EU COMMUNITY LAW REGULATIONS ON GROSS DEBT OF GENERAL GOVERNMENT

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Abstract

The article discusses regulations of the Community law concerning government debt. The author presents excessive deficit procedure which is contained in Article 104 of the Treaty Establishing the European Community and in the Protocol on this procedure appended to the Treaty and in the Stability and Growth Pact. In summation the author considers main advantages of those regulations and shows a number of flaws at the stage of their practical application.

Key words

Excessive deficit procedure, deficit of general government, gross debt of general government, reference value, convergence programs, stability programs

The basic regulations defining excessive deficit procedures relating to the euro area countries are contained in Article 104 of the Treaty Establishing the European Community (EC Treaty)[1], and in the Protocol on this procedure appended to the Treaty[2] and in the Stability and Growth Pact.[3]

Under the EC Treaty's Article 104, the EU member states are obligated to avoid excessive government deficits. The responsibility to monitor the development of budgetary situation and of the stock of government debt in individual member states is vested in the European

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[1] Treaty Establishing The European Community – EC Treaty, (consolidated version incorporating the changes made by the Treaty of Amsterdam and certain related acts, signed at Amsterdam on 2 October 1997 and incorporating the amendments made by the Treaty of Athens, signed on 16 April 2003), *OFFICIAL JOURNAL C 321E OF 29 DECEMBER 2006.*

[2] Protocol on the excessive deficit procedure (no. 20) annexed to the EC Treaty.

[3] Resolution of the European Council on the Stability and Growth Pact (Amsterdam, 17 June 1997) , Official Journal C 236 of 02.08.1997.

Commission. Its objectives also include identification of gross errors that may contribute to budgetary difficulties, and examination of compliance with budgetary discipline by the member states on the basis of two criteria. The first is concerned with the answer to the question whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value. If so, the Commission examines in particular whether this ratio has declined substantially and whether the excess over the reference value is only exceptional and temporary, and the ratio remains close to the reference value. The second criterion examines whether the ratio of the government debt to gross domestic product exceeds a reference value, and if so, whether this value is sufficiently diminishing and approaching the reference value at a satisfactory pace.

Reference values have been specified in the Protocol on the excessive deficit procedure, annexed to the EC Treaty, and they are: 3% for the ratio of the planned or actual government deficit [deficit of general government] to gross domestic product; 60% for the ratio of government debt [gross debt of general government] to gross domestic product. Government deficit should mean, as defined by ESA 95[4], net borrowing of the government finance sector, that is the central government budget, regional and local government budgets, and social security funds, whereas debt means total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government. We should observe that the imprecise wording used in the EC Treaty stipulating that the ratio of government deficit to GDP should be close to the reference value allows the Commission considerable leeway in assessing the budgetary situation of a member state but it can also give rise to controversies between this country and the Commission.[5] A more pragmatic and liberal approach was used with the second criterion because the Treaty provisions do not explicitly require that the ratio of government debt to the GDP should be close to the reference value. There is only a provision saying that when the ratio exceeds this value, it should diminish 'at a satisfactory pace', thereby acknowledging that the fact alone of the diminishing ratio of government debt to GDP is already a positive phenomenon.

The detailed procedure with a view to identifying and reducing excessive deficit, set out in Article 104 of the EC Treaty, comprises several specific measures.

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[4] European System of Integrated Economic Accounts.

[5] L. Oręziak, *Finanse Unii Europejskiej,* Warszawa, Wydawnictwo Naukowe PWN, 2005, pp. 53-54.

Step one is of preparatory character and is related to the provision of information on their budgetary situations by member states twice a year (by 1 March and 1 September).

Measure two consists in the Commission examining compliance of budgetary discipline in member states with the criteria referred to in Article 104, paragraph 2 of the EC Treaty. When the Commission decides that the member state concerned does not fulfill the foregoing requirements, the Commission prepares a report, which specifies whether the government deficit exceeds government investment expenditure[6], and also takes into account all other macroeconomic factors that have a balancing effect on the budget. It should be observed that this report can be also prepared by the Commission if the member state fulfils the requirements under the aforementioned criteria but it is of the opinion that there is a risk of an excessive deficit.

Step three is the opinion about this report issued by the Economic and Financial Committee. If on the basis of this opinion the Commission considers that an excessive deficit in a member state exists or may soon occur, it addresses its opinion on the matter to the Council of the European Union.

Stage four under the procedure takes place when the Council, acting by a qualified majority, (and having considered any observations made by the Commission and the member state), decides that an excessive government deficit exists or not. This decision should be made within three months of the date of provision of information on their budgetary situation by the member states to the Commission.

