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## Reforming the Stability and Growth Pact in Times of Crisis

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## Abstract

It is a commonplace that the mechanisms established in the stability and growth pact are blunt instruments. They are highly politicised as both the establishment of infringements and possible sanctions are subject to votes in the EU Council. The financial crisis of 2009/10 has dramatically altered the financial situation of many EU member states and has also shown the need for new regulatory instruments to enforce budgetary discipline in the Euro zone. Figures on the EU member states' budget debts from 1999 to 2010 support this argument empirically. We discuss the current reform proposals and show that the introduction of a reversed qualified majority is likely to strengthen substantially the position of the European Commission to sanction non-complying member states. This becomes possible because decisive players in the EU Council will be closer to the position of the Commission.

## Keywords

Stability and Growth Pact; EU; Financial Crisis

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*"The fate of a country cannot be left in the hands of experts alone!"* Christine Lagarde 2010, former French Finance Minister (Associated Press 2010, Sep 28)

## INTRODUCTION

The European Union's Stability and Growth Pact (SGP) serves to support a balanced macroeconomic development within the Union and sound fiscal policies in the member states.<sup>1</sup> From a theoretical point of view, its establishment can be described as a self-imposed constraint to which the member states commit themselves (Fourcans and Warin 2007; von Hagen 2010). They agreed to stick to the well-known reference values and appointed the European Commission as a guardian provided with agenda-setting power (Lindbeck and Niepelt 2006). Further, they established a catalogue of ever stricter sanctions once the SGP is violated. However, it is widely acknowledged that the SGP is a blunt instrument due to the absence of an automatism for sanctions. Rather, the enforcement of its rules used to be subject to decisions by a qualified majority in the EU Council, which gave room for manoeuvre and political discretion.

Not surprisingly, the ongoing financial crisis has triggered a political debate on the efficiency of the SGP's rules and how to improve the existing regulatory instruments to enforce budgetary discipline better in the European Union. Certainly, the financial crisis and the EU member states' budgetary policies are two distinct albeit intertwined matters. While in some member states sound fiscal policies were upset by events in the banking sector, e.g., in Ireland, in others the financial crisis 'only' aggravated an already problematic situation of public budgets – most prominently in Greece (Featherstone 2011). But, whatever the causes, the crisis has certainly been a catalyst for a debate which has led to the reform of the SGP.

In this debate, the introductory quote from the former French Finance Minister Lagarde represents one extreme, according to which the enforcement of the pact should remain subject to political discretion. At the other extreme, the European Commission asked for far reaching reforms and launched a total of six proposals for regulations and directives which were finally adopted in November 2011. The core of these SGP reforms is the introduction of a Reversed Qualified Majority (RQM) in the EU Council. The goal of this

article is to show that this part of the reform is especially apt to render the SGP more efficient than its previous setup.

To this end, the article proceeds as follows: we start by briefly introducing the SGP. Using a simple spatial model, we show on a theoretical basis why member states did not have to fear sanctions under the previous rules governing the SGP. We then show empirically that violations of the deficit and debts criteria from 1999 to 2010 were daily fare (Fingland and Bailey 2008) and that in fact true sanctions were never enforced. As a next step, we demonstrate the effect of the reversed majority in theoretical scenarios using the spatial model already introduced. Subsequently, we develop an index from several budgetary and political indicators that enables us to map the preferences for sanctions of the Euro zone members. Thereby, we are able to highlight the practical relevance of the RQM in empirical scenarios. Although the reform does not create a real automatism for sanctions, the Stability and Growth Pact will likely become less subject to political discretion. This is good news, given that the excessive deficits and debts, as in the cases of Greece, Ireland, Portugal, Italy or Spain, are a threat not only to their own stability, but to all the member states sharing the Euro.

