (TEC) and in the future, still potential, Treaty Establishing a Constitution for Europe (CON), it is hard to find even the location of fiscal policy both in the current and in the possibly future primary norms of the European Union (see their pretty similar contents in Appendixes 1 and 2). I therefore doubt that the median voter, having to ratify the Constitution for Europe signed in October 2004 by 25 Heads of State and Government, understands what he/she is choosing about a presumably major component of European economic policies (in some countries' referenda the yes has prevailed, as in Spain, in others the no was prevalent, as in France and the Netherlands).

In this paper I will first concentrate on the puzzle concerning fiscal policy in Europe (Section 2) . I will then allocate Section 3 to a rather detailed description of the Stability and Growth Pact (SGP), which is the most important binding constraint for European Member States' budgets<sup>1</sup>. Section 4 will conclude indicating why, in my opinion, the first impression got by an occasional reader of the contents of the TEC and the CON, according to which there does not exist any European fiscal policy, may after all be more correct than many experts' analyses of European matters showing a scholarly, full knowledge of every SGP detail.

## 2. THE APPARENT ABSENCE OF A EUROPEAN FISCAL POLICY

At first, fiscal policy appears indeed to be almost absent in European primary norms, if one looks at the level of disaggregation given by Parts, Titles, Chapters and Sections of the Treaties (see Appendixes 1 and 2). That policy is not even mentioned in the principles and in the long list of policies provided in TEC (Articles 2 and 3 in Part 1 and Part 3 Titles I-XXI); and the same impression is given by CON, if one reads the objectives of the Union (Article I-3 in Part 1 Title I), the Union competences and the list of more than 25 economic policies described there (Articles I-11 – I-17 in Part 1 Title III and Part 3 particularly Title III Chapters 1-5).

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<sup>1</sup> An even longer description of the SGP can be found in Kostoris Padoa Schioppa (2005).

*Table*  
*The budgets of the Community and Member States, 2000*

	Member States		EU		Total	
	Euro bn	% EU GDP	Euro bn	% EU GDP	Euro bn	% EU GDP
General public services	500	5.8	9.4	0.1	436 <sup>b</sup>	5.1
of which transferred to EU <sup>a</sup>	73	0.8	-	-	-	-
Defence	153	1.8	0.0	0.0	153	1.8
Public order and safety	137	1.6	0.1	0.0	137	1.6
Economic affairs	331	3.9	53.3	0.6	384	4.5
Environment protection	62	0.7	5.4	0.1	67	0.8
Housing and community amenities	85	1.0	0.1	0.0	85	1.0
Health	477	5.6	0.1	0.0	477	5.6
Recreation, culture and religion	70	0.8	0.1	0.0	70	0.8
Education	430	5.0	1.9	0.0	432	5.0
Social protection	1,648	19.2	24.4	0.3	1,672	19.5
Total net of transfers to EU	3,820	44.7	94.8	1.1	3,915	45.7
Total	3,893	45.5	-	-	-	-

<sup>a</sup> The national transfers to the EU budget are the VAT and the GNP resources.

<sup>b</sup> National general public services minus the transfers to the EU plus EU expenditure on general public services.

Source: A. Sapir *et al.* (2004), p. 26, based on Eurostat New Cronos database [Classification of the Functions of Government (COFOG)], European Commission and own calculations. The EU budget figures are payment appropriations authorised.

However, there are two locations in the European Treaties where some explicit, though partial mention of fiscal policy seems to exist. TEC and CON both list in their contents some topic that could look like aspects of macro budgetary policies: in particular (i) tax provisions are recalled in TEC (Part 3 Title VI Chapter 2), later labelled in CON as fiscal provisions (Part 3 Title III Chapter 1 Section 6); (ii) the Union's yearly budget is illustrated both in TEC (Part 5 Title II, Articles 268 and following) and, together with the multi-annual financial provisions, in CON (Part 1 Title VII, Articles I-53 and following and Part 3 Title VI Chapter 2).

A deeper analysis of (i) confirms that fiscal provisions have nothing to do with fiscal policy, as usually understood. They regard a certain number of specific microeconomic taxes and not the budget as a whole. Furthermore, the Treaties are concerned there with what taxes cannot rather than can do: essentially taxes have not to distort competition. A deeper examination of (ii) shows that this in fact does concern the European budgetary policy, but only that particular part of it which is activated by the common (federal) budget not by the (sum of ) single Member States' budgets: the former represents 1-1.3% of the European GDP while the latter corresponds to 45% of GDP, as the enclosed Table illustrates. Moreover, the Treaties require the common budget be always in balance, probably because out of the three famous Musgravian functions (allocation, redistribution, stabilization/growth) a public budget has to perform, the main one on which the European budget has traditionally been focussed is the former function, which, according to Musgrave's theory, always has to lead to a balanced budget; by contrast, the latter is the only function which allows a deficit spending without prejudice for long term financial sustainability and future generations' wellbeing.

My explanation of the apparent paradox concerning the European fiscal policy is three-fold. There seem to exist historical, as well as logical and empirical reasons for it.

Discussing about historical motivations, it has to be stressed that the TEC was born in Rome in 1957 with microeconomic, allocation objectives, in particular with the basic target to construct a customs union, a common market abolishing tariff and non-tariff barriers to trade within Europe, while setting a common commercial policy relative to the rest of the world. The Community has later developed along the same lines: in the 1985 construction of a single market (with the famous 4 freedoms, i.e. the free movement of goods, services, persons and capital), together with the abolition of frontiers among some Member States willing to sign the Schengen Agreement; and in the 1999 creation of a single currency and a unified monetary policy. Redistribution purposes and macro policies were originally outside the scope of the European Union for two reasons. Both (i) because of the strong influence exercised in the late 40's and the 50's by the US, willing to help and finance the reconstruction of Europe devastated by the war, at the condition of maximum efficiency implied by competition and trade liberalization (contrary to previous fascist and nationalistic European regimes prone to autarchy). And (ii) because European Nations were at the time (and probably still are, to some extent) convinced of the importance to maintain the command of macro instruments, according to the Keynesian approach. In this perspective, in 1957 Member States only accepted to put under the cap of a common, though not a supranational European policy, some budgetary items, notably ( besides the less important transport policy) the agricultural policy, still at the time very demanding in financial terms. That allowed the Nations to maintain their decision-making power on the CAP while obtaining to share its financial burden with the common European budget: a game which benefited, as it still does, particularly France, while the UK was later able to avoid its excessive contribution to French agriculture through the British rebate accorded to Mrs Thatcher and still in existence. Notice that the CAP (Common Agricultural Policy) represented also in another sense a derogation relative to the fundamentals on which the TEC signed in 1957 was based, as it was (and still is) favouring not efficiency through competition but the protection of peasants' interests.

Discussing about the logical reasons of that paradox, one has to remark that in the European Treaties policies are identified in two ways. Either in CON (i) by the level of competence at which they are exercised, following fiscal federalism principles (particularly subsidiarity), and accordingly there exist 5 kinds of competences (exclusive of the EU, exclusive of Member States and/or their Regional, Local Governments, shared between the EU and its Partners, national policies mildly coordinated by the EU, finally national policies for which the Union provides supportive and complementary actions): but fiscal policy may be exercised at all levels of competence. Or in CON and in TEC (ii) by the specific content of the policies, which are identified in a micro very detailed way: but fiscal policy (taxes and expenditures) may be used for each and all these fields. From this viewpoint, the budget can be considered an alternative or a complementary instrument relative to other means, like various forms of command, regulation, or control of the public sector on the market. The European Treaties do not classify economic policies according to the instruments utilized, failing to focus also on the relevant distinction between policy rules *versus* discretion. Nonetheless, to make some examples, the experts know that in the Treaties

the competition policy consists of rules decided at the communitarian level, which are implemented at the national level and are basically controlled by the European Commission and by National Antitrust Authorities; the monetary policy is discretionarily chosen, executed and controlled at the supranational level by the European Central Bank; cohesion policies are mainly national but some decision-making and a large co-financing are currently shared with the Union, its common budget being spent by 35.5% in 2005 in the so called Structural Funds; while employment policies are strictly national, the Union exercising on them only some weak monitoring and ineffective open coordination.