Step five is taken when the Council decides that an excessive deficit exists. It then makes a recommendation to the member state with a view to bringing that situation to en end within a given period. If the state concerned fulfils the directives of the Council, the procedure ends. In practice, the Council usually recommends that the deficit be corrected within the shortest period possible, and specifies two time-limits. The first, usually lasting four months, is given for taking effective action by the member state. The second time-limit is the period after the end of the next budgetary year, when it is possible to genuinely correct debt unless exceptional circumstances support a longer period of time.

[6] "investment" means gross fixed capital formation as defined in the European System of Integrated Economic Accounts.

Step six consists in the Council's assessment of whether the member state has effectively implemented its recommendations. The reduction of deficit level by at least 0.5% of GDP annually is usually regarded as effective. If this does not happen then further procedure is suspended and the Commission and Council only monitor the efficacy of the actions taken.
Measure seven is applied when the Council establishes that the member country has failed, in the specified period (a maximum of four months), to take appropriately effective measures in response to recommendations addressed to it. Under such circumstances the Council may make the recommendations public.

If a member state persists in failing to apply remedial measures, step eight may follow, i.e. the Commission will call upon the member state concerned to take, within a specified time-limit, measures for the deficit reduction, which the Council deems necessary in order to remedy the situation.

Step nine consists in that the Council may 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, 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 Council's view, been corrected,
- to impose fines of an appropriate size.

The Council abrogates all its decisions taken under the procedure described here as the excessive deficit in the member state has, in the Council's view, been corrected. It should also be noted that the aforementioned sanctions, including the Council making its recommendations public in connection with the excessive deficit do not apply to non-members of the euro zone[7].

[7] Article 122(3) of the Treaty.

To sum up the solutions adopted within the framework of the excessive deficit procedure defined in the EC Treaty, it should be concluded that essentially, in keeping with their name, they are concerned only with the effect on the government deficit reduction while the issue of limiting government debt as the consequence of a persistent deficit is of secondary importance. What is vital is that this procedure assumes a great freedom of the member states participating in it and the discretionary character of all measures and sanctions that may be taken by the Council. This is the result of maintaining the decentralized character of budgetary policy within the Community but it also determines the comparatively restricted possibilities of imposing discipline on this policy within the framework of the presented regulations. These characteristics of the Treaty regulations seen as their weakness were the reason for the adoption in June 1997 of the Stability and Growth Pact. Its basic objective is to strengthen the effectiveness of EC Treaty provisions in the area of eliminating excessive deficits. The Pact consists of three elements:

1) Resolution of the European Council adopted at its meeting in Amsterdam on 16 June 1997[8], in which member states undertook to take measures in order to attain, in the medium-term perspective, the situation close to a budget equilibrium or budget surplus.
2) Council Regulation No. 1466/1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[9], termed "preventive', which contains solutions intended to prevent excessive deficits.
3) Council Regulation No. 1467/1997 on speeding up and clarifying the implementation of excessive deficit procedures[10] called "repressive" or "deterrent", which is the actualization of provisions of Article 104, EC Treaty, both in respect of detailed application rules and sanctions to be imposed.

[8] **Resolution of the European Council on the Stability and Growth Pact (Amsterdam, 17 June 1997) , Official Journal C 236 of 02.08.1997.**

[9] **Council Regulation (EC) No** 1466/1997 **of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, Official Journal L 209 of 02.08.1997.**

[10] **Council Regulation (EC) No** 1467/1997 **of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, Official Journal L 209 of 2 August 1997.**

The Stability and Growth Pact covers all EU countries but its repressive part applies only to the euro area countries (subject to derogation as specified by general rules in the EC Treaty). Because the two aforementioned regulations are fundamental to the Pact, we can say that it is an intergovernmental agreement in its basic formula, while the Council resolution defines the general philosophy in applying its provisions. As regards the preventive part, of great importance is the obligation of the euro area countries to prepare stability programs of several years' duration and of the remaining EU countries to draw up convergence programs. The feature that both these programs share is the obligation to define the objectives relating to government deficit and government debt with the macroeconomic assumptions adopted by the member state concerned for particular years of the period covered by the program, such as: real GDP growth, inflation rate, unemployment rate, the size of government investment spending, etc. Moreover, the countries that draw up convergence programs should include in them medium-term objectives of money policy and characterize the effect of exchange rate policy on the implementation of these objectives.

These programs are submitted to the Commission in the autumn at the time when governments present their budget assumptions to national parliaments. They cover a five-year period: the current budgetary year, next year and three successive budgetary years. They are subject to the Council's assessment after considering the opinions of the Commission and the Economic and Financial Committee. In particular, the Council examines whether the objectives of budgetary policy intended by the government do not threaten to produce excessive deficits and whether they comply with the Broad Economic Policy Guidelines laid down in Article 99 of the EC Treaty and passed annually by the Council. It is also essential that they meet the requirements under the so-called Code on the content and form of stability programs (the point is especially the conformity of information and figures contained in them with the standards used under the European System of Accounts.[11] If significant objections are raised, the Council requests individual member countries to effect corrections in their stability programs.