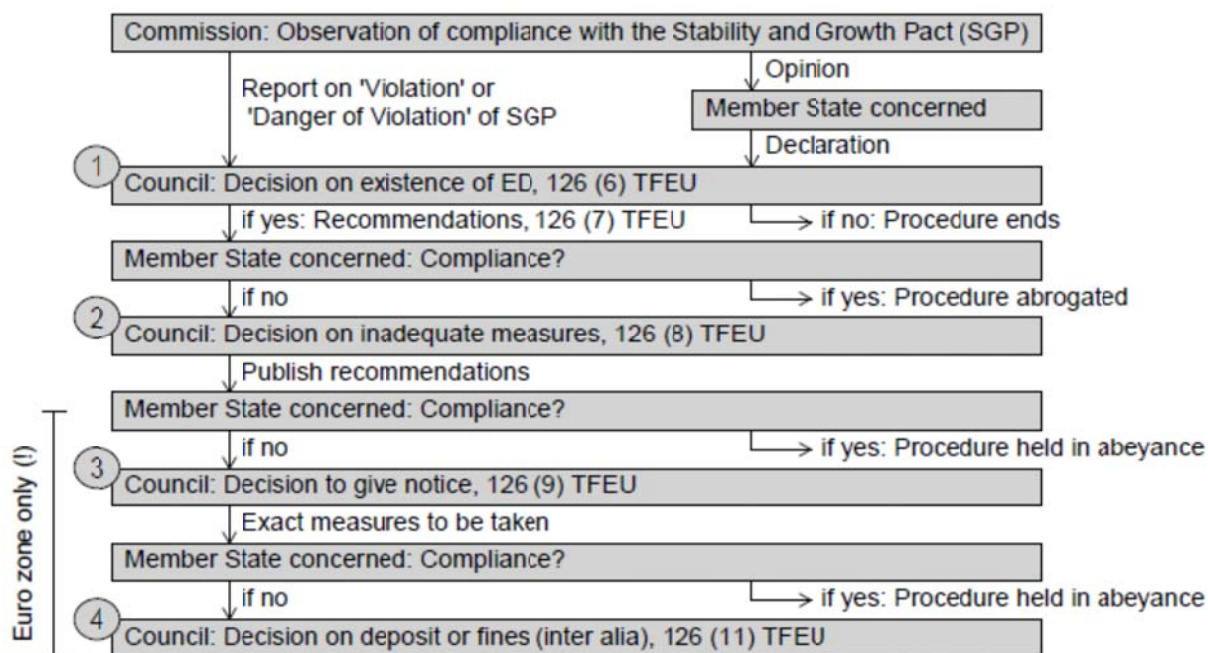
## THE STABILITY AND GROWTH PACT IN THEORY AND PRACTICE

In this section we first describe the Stability and Growth Pact in brief and with a focus on the Excessive Deficit Procedure. We then take an analytical view of the SGP which is informed by previous analyses of Council decision-making. This enables us to evaluate the likelihood of an adequate enforcement of the past rules – which seems to be rather low. The theoretical reasoning is confirmed by the numerous infringements of the reference values by member states over the last 10 years which are in stark contrast to the actual number of procedures.

### Legal basics

The SGP consists essentially of two pillars, commonly referred to as the 'preventive' and the 'corrective' arms. The first pillar establishes the rules that govern the surveillance of budgetary and macroeconomic developments in the member states (Article 121 Treaty on the Functioning of the European Union (TFEU)). The second pillar establishes the 'Excessive Deficit Procedure' (EDP) that comes into play once a violation of one or both of the reference values has been observed or if there is a high probability of such a violation. The functioning of this mechanism is laid out in Art. 126 TFEU (ex Article 104 TEC), which is further specified by Regulation (EC) No 1467/97.<sup>2</sup> Our focus is on the Excessive Deficit Procedure (EDF) as an exemplary case. In short, this procedure consists of four stages that imply ever stricter obligations on member states which do not comply with the references values (see Figure 1). This procedure may ultimately lead to deposits or fines. It is important to note that whenever the Council takes a vote in the course of the procedure, it has to do so on a proposal from the Commission by a qualified majority, excluding the member state in question. As Figure 1 shows, the Council has to take four votes to adopt sanctions in the form of deposits or fines before they come into effect.