Discussing about the empirical reasons of the apparent absence of a European fiscal policy, one has to take into consideration pragmatically that it would probably deserve more space in the Treaties if the common budget were not only larger, but also more devoted to items of great relevance for European citizens like the welfare state (health care, compulsory pensions, fight against poverty) rather than to insignificant topics for the majority of the population like the CAP, itself representing in 2005 a bit more than 40% of the common budget (it used to correspond to more than 80% of that budget in 1973), with non-zero but negative outcomes for all European consumers and for all producers in developing countries!

### 3. THE APPARENT PRESENCE OF A EUROPEAN FISCAL POLICY

Does the above discussion mean that fiscal policies are literally ignored by the European Union norms? The answer is negative for two reasons. First, because the most important component of the European fiscal policy is discussed both in TEC (Article 104) and, almost identically, in CON (Article III-184) and in their annexed Protocol on «excessive deficit procedure», but it is hidden in the Treaties under the too general label of «economic policy» (a Chapter in TEC, which becomes a Section in CON): that requires from the reader a special digging in one of the Treaties' 400- 500 pages. Second, because the Treaties are the only primary source of European norms, but by no means the only source of the latter; a very significant part of the European fiscal policy, contained in the SGP and formally born in 1997 through a European Council Resolution (in Amsterdam) and two Council's Regulations (1466/97, 1467/97), is derived from secondary norms. The differences between primary and secondary sources and within each of those sets are relevant from the point of view of potential reforms. To change the Articles of the Treaties, the ratification procedure directly or indirectly involves almost 500 million people belonging to 25 European countries<sup>2</sup>. To modify the Protocols it is sufficient to have the unanimity of the European Council, i.e. it is not necessary to consult the Member States' electorates or their representatives. The same unanimous procedure is needed to amend the Resolution and the most important of the two Council's Regulations (1467/97), while the other Regulation can be reviewed by simple Council majority.

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<sup>2</sup> Given the major importance of Art. 104 in TEC, the latter is entirely reproduced in Appendix 3.

### 3.1 The Treaty's Article 104 and the Protocol on the excessive deficit procedure

Article 104 of TEC, to which I will refer as it is the law actually in force (but one can look at Article III-184 of CON or at Article 104C of the Maastricht Treaty), explicitly imposes reference values for the public deficit/GDP and debt/GDP ratios of all Member States in the Union. The annexed Protocol on the excessive deficit procedure (n. 20 in TEC, n. 5 in the Maastricht Treaty and very similarly n. 10 in CON) simply states that «the reference values - referred to in the Treaty – are 3% for the ratio of the planned or actual Government deficit to gross domestic product at market prices [GDP]; 60% for the ratio of Government debt to GDP». Four elements of these primary norms on the European fiscal policy deserve the maximum attention: their objectives, the derogations to the budgetary surveillance's general rules, the mitigating factors in evaluating the Member States' General Government deficit and debt, finally, the system of decisions, recommendations, sanctions regarding countries' public finance disequilibria.

According to Article 104, the objective of the Commission's monitoring «of the budgetary situation and of the stock of Government debt in the Member States» is to identify «gross errors». Some derogations relative to the reference values have to be taken into consideration. In fact there does not exist an excessive deficit if the ratio of the planned or actual Government deficit to GDP exceeds the reference value, but «either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value»<sup>3</sup>. Similarly, there is no excessive debt if its ratio to GDP, though exceeding the reference value, «is sufficiently diminishing and approaching the reference value at a satisfactory pace». Whenever «a Member State does not fulfil the requirements under one or both of the criteria» mentioned above, the Commission's judgement is not mechanical, as Art. 104 foresees that «the Commission shall prepare a report» which «shall also take into account whether the Government deficit exceeds Government investment expenditure and take into account all other relevant factors, including the medium term economic and budgetary position of the Member State». Finally, following Art. 104, if the Council «decides», on the basis of «a recommendation from the Commission», that «an excessive deficit exists», it «shall make recommendations to the Member State concerned with a view to bringing that situation to an end within a given period», not rigorously specified.

As a summary, it is easy to understand that the binding constraints imposed by the Treaties at the European level on each Member State's fiscal policy concern, on the one hand, the steady state ratio of debt to GDP (at 60%), and, on the other hand, the ratio to GDP of the balance between public expenditures and taxes (at 3% , unless exceptional and temporary circumstances arise). Each country is therefore free to chose the level and the composition of public spending, fiscal rates, General Government assets and liabilities compatible with those constraints.

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<sup>3</sup> According to Buti and Sapir (1998), the three conditions of exceptionality, temporariness and closeness to the target have to be jointly assessed.

### 3.2. The Stability and Growth Pact (SGP)

The Stability and Growth Pact is defined in a formal sense by the European Council Resolution issued in Amsterdam on June 17, 1997 and by Council Regulations 1466/97 and 1467/97 of July of the same year. The basic philosophy underpinning the SGP remains that of the TEC, but in a more severe, narrower way. «Sound Government finances are crucial – it is stated in the Netherlands' capital - to preserving stable economic conditions in the Member States and in the Community. They lessen the burden on monetary policy and contribute to low and stable inflationary expectations such that interest rates can be expected to be low. They are an essential condition for sustainable and non-inflationary growth and a high level of employment».

In 1997, there is an additional medium term objective introduced by the SGP relative to the TEC, i.e. the requirement to reach a balanced budget over the cycle, while the 3% (meant as *Drei Komma Null*) has to be considered a ceiling never to overcome in the short run. More precisely, since the Amsterdam summit, the EU Member States are requested to pursue the medium-term objective (MTO) of a «budget close to the balance or in surplus», and, if necessary, to adopt corrective measures which «should be completed in the year following its identification unless there are special circumstances». Indeed, the SGP, on the one side, implacably sets the timing and modalities<sup>4</sup> of the procedure for the surveillance of budgetary flow positions (ignoring for incomprehensible reasons the stock problems) and, on the other side, specifies the sanctions on defaulting Member States<sup>5</sup>.

The reinforcement of the SGP relative to the Treaty is perceived also by looking at the 1997 illustration of the derogations to general rules, in particular at the exact definition of «the concept of an exceptional and temporary excess over the reference value as referred to in Article 104». Indeed, Regulation 1467/97 states that «the excess of a Government deficit over the reference value shall be considered exceptional and temporary, [...] when resulting from an unusual event outside the control of the Member State concerned and which has a major impact on the financial position of the General Government, or when resulting from a severe economic downturn [...]. The Commission ...shall, as a rule, consider an excess over the reference value resulting from a severe economic downturn to be exceptional only if there is an annual fall of real GDP of at least 2%. [...] The Council shall, in its overall assessment, take into account any observations made by the Member State showing that an annual fall of real GDP of less than 2 % is

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<sup>4</sup>The Amsterdam Resolution states that: «the Council is committed to a rigorous and timely implementation of all elements...; in particular:

- pursuant to Art. 104 C, Section 7, it recommends the timely correction of excessive budgetary deficits upon emergence or within the following year, unless there are special circumstances;
- it shall impose sanctions on Member States failing to act in compliance with the Council decisions;
- it shall require a non-interest-bearing deposit whenever the Council decides to apply sanctions to a participating Member State in accordance with Article 104c (11);
- it is invited to convert deposits into fines two years after the decision to sanction the defaulting Member State in accordance with Article 104c (11) ».

<sup>5</sup> Art. 11 of Regulation 1467/97 states that: «when the excessive deficit results from non-compliance with the criterion relating to the Government deficit ratio in Article 104c (2) (a), the amount of the first deposit shall comprise a fixed component equal to 0,2 % of GDP, and a variable component equal to one tenth of the difference between the deficit as a percentage of GDP in the preceding year and the reference value of 3 % of GDP».

nevertheless exceptional in the light of further supporting evidence, in particular on the abruptness of the downturn or on the accumulated loss of output relative to past trends [...]».