The Pact's "repressive part" specifies the details of excessive deficit procedure and the system of sanctions against the countries that allow such a deficit. Under the Pact's provisions, the government deficit higher than a reference value of 3% of GDP may be regarded as

[11] See more: *Format and content of stability and convergence Programs,* "European Economy" no. 3 , 2002, pp. 239-247.

exceptional and temporary (and ultimately carrying no sanctions) in two cases. The first relates to the situation when the deficit is the result of exceptional events that are outside the control of the member state concerned and have a significant effect on the general government balance. The second case occurs when the deficit is the result of a severe economic downturn, understood as an annual real decline of GDP by at least 2%. At the same time it has been assumed that where a GDP decline is within the 0,75% to 2% range, the Council itself makes a discretionary decision whether the exceeding of the admissible deficit level can be regarded as exceptional, whereas, where a decline of the real GDP is lower than 0,75%, this constitutes no grounds for regarding the excess over the deficit limit as temporary.

Having taken the foregoing circumstances into account, in the situation when a member state has not met the Council's previous recommendations and persists in failing to correct the excessive deficit, the Council may decide to impose sanctions on the state concerned. In the first place, these are in the form of a non-interest-bearing deposit, which should be made with the Commission by the state, which allows such a deficit. The deposit consists of the constant part (the size of 0,2% of GDP) and the variable part (in the amount of one tenth of the difference between the actually existing deficit and the reference value of 3% of GDP). The two parts of the deposit can be a maximum of 0,5% of the GDP of the country that should make it. The deposit is returned when the deficit declines below 3% of GDP. It is interesting that if within two years of the issuance of the decision on making a deposit the excessive deficit is not corrected, the deposit will be forfeited to the Community, thus becoming an actual punishment.

To sum up the discussion on the regulations of the Community law concerning government debt, it should be said that while the idea of introducing them appears right and necessary, they show, regrettably, a number of flaws at the stage of their practical application.

Their main advantage is that they obligate EU member countries to deal with their budgetary policy in a medium-term perspective or while an economic cycle lasts. With regard to the euro area countries, the main objective of the regulations lies in attaining balance or surplus in the budgets. Compliance with these recommendations means, in practice, creating large room for necessary maneuver in order to avoid an excessive deficit under the circumstances of a

severe economic downturn, and to enable the so-called automatic stabilizers of the economic situation to work properly.[12]

It should be noted at this point that during the work on the Maastricht Treaty, the possibility was considered of taking into account, in the assessment of the general government balances of the member states, not only the economic condition but also the nature of government expenditure the incurring of which results in excessive debt. It was proposed that a deficit which serves to finance government investment be regarded as justified while it would be inadmissible to use it to finance current expenditure. This idea was eventually not included in the EC Treaty's clauses, however, some of its elements can be found in the provisions under Article 104, paragraph 3, from which arises the obligation for the Commission to compare, while assessing the compliance with government debt limits by the member state concerned, the level of government deficit with the size of government investment expenditure. It should however be explicitly stated that this criterion is only of subsidiary importance and the fact of incurring high investment expenditure cannot be considered an exceptional circumstance justifying the excess over the reference value of 3% of GDP because in such cases this would lead to excessive and unreasonable increase in the expenditure of this kind.[13]

One of the emphasized fundamental advantages of the Community law regulations on general government debt is their high flexibility. It is ensured already at the initial stage when the deficit exceeding 3% of GDP can be considered admissible when it is the result of exceptional, objective random events or an economic downturn. Later, at the stage of the procedure against the state, whose negative general government balance was judged as excessive, it is possible to take into account special circumstances while specifying the time-limit for its correction. This flexibility is highly significant because it is not possible to cover with one simple legal rule all possible political and economic situations that may occur at the stage of budget implementation.[14]

At the same time, the system of disciplining the euro area countries, provided for in the EC Treaty and the Stability and Growth Pact, is characterized by the gradual intensification of measures, which are implemented with a view to preventing excessive debt and combating it.

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[12] *The implementation of the Stability and Growth Pact*, "ECB Monthly Bulletin", May 1999.
[13] L. Oręziak, *Finanse Unii Europejskiej...* op. cit., p. 64.
[14] See: *The excessive deficit procedure*, "ECB Monthly Bulletin", June 2003.

The least severe are those consisting in making a recommendation by the Council to the member state and possibly making it public, while the strictest ones include the requirement to make a non-interest-bearing deposit, and its forfeiture to the Community in the extreme case.