These are severe, quantitative limitations of Member States' fiscal policy, which become even more severe in the first, significant revision of the SGP, made in 2003, though the latter has been labelled for political and governance motivations as a mere reinterpretation. On March 7 2003, the ECOFIN adopted, under the Greek Presidency of Mr. Nikos Christodoulakis, a Report (6877/03–Presse 61) on «Strengthening the Co-ordination of Budgetary Policies», initially drawn up by the Commission in November 2002, which has been later endorsed by the European Council in Brussels on March 20-21 2003<sup>6</sup>. In that Report, the Council, among other things<sup>7</sup>, was asking for a further surveillance on structural balances, alongside with the control of the non-cyclically-adjusted budget balances (the only ones really monitored up to that time). Indeed, the Member States of the Eurogroup whose budget was in deficit were requested to fulfil an additional constraint, reducing annually by 0.5% of GDP their structural balance, net of automatic stabilizers: «Member States' Stability and Convergence Programmes must continue to present nominal data. Compliance with the close to balance or in surplus requirement of the SGP should be assessed in cyclically-adjusted terms; one-off measures should be considered on their own merits on a case-by-case basis. [...] Those euro-area Member States whose deficits exceed the close to balance or in surplus requirement are committed to a minimum annual reduction of 0.5% of GDP».

### 3.3 The 3 sets of criticism of the European fiscal policy

The strictness of the 1997 SGP's rules, only reinforced in 2003, has provoked in recent years, together with other aspects of the European fiscal policy, an increasing number of analyses<sup>8</sup> and criticism. Here is a (non exhaustive) list of 3 kinds of critical comments.

(A) The first set is based on the idea that a more expansive fiscal policy is the pre-requisite for any re-launching of the European economy. The latter viewpoint is shared by most post-Keynesian scholars, convinced that deficit spending helps solving the existing cyclical and structural problems of Europe. It is also shared by many detractors of the so-called «Europe of bankers», that monetarist eurocracy perfectly embodied (in their minds) by the Executive Board of the European Central Bank, which is thought to be too stability-oriented and too little growth-oriented, as if there existed a clear trade-off between the two targets; a trade-off precisely denied by the approach underpinning the Treaty (Protocol included) and the Pact. Many majority parties with different political inspirations (from Social-democrats to Conservatives) join that view, particularly in large European countries experiencing a scarce growth, probably because

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<sup>6</sup> The Presidency Conclusions of the Spring European Council 2003 declare: «against this background, the European Council endorses the Key Issues Paper adopted by the Council (ECOFIN), which together with these Conclusions will be the basis of the forthcoming Broad Economic Policy Guidelines...while inviting the Council and Member States to implement its Conclusions».

<sup>7</sup> The Council for the first time introduced in the formal SGP the requirement that the budgetary surveillance and the excessive deficit procedure should also contribute to ensuring a satisfactory debt (and not only deficit) decrease: «the pace of decline in public debt plays an important role in budgetary surveillance, especially in highly indebted countries. In conformity with the Treaty provisions, the excessive deficit procedure should contribute to ensuring a satisfactory pace of debt reduction».

<sup>8</sup> Just to quote few examples, see Franco *et al.* (2002), Buti *et al.* (2003), CAE (2004).

they wish to please their electorates through the expansionary use of public budgets, while opposition parties are usually much more rigorous for similar and opposite reasons of political economy.

This composite group has asked «to lisbonize» the Pact, that is to connect it more to the Lisbon Agenda, where the Portuguese capital refers to the Presidency Conclusions of the Lisbon European Council of March 23-24, 2000. However, that quotation, which mirrors a prejudice-free antithesis to Europe while opposing the particular European approach embodied in Article 104, the connected Protocol and the SGP, is in fact rather ambiguous. Admittedly, the Pact is the expression of a supply-side approach, where the structural rigidities of the system, the insufficient accumulation, the excessive presence of the State on the market cause at the same time inadequate growth and some propensity for inflation, so that fighting in favour of a higher nominal stability would also lead to boost growth. The Lisbon Agenda, on the contrary, stems from a compromise between a supply- and a demand-management approach. It shows optimism and euphoria for the European economic situation, perhaps because the year 2000 is the only one in the past decade when the European growth rate was above 3%, so that, according to the Lisbon Presidency Conclusions, «the Union [was] experiencing its best macro-economic outlook for a generation». Hence, at the time it seemed right to «sustain the healthy economic outlook and favourable growth prospects by applying an appropriate macro-economic policy mix», the latter being the typical tools of the Keynesian panoplia, under the hypothesis of a trade-off between inflation and unemployment, and no concern for long-term effects and sustainability. However, the Lisbon Agenda does not imply abandoning the traditional EU approach, whereby the dual targets stability-growth and efficiency-equity are made internally consistent through the competition mechanisms which, by awarding the best, provide the right incentive to optimal allocation and at the same time the fair system to recognize the merit. In this optics, the Lisbon Presidency Conclusions, adopting the traditional supply-side scheme, indicated that «the new strategic goal for the next decade - to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion -» required stepping up «the process of structural reform for competitiveness and innovation and ... completing the internal market », leading to «modernizing the European social model, investing in people and combating social exclusion».

(B) Given those ambiguities, alongside with the post-Keynesian opposition to the whole system of the excessive deficit procedure , other forms of criticism emerge (in connection or in alternative to the listed ones), drawing inspiration precisely from the traditional Community spirit. Some critics, perhaps more royalist than the King or more catholic than the Pope, focus on the differences between the Treaty (Protocol included) and the Pact in a strictly formal sense. They rightly point out that Article 104, unlike the Council's Regulations of 1997, illustrates the awareness of the important qualitative distinction between public expenditure in current and in capital account: indeed, deficit spending for investment creates no burden for public finances inasmuch the larger productivity it triggers eventually induces a tax rise which tends to offset the initial imbalance. Consequently, a revision of the Pact is demanded, based on the golden rule, which is already present for example in Article 115 of the German Basic Law of 1949, amended in 1976. In 2004-2005, among others, the British Chancellor of the Exchequer, Gordon Brown,



the Italian Prime Minister, Silvio Berlusconi, and the French President, Jacques Chirac, have advocated this approach.

Article 104 of the Treaty (but not the Pact in a strictly formal sense) makes reference to the role of medium-term economic targets in public finances, which are potentially inconsistent with short-term goals. In this vein, the former German Chancellor, Gerard Schröder, in his letter-manifesto to the *Financial Times* of January 17, 2005 has written that «in the short time, reforms – as provisions...to safeguard the social security system, improve the labour market or introduce fiscal reforms – may obstacle growth or increase the deficit. But, in the medium run, their impact on growth, employment and public budget is definitely positive. Expenditures on education, innovation, research and development can also have a positive effect».

The reform proposals of some Conservatives, such as those of the Dutch Finance Minister, Gerrit Zalm, who more than anyone else in 1997-1998 opposed, together with his then colleague Theo Weigel from Germany, the entry of Italy (and the lira) into the Eurogroup (and the single currency), also belong to the Community tradition. They (rightly) recall that the TEC and its Protocol (but not the SGP) create a consistent link between the deficit/GDP and the debt/GDP ratios. Thus, in his interview released to the Italian newspaper *Il Sole 24 Ore* on January 10, 2005, Mr. Zalm has asked that the SGP reform should envisage a «diversified treatment among countries according to their debt levels...Hence, Italy, Belgium, Greece...and the countries with a public debt above 60% of GDP have to make greater efforts to reduce it and must set more severe MTOs in order to tend to a budget surplus. Countries with debts below 60% may pursue a less stringent policy and may have limited medium-term deficits».

Those words show the awareness that, as any student of Macroeconomics well knows, in the steady state, if no variation occurs in the financial assets and liabilities (which play a role in the debt and not in the deficit creation), the debt/GDP ratio equals the deficit/GDP ratio divided by the nominal GDP growth rate. Thus, a numerical coherence between the two public finance parameters (3% and 60%) existed in the Maastricht Treaty, because in 1992 the nominal GDP growth rate was about 5%. Moreover, the golden rule was numerically satisfied at the time, as the average European public investment to GDP ratio was in the beginning of the 90's approximately equal to 3%. That close numerical connection has gone lost in the following decade and no longer exists today, owing to the slowdown of the European economies combined with an inflation decrease and to a reduction in public capital accumulation. Furthermore, the logic is completely missing in the 1997 SGP (and in its 2003 reinterpretation), because – given the steady state solution of the differential equation mentioned above – it is simply impossible to obtain a balanced budget in the medium run together with a constant debt/GDP ratio equalling 60%, unless the unlikely and unfavourable hypothesis of a zero growth rate is assumed.

Therefore, growing countries with debt/GDP ratio below 60% should register a deficit in order to obtain that target, while countries above 60% with the same objective should develop and maintain a budget close to balance or in surplus. In any case, the sacredness of a medium-term balanced budget has to be questioned, as it is incomprehensible. This piece of criticism has been already made upon the birth of the Pact in a strictly formal sense, and even Theo Weigel, who longed for a sharp 3.0% maximum deficit-to-

GDP ratio in the short-term, was willing to allow for a medium-term negative balance of 1% of GDP (see Stark, 2001).

While in the steady state, thanks to that differential equation, the faster is the economic dynamics the higher may be the deficit/GDP ratio, given a constant target on debt/GDP ratio, in the short run, as Zalm himself has noted, it is better «to be more rigorous in managing public accounts when the economic cycle is favourable and more flexible in downturns».

(C) Alongside with those forms of Pact criticism stemming from the European tradition (supply side) or at least consistent with some part of it (demand side), there exist other critical comments of the European fiscal policy which do not belong to the traditional Community spirit. I am not thinking to euro-sceptics, for example British Liberals, annoyed by any super-national rule perceived as a bureaucratic and often inappropriate interference. Nor am I thinking to the requests of many cicada-Governments within the Eurogroup, for instance France and Germany, who would like sanctions to be postponed or reduced, if not eliminated; in this strategic game, they have found the support of obliging ECOFIN Presidents, such as the Minister of Finance Giulio Tremonti in November 2003, according to a *do ut des* rule<sup>9</sup>, and of monetarist experts convinced that the interest rate mechanism is sufficient to sanction the non-virtuous behaviours of indebted States.

My personal critique concerns the effective enforceability of the European fiscal policy: there exists an intrinsic mechanism in the SGP governance and an inexorable empirical trend making unlikely the adoption of the excessive deficit procedures for two kinds of complementary reasons; moreover, a third element tends to soften the effectiveness of those procedures, even if they were firmly adopted. This is firstly because it is the Council who decides whether to assess that an excessive deficit exists and proposes to reduce countries' deficit eventually sanctioning cicada-States on the basis of a recommendation by the Commission, the «recommendation» being in the European jargon, unlike the «decision», not more than a non-binding opinion (see Leonard, 2005); the Council itself consists of national politicians and is not a technical body free from the «tyranny of the democracy», as the Commission is at present or as a *super-partes* Authority might be in the future, if it were created in the wake of a new common Code of Conduct for budgetary positions in Europe. Secondly, as a matter of fact, the majority of euro countries is more and more often in one of the three following situations: either the country has already overcome some parameters of the Pact (such as Ireland or Portugal, who received an early warning in 2001 and 2002 respectively); or the country is presently exceeding the deficit/GDP ceiling (among others, in 2004-2005 France, Germany and Italy<sup>10</sup>, but «in 2003 – the Commission states<sup>11</sup> – among the 25 EU Member States, 11 had deficits exceeding the 3% of GDP deficit limit and 8 were in surplus »); or the country is about to exceed that ceiling (such as the United Kingdom)<sup>12</sup>. And if this is the

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<sup>9</sup> This exchange of favours between European Governments may help them but can damage their countries, particularly those where the external constraint is the main instrument to transform myopic cicadas into far-sighted ants (see Kostoris Padoa Schioppa, 2001).

<sup>10</sup> See Commission of the European Communities, 2005, showing that, on average, in the EU-25 the public deficit amounts to 2.8% of GDP in 2004.

<sup>11</sup> See Commission of the European Communities, 2004a.

<sup>12</sup> See IMF, 2005.

situation, the SGP governance is highly imperfect, because, as Juvenalis used to say, «*quis custodiet ipsos custodes*» (who watches the watchmen)? Obviously, policy coordination – traditionally encouraged and considered a plus in the European Treaties – becomes on the contrary, in this context, an instrument for weakening the enforcement of policy procedures concerning the European fiscal policy. Thirdly, even if the Council were willing to adopt those procedures, deciding that an excessive deficit exists and needs to be corrected and eventually sanctioned, the Council, according to Art. 104, could only «make recommendations to the Member States concerned»<sup>13</sup>: the latter are not a strong instrument for the SPG's effectiveness, as they essentially consist in a form of moral suasion, obtaining the desired results only to the extent that the preaching institution has a charisma.

The recent efforts of Member States, particularly of large and spendthrift Nations, rather than focusing on the insufficient enforcement and effectiveness of the European fiscal policy, have persistently concentrated on the opposite request for growing autonomy from Europe. It is no coincidence that the demand to postpone and reduce sanctions towards defaulting countries has sometimes been combined (for instance on the part of the former German Chancellor Schröder) with the proposal to consider in the deficit computation each Member State's contribution to the EU budget, thus insisting on the idea that fiscal policy should remain within national competences, without interference from the EU. Schröder, in the already-mentioned letter-manifesto to the *Financial Times*, has been explicit on both subjects: «The Commission and the Council should take due account of the Member States' contributions to the euro-zone stabilisation,...of specific constraints, of solidarity initiatives within the Union...the German constraints include...the payment of huge sums to the European Union...Besides, the Member States' competence on their economic and budget policies should be respected».

The former argument is politically strong as it represents a credible threat, Germany being the maximum net contributor to the EU budget in 2003 (by 0.36% of its GNI, a figure close to the difference between the amount «requested» by the Commission to reduce the German deficit and start settling the German accounts and the sum «offered» by Berlin in the famous ECOFIN meeting of November 2003)<sup>14</sup>. However, from a technical viewpoint, it would be wrong to subtract 0.36% of GNI from the calculation of the German deficit/GDP ratio because without that EU budget, according to Gros (2005), Berlin would spend even more and would produce an even larger public deficit for its eastern Länder.

Schröder's second argument should be politically weak, if a German nationalist claim were considered premature to the European conscience, due to the fear for a re-emergence of those German «demons»,

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<sup>13</sup> In fact, this recommendation is only a first step. At a later stage, according to Art. 104 Paragraph 9, «if a Member State persists in failing to put into practice the recommendations of the Council, the Council may decide to give notice to the Member State to take, within a specified time limit, measures for the deficit reduction which is judged necessary by the Council in order to remedy the situation». And finally «as long as a Member State fails to comply with a decision taken in accordance with Paragraph 9, the Council may decide to apply or, as the case may be, intensify one or more of the following measures:

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

<sup>14</sup> These data are reported, for example, in the website of the European Commission (2004b) and are re-examined by Gros and Micossi (2005)

which Kohl's generation knew well, but which are alien to the present generation in the whole Europe. Conversely, that point would seem politically strong, if the EU-25 were to forget the past and were ready to accept the dominant position Germany has conquered after the fall of the Berlin Wall and the Eastern enlargement of the European Union. It would also look politically appealing to other Governments, to the extent that they were convinced that they themselves could gain some degrees of independence in their fiscal policy as a by-product of the one presumably granted to Germany. In any case, from a technical viewpoint, Schröder's second claim would lay itself open to criticism, because it ignores the existence of negative externalities caused by the impact of a cicada-State (particularly if big) on its Partners and thus violates the subsidiarity principle.