The advantages of implementing the excessive deficit procedure also include prevention of situations where the reckless budgetary policy of some countries would carry adverse consequences for the remaining EU states in the form of stimulation of inflation and increased interest rates on the single European market, which might contribute to weakening the effectiveness of the European Central Bank's money policy.

Despite the largely favorable assessment of the aforementioned legal solutions, the EU member states signal a number of doubts and difficulties in their practical application.[15] The basic ones are that these procedures limit the possibility of lowering taxes in order to stimulate the economic situation, which is especially unfavorable, given the fact that the countries with the lowest economic development have the highest government deficit at the same time. Consequently, the imposition of severe penalties will not produce proper results in their case anyway.

It is also interesting that the member states tend to include in their stability and convergence programs too optimistic assumptions on the anticipated rate of economic growth for next years, which results in a failure to attain the intended objectives concerning the general government balance. Moreover, adjustment measures are usually applied at the every end of the period covered by a program, which weakens their effectiveness. A number of difficulties are also connected with the possibility of obtaining and assessing data related to budgetary situations.

It is also stressed that the ineffectiveness of the excessive deficit procedure is justified by the pressure caused by multilevel surveillance by EU institutions over the practical implementation of the procedure.

[15] See: *Implementing the Stability and Growth Pact* , "Public Finance in EMU", European Commission 2007.

Taking the foregoing weaknesses into account, during discussions on the reform of EU institutions and the shape of the EU Constitution, various changes in the existing legal regulations were suggested. They would consist, inter alia, in introducing the requirement of annually improving general government balance in the countries with an excessive deficit by a certain amount specified in advance. There were also suggestions that more emphasis be put on the question of the level of general government debt, especially in the countries where it exceeds the reference value of 60% of GDP. In those countries, stability programs being prepared should include strategies for debt reduction below this value. It was also postulated that the EU member states must necessarily comply with the requirements relating to the collection and passing to the Commission, of complete and reliable data characterizing their budgetary situation. It was also indicated that it is possible to exclude some expenditure while calculating the amount of the government deficit, e.g. the expenditure related to the financing of the armed forces or education.

As a result of the aforementioned objections, the ECOFIN Council presented the report "*Improving the implementation of the Stability and Growth Pact*" on 20 March 2005[16], which became the basis for reforming the previous legal solutions in force, the reform consisting in amending Regulations nos. 1466/1997[17] and 1467/1997[18]. The amendments introduced relate, inter alia, to the possibility of differentiating medium-term macroeconomic objectives so that they could give up the requirement that the budgetary position be close to equilibrium or show a surplus. When calculating the admissible government deficit level, a safe margin for exceeding it was taken into account, according to which it would range from -1% GDP to the state of equilibrium or a budgetary surplus (by this part of the deficit, appropriately corrected, which is cyclically determined) .[19] The reform also consists in taking into account, in the assessment of implementation by the EU member states of their convergence programs, the structural reforms carried out by these states with a view to long-term lowering of government expenditure (e.g. reforms of the pension system). The obligation to correct the deficit by 0,5% of GDP annually was explicitly specified, taking however into account the principle that in

[16] "*Improving the implementation of the Stability and Growth Pact*", Document COM (2004) 581.
[17] Council Regulation (EC) No 1055/2005 of 27 June 2005 amending Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies
[18] Council Regulation (EC) No 1056/2005 of 27 June 2005 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, **Official Journal L** 174 of 7.07.2005.
[19] More on this subject: A. Nowak-Far, *Pakt Stabilności i Wzrostu. Funkcje, działanie i przyszłość*, Wyd. C. H. Beck, Warszawa 2007, pp. 86-94.

the period of prosperous economy the "adjustment effort" should be greater in this respect while during a recession – smaller. Longer procedural time-limits and time limits for taking remedial measures were introduced.

Literature:

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[2] Protocol on the excessive deficit procedure (no. 20) annexed to the EC Treaty.

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[4] Council Regulation (EC) No 1466/1997 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, Official Journal L 209 of 02.08.1997.

[5] Council Regulation (EC) No 1467/1997 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, Official Journal L 209 of 2 August 1997

[6] Council Regulation (EC) No 1055/2005 of 27 June 2005 amending Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies

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[11] Nowak-Far A., *Pakt Stabilności i Wzrostu. Funkcje, działanie i przyszłość*, Warszawa, Wyd. C. H. Beck, 2007, pp. 86-94.

[12] Oręziak L., *Finanse Unii Europejskiej*, Warszawa, Wydawnictwo Naukowe PWN, 2005, pp. 53-54.

[13] *The excessive deficit procedure*, "ECB Monthly Bulletin", June 2003.

[14] *The implementation of the Stability and Growth Pact*, "ECB Monthly Bulletin", May 1999.

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