### 3.4 The 2005 reform of the SGP

The next step consists in testing whether the reform of the SGP introduced by the Brussels European Council on March 22-23, 2005 satisfies those three-fold criticism (A,B,C) mentioned above, knowing that the Pact can be modified only within the limits set by Article 104 of the Treaty and can thus, on the one side, include those elements which are present in that primary norm but are absent from the 1997 and 2003 SGP rules, and, on the other side, exclude those aspects which are present in the 1997 and 2003 procedures but not in the Treaty.

My brief evaluation on the results of the 2005 Spring European Council is the following. The amendments introduced this year on the SGP are not only consistent with the Treaty, but are somehow closer to its spirit than the Pact itself, as they reach a good compromise between two of the three requests for revision (A and B but not C), emerged in the past two years. The reason for this assessment will clearly appear from the wording of the Presidency Conclusions of the 2005 Brussels European Council (see 7619/05).

On short-term objectives, the European summit has introduced a more dynamic approach. Indeed, «Member States that have not yet reached their MTO should take steps to achieve it over the cycle. Their adjustment effort should be higher in good times; it could be more limited in bad times. In order to reach their MTO, Member States of the euro zone or of ERM-II should pursue an annual adjustment in cyclically adjusted terms, net of one-offs and other temporary measures, of 0.5% of GDP as a benchmark. <Good times> should be identified as periods where output exceeds its potential level, taking into account tax elasticities». More generally, the need to «avoid pro-cyclical policies» is reiterated, as asked for by Mr. Zalm, in order «to actively consolidate public finances in good times ».

Furthermore, on the medium- and long-term objectives, the Brussels Spring summit recognizes, as the Dutch Minister had asked for, that due account must be taken of the connection between public deficit and debt and, as proposed by the former Chancellor Schröder, «of the growing economic and fiscal heterogeneity within the EU-25». Thus, the Presidency Conclusions state that «MTOs should be differentiated and may diverge from positions of close to balance or in surplus for individual Member States on the basis of their current debt ratio and potential growth, while preserving sufficient margin

below the reference value of 3% of GDP. The range for the country-specific MTOs for euro area and ERM-II Member States would thus be, in cyclically adjusted terms, net of one-off and temporary measures, between -1% of GDP for low debt-high potential growth countries and balance or in surplus for high debt-low potential growth countries. The long-term sustainability of public finances would be supported by the convergence of debt ratios towards prudent levels. Implicit liabilities (related to increasing expenditure in the light of ageing populations) should be taken into account, as soon as criteria and modalities for doing so are appropriately established and agreed by the Council».

The novelties introduced by the European Council of March 22-23, 2005 in the area of derogations to the excessive deficit procedure are equally important, as in this case, too, significant, sensible changes rather than simple additions are observed. Indeed «the Council considers that the current definition of a <severe economic downturn> given in Regulation 1467/97 is too restrictive... The Council considers the Paragraphs (2) and (3) of Article 2 in Regulation 1467/97 need to be adapted in order to allow both the Commission and the Council... to consider as exceptional an excess over the reference value which results from a negative growth rate or from the accumulated loss of output during a protracted period of very low growth relative to potential growth». The negative sign of the growth rate becomes therefore sufficient for derogations.

With reference to the mitigating factors which the Commission should consider in evaluating budgetary positions, the Conclusions of the European summit of March 2005 recognise that «special attention must be paid to pension reforms introducing a multi-pillar system including a mandatory fully-funded pillar. Although those reforms entail a short-term deterioration of public finances during the implementation period, the long-term sustainability of public finances is clearly improved. Thus...Member States implementing such reforms should be allowed to deviate from the adjustment path towards the MTO, or from the MTO itself ».

Finally, dealing with the timing and modalities of sanctions, the Brussels summit of March 22-23, 2005 introduces the novelty to postpone deadlines and soften sanctions relative to Regulation 1467/97. In particular, in special circumstances «the initial deadline for correcting an excessive deficit could be set one year later, i.e. the second year after its identification and thus normally the third year after its occurrence».

What stated so far clearly shows how the March 2005 European Council has met some of the needs expressed both by the demand- and by the supply-side advocates: it has corrected internal contradictions of the Pact in a strictly formal sense, establishing a better connection between debt and deficit constraints; it has introduced variable medium-term objectives in the various Member States and more flexibility in each country during cyclical downturns, during prolonged (though not deep) crises and, in a longer perspective, whenever structural reforms are undertaken, such as the construction of a compulsory second-pillar pension reform based on fair actuarial basis; and it has weakened sanctions. Moreover, in the Presidency Conclusions some lip service is offered to Heads of State and Government. «An improved national ownership of budgetary policies » is hoped for, and special consideration is given «to budgetary efforts towards increasing or maintaining at a high level financial contribution ...to achieving

European policy goals, notably the unification of Europe [in primis of Germany!]]» and «to fostering international solidarity», as asked for by President Chirac (unfortunately with tools such as the Tobin Tax rather than by reducing the inefficient protection to European agricultural workers granted by the CAP!). There are also some sentences in the Presidency Conclusions of the 2005 Spring summit, able to please those (the English and the Italians) who were asking that productive public expenditures (in particular for research and employment) should be considered separately: «the Commission's report ... should appropriately reflect developments in the medium-term economic position (...the implementation of policies in the context of the Lisbon Agenda and policies to foster R&D and innovation) and developments in the medium-term budgetary position (...debt sustainability, public investment and the overall quality of public finances)».

Finally, a very promising statement of the March 2005 Presidency Conclusions both for those who thought the old Pact was not rigorous enough, as well as for those who felt the Pact was not flexible enough is that the new SGP's «aim is not to increase the rigidity or flexibility of current rules but rather to make them more effective». In this optic the reformed SGP of 2005 is intended to satisfy those who thought the Pact was «stupid», for example the former President of the Commission, Romano Prodi. Indeed, it is stated that, «in strengthening and clarifying the Pact, it is essential to secure a proper balance between the higher degree of economic judgement and policy discretion in the surveillance and co-ordination of budgetary policies and the need for keeping the rules-based framework simple, transparent, enforceable».

### 3.5 Weakness and strength of the new, 2005 SGP

In the strategy just described, one can see both the strength and the weakness of the new, 2005 SGP: when the Pact becomes a more «intelligent» and balanced mix between rules and discretion and, ultimately, more discretionary and soft than in its original 1997 formulation (and in its 2003 reinterpretation), so as to take into account the different Member States' situations, cyclical conditions, growth potentials and public finance disequilibria, that is also the moment where the policy design concerning the governance of the Pact has to improve and become good enough to address the new major problems; however, this is not the case, as the decision-making mechanisms of the European fiscal policy have not been modified during the 2005 Brussels Spring summit along the lines indicated by the third (C) set of criticism. Unfortunately the internal conflict of interests, stemming from the overlapping between controllers and controlled within the governance body responsible for the budgetary surveillance, has not been solved neither through a transfer of powers from the Council to the Commission or to any other possible future independent Authority, nor through a better balance of powers between the different European institutions involved in the European fiscal policy implementation.

In addition, one has to ask whether the revised SGP will trigger rapid growth in European economies. My answer tends to be negative because more expansionary fiscal policies at the national level, following the Pact reform of March 2005, do not seem neither necessary nor sufficient to obtain that result. Unlike

what happens in the United States, Europe – particularly in its major countries – is not undergoing a cyclical slowdown, but rather a long standstill, and the European stagnation has little to do with the insufficient aggregate demand and much to do with supply-side problems, particularly market malfunctioning and excessive costs due to regulatory and price rigidities. It is neither necessary nor sufficient to raise the deficit in order to obtain a General Government streamlining, cutting redundant public employees, increasing the percentage of fixed-term contracts, fostering the mobility towards the most requested social services, enhancing the accountability of high officials, promoting administrative simplifications. Indeed, all that would reduce the deficit, improving productivity in public employment and in the market, thus increasing the European wellbeing of citizens, consumers, enterprises. There are some other innovations aimed at fostering the degree of market competition as a fundamental pre-requisite for more efficiency and equity, which would not weight on public budgets, as they only concern the State in its regulatory capacity: from the overall liberalization of public utilities which are being privatized, to the single market widening and deepening, from the general adoption of the principle of mutual recognition in European labour markets and welfare states as well as in the other three fields of the 4 freedoms, to the reform of services and professions following the so-called Bolkestein Directive, in spite of the opposition by trade unions and strong lobbies acting in the public opinion and in the Governments and Parliaments of the EU Member States. Other changes increasing market productivity do not raise public deficit: for instance, some reduction of the insiders' protection legislation (favouring both firms and private employees), a further flexibility in the product and financial markets, a rising number of working hours are being obtained without public cost, under the pressure of de-localizations and globalizations, fortunately inclusive of the Eastern-Central Europe where an equally trained labour force is willing to work more in the week, in the year, in the life cycle.

Admittedly, there are other tools to develop supply which would weight on the General Government budgets – from the incentives to the private sector or the direct public accumulation in ITC, to tax cuts for firms and self-employed able to make innovations in the service sector, from social absorbers, to investments in the employees' human capital through education, health care, research. However, it would have not been necessary to modify the SGP in 2005 to reach those objectives, for many reasons. Firstly, if the public resources are to be reallocated for productive goals, then the corresponding increased expenditures or smaller revenues should be combined with savings in less productive sectors. For example, pension systems should be revised, raising the retirement age, shifting contributions from defined-benefit to defined-contribution schemes and from pay-as-you-go mandatory systems to optional fully-funded, generally more profitable regimes. Secondly, a maximum negative balance (3%), which does not over-commit future generations to pay for budgetary choices they have not endorsed, leaves nevertheless the present decision-makers free to opt for the level and composition of taxation and spending they prefer, corresponding to that balance. A binding public budget constraint guarantees the effectiveness of those free choices. Soft budget constraints characterising «real socialism» economies have produced the damages we well know. It is then correct for each society to set responsibly whether to spend much and impose a high level of taxation (as Scandinavian democracies or France prefer to do) or

whether to spend little, lowering the tax wedge ( as Anglo-Saxon countries ,United Kingdom and Ireland, wish to do). What seems an impossible task is to have his/her cake and eat it at the same time, as Italians would like to do, in addition trying to cook a larger cake with a declining productivity essentially due to inadequate technological innovations and lower working hours both of full-time and of part-time employees (according to the data by the European Commission, 2003).

#### 4. THE LIKELY REAL ABSENCE OF A EUROPEAN FISCAL POLICY

At the end of last Section I have come to the conclusion that the somehow needed reform of the SGP has not been realized in a proper way in March 2005. The revision has been extensive but still it is incomplete and insufficient to solve European economic problems. In fact, deep distortions remain in the governance of the European fiscal policy, the surveillance of Member States' budgets still being (irrationally, though comprehensibly) under the exclusive control of national Governments, namely of those who should be controlled. Their coordination policy, in this perspective, is perverse. Moreover, their effectiveness in recommending fiscal adjustments to Partners in excessive deficit and eventually in sanctioning them only relies on moral suasion. Unless those distortions are eliminated, the higher degree of discretion and flexibility introduced by the 2005 Spring European summit will become a new source of difficulties for the Union's stability and growth. The result that optimistic observers expect from the 2005 review of the Pact – which is now perceived as more «intelligent», hence more enforceable – risks to become an illusion eventually ending up in a weaker, more unreliable constraint easy to be bypassed, as pessimistic observers would say. Indeed if, according to the new 2005 SGP, the cicada-States felt more free to enlarge their deficits, this would probably cause higher inflationary pressures, particularly in large European countries dominated by supply problems, and would not increase output either in their domestic markets or, given the existing spillovers, in the rest of the Union. On the contrary, interest rates would have to rise, justifying the stand of the European Central Bank which has insistently invited to avoid any Pact reform, perhaps drawing inspiration from that founding father of the European Community, Jean Monnet, who used to say that «before sending a letter you have to be sure to be able to write the answer».

In this situation, one would be tempted to propose to further complete the 2005 revision of the SGP, following the lines described above at point (C). However, that would turn out to be not only politically unfeasible, given that the Pact can be changed exclusively through the unanimous consensus precisely of the national Governments that do not want to give up to their power; it would also prove to be probably useless. The modification of the governance of the Pact, even if it were possible, is a necessary not a sufficient condition to restore the effectiveness of European policy rules constraining the Member States' fiscal policy. The latter rules are useful because each country's public deficit and debt spill over and create negative externalities on the other European Partners, which cannot be eliminated by the market mechanisms under *laissez-faire* assumptions. Alternative European interventions on national fiscal policies, like strong forms of coordination or harmonization, risk being harmful or at least worrying ,as they tend to invade more the typical State's prerogatives on the level and composition of public expenditures, taxes,



assets and liabilities. Yet the enforcement and the effectiveness of procedures of the kind indicated in the new SGP require not only new forms of decision-making concerning the Pact; more generally they also require the restoration of the credibility of all the European institutions involved in the excessive deficit elimination, given that their charisma is necessary to make moral suasion on Member States effective.

One may be doubtful about the current reputation of European institutions. To understand it, it is sufficient to look for example at the 13 July 2004 Judgment of the European Court of Justice in Case C-27/04, unanimously considered «solomonic» in evaluating the institutional conflict which had arisen between the Commission and the ECOFIN on November 25, 2003: then the Finance Ministers opposed the recommendations of the Commission concerning France and Germany on the excessive deficit procedure described at Article 104 of the Treaty. Facing the fact that in that moment a discriminatory form of soft interpretation of the Treaty (Protocol included) and of the Pact was adopted by the ECOFIN for strong countries, whereas in the past a hard implementation of the norms had been obtained for weak countries, thus mining the European fiscal policy credibility, the Court ruling has remained ambiguous: on the one side, it finds legitimate the Council's choice not to have proceeded against Berlin and Paris, in contrast with the Commission's recommendation, but, on the other side, it «annuls the Council's conclusions of November 25, 2003 towards France and Germany, as the Council holds the excessive deficit procedure in abeyance and modifies the recommendations previously made by the Council to each Member State for correction of their excessive deficit pursuant to Art 104 (7)». Like individual virginity, institutional reputation, once lost, is difficult to be restored.

More generally, there is an overall mood in Europe today which makes any European strategy not credible in Member States' public opinion and hence in their policy-making. That seems to be, on the one hand, the consequence of the disappointing performance of European economies after the misperceived promises of improvements induced by the euro, and, on the other hand, the external effect of the failing ratification of the European Constitution in the 2005 Spring referenda of France and the Netherlands. As a consequence, nowadays a Minister of Finance of a country like Italy, exceeding the 3% of deficit/GDP ratio, having a debt/GDP ratio for the third year stuck at the level of 106%, may allow himself to say, as the former Minister Domenico Siniscalco did last Summer, that he will not be doing any significant fiscal adjustment against such enormous disequilibria. This time not even the Commission has dared to oppose a strong reaction. In fact every Italian political party, every trade union have supported Siniscalco's approach, contrary to what it generally happens in the Bel Paese. And few weeks later he had to quit the Government not for this reason.

The question then arises: do we still have an effective European fiscal policy? Will we have a different one in the near future may be through a further reform of the Growth and Stability Pact? My likely answers tend to be both negative.

**CONSOLIDATED VERSION OF THE TREATY ESTABLISHING THE EUROPEAN COMMUNITY**

*Official Journal C 325 of 24 December 2002*

**CONTENTS**

I — TEXT OF THE TREATY

- Preamble
- Part one — Principles
- Part two — Citizenship of the Union
- Part three — Community policies
- TITLE I — Free movement of goods
  - Chapter 1 — The Customs Union
  - Chapter 2 — Prohibition of quantitative restrictions between Member States
- TITLE II — Agriculture
- TITLE III — Free movement of persons, services and capital
  - Chapter 1 — Workers
  - Chapter 2 — Right of establishment
  - Chapter 3 — Services
  - Chapter 4 — Capital and payments
- TITLE IV — Visas, asylum, immigration and other policies related to free movement of persons
- TITLE V — Transport
- TITLE VI — Common rules on competition, taxation and approximation of laws
  - Chapter 1 — Rules on competition
    - Section 1 — Rules applying to undertakings
    - Section 2 — Aids granted by States
  - Chapter 2 — Tax provisions
  - Chapter 3 — Approximation of laws
- TITLE VII — Economic and monetary policy
  - Chapter 1 — Economic policy
  - Chapter 2 — Monetary policy
  - Chapter 3 — Institutional provisions
  - Chapter 4 — Transitional provisions
- TITLE VIII — Employment
- TITLE IX — Common commercial policy
- TITLE X — Customs cooperation
- TITLE XI — Social policy, education, vocational training and youth
  - Chapter 1 — Social provisions
  - Chapter 2 — The European Social Fund
  - Chapter 3 — Education, vocational training and youth
- TITLE XII — Culture
- TITLE XIII — Public health
- TITLE XIV — Consumer protection
- TITLE XV — Trans-European networks
- TITLE XVI — Industry
- TITLE XVII — Economic and social cohesion
- TITLE XVIII — Research and technological development
- TITLE XIX — Environment
- TITLE XX — Development cooperation
- TITLE XXI<sup>(1)</sup> — Economic, financial and technical cooperation with third countries
- Part four — Association of the overseas countries and territories
- Part five — Institutions of the Community
  - TITLE I — Provisions governing the institutions
    - Chapter 1 — The institutions
      - Section 1 — The European Parliament
      - Section 2 — The Council
      - Section 3 — The Commission
      - Section 4 — The Court of Justice
      - Section 5 — The Court of Auditors
    - Chapter 2 — Provisions common to several institutions

- Chapter 3 — The Economic and Social Committee
- Chapter 4 — The Committee of the Regions
- Chapter 5 — The European Investment Bank
- TITLE II — Financial provisions
- Part six — General and final provisions
- Final provisions
- Annex I — List referred to in Article 32 of the Treaty
- Annex II — Overseas countries and territories to which the provisions of part four of the Treaty apply
- (1) Title inserted by the Treaty of Nice.

II — PROTOCOLS (text not reproduced with the exception of the four Protocols adopted by the Nice Intergovernmental Conference Protocols annexed to the Treaty on European Union and to the Treaty establishing the European Community:

- Protocol (2) integrating the Schengen *acquis* into the framework of the European Union (1997)
- Protocol (3) on the application of certain aspects of Article 14 of the Treaty establishing the European Community to the United Kingdom and to Ireland (1997)
- Protocol (4) on the position of the United Kingdom and Ireland (1997)
- Protocol (5) on the position of Denmark (1997)

Protocols annexed to the Treaty on European Union, to the Treaty establishing the European Community and to the Treaty establishing the European Atomic Energy Community:

- Protocol (6) on the Statute of the Court of Justice (2001) (text reproduced hereafter)
- Protocol (7) annexed to the Treaty on European Union and to the Treaties establishing the European Communities (1992)
- Protocol (8) on the location of the seats of the institutions and of certain bodies and departments of the European Communities and of Europol (1997)
- Protocol (9) on the role of national parliaments in the European Union (1997)
- Protocol (10) on the enlargement of the European Union (2001) (text reproduced hereafter)

Protocols annexed to the Treaty establishing the European Community:

- Protocol (11) on the Statute of the European Investment Bank (1957)
- Protocol (12) on Italy (1957)
- Protocol (13) on goods originating in and coming from certain countries and enjoying special treatment when imported into a Member State (1957)
- Protocol (14) concerning imports into the European Community of petroleum products refined in the Netherlands Antilles (1962)
- Protocol (15) on special arrangements for Greenland (1985)
- Protocol (16) on the acquisition of property in Denmark (1992)
- Protocol (17) concerning Article 141 of the Treaty establishing the European Community (1992)
- Protocol (18) on the Statute of the European System of Central Banks and of the European Central Bank (1992)
- Protocol (19) on the Statute of the European Monetary Institute (1992)
- Protocol (20) on the excessive deficit procedure (1992)
- Protocol (21) on the convergence criteria referred to in Article 121 of the Treaty establishing the European Community (1992)
- Protocol (22) on Denmark (1992)

- Protocol (23) on Portugal (1992)
- Protocol (24) on the transition to the third stage of economic and monetary union (1992)
- Protocol (25) on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland (1992)
- Protocol (26) on certain provisions relating to Denmark (1992)
- Protocol (27) on France (1992)
- Protocol (28) on economic and social cohesion (1992)
- Protocol (29) on asylum for nationals of Member States of the European Union (1997)
- Protocol (30) on the application of the principles of subsidiarity and proportionality (1997)
- Protocol (31) on external relations of the Member States with regard to the crossing of external borders (1997)
- Protocol (32) on the system of public broadcasting in the Member States (1997)
- Protocol (33) on protection and welfare of animals (1997)
- Protocol (34) on the financial consequences of the expiry of the ECSC Treaty and on the Research Fund for Coal and Steel (2001) (text reproduced hereafter)
- Protocol (35) on Article 67 of the Treaty establishing the European Community (2001) (text reproduced hereafter)

Protocol annexed to the Treaties establishing the European Community and the European Atomic Energy Community:

- Protocol (36) on the privileges and immunities of the European Communities (1965)

**TREATY ESTABLISHING A CONSTITUTION FOR EUROPE**

*Official Journal C 310 of 16 December 2004*

**CONTENTS**

I — TEXT OF THE TREATY

Preamble

Part one

TITLE I — Definitions and objectives of the Union

TITLE II — Fundamental rights and citizenship of the Union

TITLE III — Union competences

TITLE IV — The Union's institutions and bodies

Chapter I – The institutional framework

Chapter II – The other Union institutions and advisory bodies

TITLE V — Exercise of Union competences

Chapter I – Common provisions

Chapter II – Specific provisions

Chapter III – Enhanced cooperation

TITLE VI — The democratic life of the Union

TITLE VII – The Union's finances

TITLE VIII — The Union and its neighbours

TITLE IX — Union membership

Part two – The Charter of Fundamental Rights of the Union

TITLE I - Dignity

TITLE II – Freedoms

TITLE III – Equality

TITLE IV – Solidarity

TITLE V – Citizens' rights

TITLE VI – Justice

TITLE VII – General provisions governing the interpretation and application of the Charter

Part three – The policies and functioning of the Union

TITLE I – Provisions of general application

TITLE II – Non-discrimination and citizenship

TITLE III – Internal policies and action

Chapter 1 – Internal market

Section 1 – Establishment and functioning of the internal market

Section 2 – Free movement of persons and services

Section 3 – Free movement of goods

Section 4 – Capital and payments

Section 5 – Rules on competition

Section 6 – Fiscal provisions

Section 7 – Common provisions

Chapter 2 – Economic and monetary policy

Section 1 – Economic policy

Section 2 – Monetary policy

Section 3 – Institutional provisions

Section 4 – Provisions specific to Member States whose currency is the euro

Section 5 – Transitional provisions

Chapter three – Policies in other areas

Section 1 – Employment

Section 2 – Social policy

Section 3 – Economic, social and territorial cohesion

Section 4 – Agriculture and fisheries

Section 5 – Environment

Section 6 – Consumer protection

Section 7 – Transport

Section 8 – Trans-European networks

Section 9 – research and technological development and space

Section 10 – Energy

Chapter 4 – Area of freedom, security and justice

Section 1 – General provisions  
 Section 2 – Policies on border checks, asylum and immigration  
 Section 3 – Judicial cooperation in civil matters  
 Section 4 – Judicial cooperation in criminal matters  
 Section 5 – Police cooperation  
 Chapter 5 – Areas where the Union may take coordinating, complementary and supporting action  
 Section 1 – Public health  
 Section 2 – Industry  
 Section 3 – Culture  
 Section 4 – Tourism  
 Section 5 – Education, youth. Sport and vocational training  
 Section 6 – Civil protection  
 Section 7 – Administrative cooperation  
 TITLE IV – Association of the overseas countries and territories  
 TITLE V – The Union’s external action  
 Chapter one – Provisions having general application  
 Chapter two – Common foreign and security policy  
 Section 1 – Common provisions  
 Section 2 – The common security and defence policy  
 Section 3 – Final provisions  
 Chapter three - Common commercial policy  
 Chapter four – Cooperation with third countries and humanitarian aid  
 Section 1 – Development cooperation  
 Section 2 – Economic, financial and technical cooperation with third countries  
 Section 3 – Humanitarian aid  
 Chapter five – restrictive measures  
 Chapter six – International agreements  
 Chapter seven – The Union’s relations with International organisations and third countries and Union delegations  
 Chapter eight – Implementation of the solidarity clause  
 TITLE VI – The functioning of the Union  
 Chapter one – Provisions governing the institutions  
 Section 1 – The institutions  
 Section 2 – The Union’s advisory bodies  
 Section 3 – The European Investment Bank  
 Section 4 – provisions common to Union Institutions, bodies, offices and agencies  
 Chapter two – Financial provisions  
 Section 1 – The multi-annual financial framework  
 Section 2 – The Union’s annual budget  
 Section 3 – Implementation of the budget and discharge  
 Section 4 – Common provisions  
 Section 5 – Combating fraud  
 Chapter three – Enhanced cooperation  
 TITLE VII – Common provisions  
 Part four — General and final provisions

## PROTOCOLS AND ANNEXES

### A. Protocols annexed to the Treaty establishing a Constitution for Europe

1. Protocol on the role of national Parliaments in the European Union
2. Protocol on the application of the principles of subsidiarity and proportionality
3. Protocol on the Statute of the Court of Justice of the European Union
4. Protocol on the Statute of the European System of Central Banks and of the European Central Bank
5. Protocol on the Statute of the European Investment Bank
6. Protocol on the location of the seats of the institutions and of certain bodies, offices, agencies and departments of the European Union
7. Protocol on the privileges and immunities of the European Union

8. Protocol on the Treaties and Acts of Accession of the Kingdom of Denmark, Ireland and the United Kingdom of Great Britain and Northern Ireland, of the Hellenic Republic, of the Kingdom of Spain and the Portuguese Republic, and of the Republic of Austria, the Republic of Finland and the Kingdom of Sweden
  9. Protocol on the Treaty and the Act of Accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic
  10. Protocol on the excessive deficit procedure
  11. Protocol on the convergence criteria
  12. Protocol on the Euro Group
  13. Protocol on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland as regards economic and monetary union
  14. Protocol on certain provisions relating to Denmark as regards economic and monetary union
  15. Protocol on certain tasks of the National Bank of Denmark
  16. Protocol on the Pacific Financial Community franc system
  17. Protocol on the Schengen *acquis* integrated into the framework of the European Union
  18. Protocol on the application of certain aspects of Article III-130 of the Constitution to the United Kingdom and to Ireland
  19. Protocol on the position of the United Kingdom and Ireland on policies in respect of border controls, asylum and immigration, judicial cooperation in civil matters and on police cooperation
  20. Protocol on the position of Denmark
  21. Protocol on external relations of the Member States with regard to the crossing of external borders
  22. Protocol on asylum for nationals of Member States
  23. Protocol on permanent structured cooperation established by Article I-41(6) and Article III-312 of the Constitution
  24. Protocol on Article I-41(2) of the Constitution
  25. Protocol concerning imports into the European Union of petroleum products refined in the Netherlands Antilles
  26. Protocol on the acquisition of property in Denmark
  27. Protocol on the system of public broadcasting in the Member States
  28. Protocol concerning Article III-214 of the Constitution
  29. Protocol on economic, social and territorial cohesion
  30. Protocol on special arrangements for Greenland
  31. Protocol on Article 40.3.3 of the Constitution of Ireland
  32. Protocol relating to Article I-9(2) of the Constitution on the accession of the Union to the European Convention on the Protection of Human Rights and Fundamental Freedoms
  33. Protocol on the Acts and Treaties which have supplemented or amended the Treaty establishing the European Community and the Treaty on European Union
  34. Protocol on the transitional provisions relating to the institutions and bodies of the Union
  35. Protocol on the financial consequences of the expiry of the Treaty establishing the European Coal and Steel Community and on the Research Fund for Coal and Steel
  36. Protocol amending the Treaty establishing the European Atomic Energy Community
- B. Annexes to the Treaty establishing a Constitution for Europe
- Annex I — List referred to in Article III–226 of the Constitution
- Annex II — Overseas countries and territories to which Title IV of Part III of the Constitution applies
- FINAL ACT
- A. Declarations concerning provisions of the Constitution
- B. Declarations concerning Protocols annexed to the Constitution

**Article 104 (Part 3, Title VII, Chapter 1) of the  
Consolidated Version  
of the Treaty Establishing the European Community**

1. Member States shall avoid excessive government deficits.
2. The Commission shall monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors. In particular it shall examine compliance with budgetary discipline on the basis of the following two criteria:

(a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, unless:

- either the ratio has declined substantially and continuously and reached a level that comes close to the reference value,
- or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

(b) whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The reference values are specified in the Protocol on the excessive deficit procedure annexed to this Treaty.

3. If a Member State does not fulfil the requirements under one or both of these criteria, the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State.

The Commission may also prepare a report if, notwithstanding the fulfilment of the requirements under the criteria, it is of the opinion that there is a risk of an excessive deficit in a Member State.

4. The Committee provided for in Article 114 shall formulate an opinion on the report of the Commission.
5. If the Commission considers that an excessive deficit in a Member State exists or may occur, the Commission shall address an opinion to the Council.
6. The Council shall, acting by a qualified majority on a recommendation from the Commission, and having considered any observations which the Member State concerned may wish to make, decide after an overall assessment whether an excessive deficit exists.
7. Where the existence of an excessive deficit is decided according to Paragraph 6, the Council shall make recommendations to the Member State concerned with a view to bringing that situation to an end within a given period. Subject to the provisions of Paragraph 8, these recommendations shall not be made public.
8. Where it establishes that there has been no effective action in response to its recommendations within the period laid down, the Council may make its recommendations public.
9. If a Member State persists in failing to put into practice the recommendations of the Council, the Council may decide to give notice to the Member State to take, within a specified time limit, measures for the deficit reduction which is judged necessary by the Council in order to remedy the situation.

In such a case, the Council may request the Member State concerned to submit reports in accordance with a specific timetable in order to examine the adjustment efforts of that Member State.

10. The rights to bring actions provided for in Articles 226 and 227 may not be exercised within the framework of Paragraphs 1 to 9 of this Article.



11. As long as a Member State fails to comply with a decision taken in accordance with Paragraph 9, the Council may decide to apply or, as the case may be, intensify one or more of the following measures:

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

The President of the Council shall inform the European Parliament of the decisions taken.

12. The Council shall abrogate some or all of its decisions referred to in Paragraphs 6 to 9 and 11 to the extent that the excessive deficit in the Member State concerned has, in the view of the Council, been corrected. If the Council has previously made public recommendations, it shall, as soon as the decision under Paragraph 8 has been abrogated, make a public statement that an excessive deficit in the Member State concerned no longer exists.

13. When taking the decisions referred to in Paragraphs 7 to 9, 11 and 12, the Council shall act on a recommendation from the Commission by a majority of two thirds of the votes of its members weighted in accordance with Article 205(2), excluding the votes of the representative of the Member State concerned.

14. Further provisions relating to the implementation of the procedure described in this article are set out in the Protocol on the excessive deficit procedure annexed to this Treaty.

The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the ECB, adopt the appropriate provisions which shall then replace the said Protocol.

Subject to the other provisions of this Paragraph, the Council shall, before 1 January 1994, acting by a qualified majority on a proposal from the Commission and after consulting the European Parliament, lay down detailed rules and definitions for the application of the provisions of the said Protocol.

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