Figure 1: The Excessive Deficit Procedure



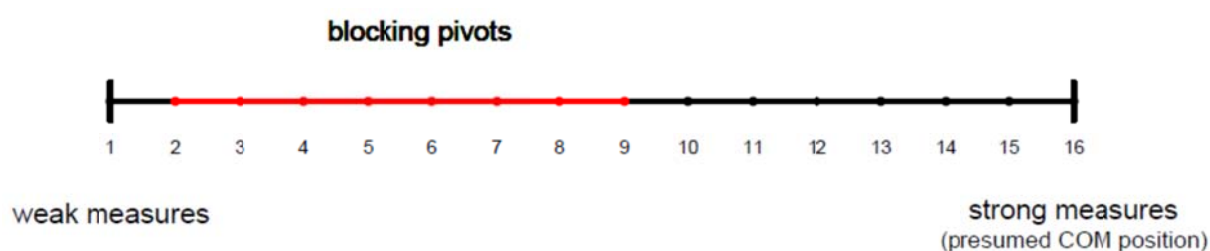
### Theoretical considerations

The problem particular to the Excessive Deficit Procedure lies in the fact that any member state judging other members may be in the dock another day. This reduces the incentive for a proper enforcement, which in turn gives rise to look at things from a broader perspective. When establishing the principles of the Stability and Growth Pact, the member states committed themselves voluntarily to certain policy goals, procedures and possible sanctions to maximise collective utility (Brennan and Buchanan 1985). However, these rules are not sufficiently specific to be directly applicable (Fischer *et al.* 2006). This may either be due to their inability to agree on sufficiently specific rules or information asymmetries on how the procedure would work in practice (see Hix 2002 for an account of how this led to the alternation of the codecision procedure). Or, knowing that they have limited knowledge of possible future states of the world, the member states consciously decide to conclude an incomplete contract (Schuknecht 2005). But, whatever the reason, part of the contract is to delegate the supervision of the rules to an agent, namely the European Commission. In this role, the Commission makes proposals to the Council in case of non-compliance with the policy goals. As such, the Commission has a considerable influence for two reasons. First, by initiating the EDP a shaming effect occurs. Second, it can confront the Council with a take-it-or-leave-it option which allows for two possible outcomes: either the status quo (if there is a blocking minority) or the Commission's proposal (if there was a qualified majority in favour). The Commission – assuming that it takes an extreme position in terms of compliance with the SGP – will thus propose whatever makes the pivotal member state indifferent between the status quo and its proposal (see e.g. Tsebelis 2002: 248 for this logic with respect to EU legislative procedures).<sup>3</sup>

As introduced above, any sanction has to be approved by a qualified majority. Thus, to block a Commission proposal, a coalition of member states that holds approximately 26 per cent Euro zone votes in the Council or that represents 38 per cent of the population is sufficient.<sup>4</sup> As the member state in question may not vote in the procedure, the exact

blocking minorities depend on the number of votes and the population of the excluded member. To illustrate the consequences of these voting rules, we distribute the 16 voting member states of the Euro zone equidistantly into a one-dimensional space (see Figure 2).

Figure 2: Degrees of escalation in the EDP



Member states on the left-hand side of the space prefer a weak enforcement of the SGP, while member states more to the right are in favour of stricter sanctions. The Commission as the agenda-setter is assumed to be in an extreme position always favouring a strict enforcement.

So far, decision-making in the Council has been analysed from essentially three angles, each of which has added to our particular understanding of the dynamics leading to the policy output produced under the Stability and Growth Pact. First and foremost, we consider the literature employing spatial models to explain the outcome of legislative procedures in the EU. This includes most prominently the works of Tsebelis (2002) from which we learn about the importance of agenda-setting and taking into account the positions of the decisive governments in analyses of EU decision-making. Our model rests on such logic by considering the agenda-setting power of the European Commission in the Excessive Deficit Procedure and the positions of the governments. However, in Tsebelis's stylised models, the actual voting weights of the governments are not considered. Rather, he regularly assumes that a Qualified Majority can be formed by five out of seven Council members which are equally powerful. Yet, for our analysis, voting weights are important, as the next body of literature points out.

Second, there is a body of literature on voting power in the Council which takes power indices as the starting point to analyses of the a priori voting power (VP) of individual governments, i.e. on the likelihood of being pivotal in an n-player game (Brams and Affuso 1976; Mann and Shapley 1964; Riker and Shapley 1968). The focus of the voting power approach differs from ours in two respects. The overall goal of VP analyses is to make probabilistic statements. We, on the other hand, using empirically informed positions and thus not considering all coalitions equally likely to form, seek to make statements on the outcome of the EDP in particular. Second, the prime interest in VP approaches is the presumed power of individual players over a large range of votes taken, regardless of their concrete policy positions. In opposition to that, our explanatory variable is the policy output produced under the EDP and how this will change given the altered voting rules. However, the VP literature points at the importance of the government's voting weights when analysing decision-making in bodies with weighted votes such the EU Council. We therefore consider the votes and the population of each member state when we try to identify which government is decisive.

Finally, there is a body of literature on cleavages in the EU Council, i.e. on the lines along which coalitions are likely to form (such as 'left vs. right' or 'north vs. south'). The empirical contributions are either based on government voting behaviour in past legislative decision-making (e.g. Hagemann and Hoyland 2008; Hosli *et al.* 2011) or based on their party-political composition as documented in party manifestos (e.g. Veen 2011). With respect to roll-call data from the EU Council, such data is not available to the public for votes taken on the Stability and Growth Pact. With respect to party manifestos, this policy area is too specific to derive conclusions from rather broad party manifestos. Yet, we learn that particular cleavages do exist and that ideological positions should be considered. This is why we construct an index from which we can deduce the governments' presumed positions in the EU Council, as we outline further below. By mapping the governments into the one-dimensional issue space, we can later identify possible cleavages between member states who oppose and those who favour a stricter enforcement of the EDP (cf. the 'Analysis' section).

For now, we aim to show the effect of the past voting rule in order to contrast it with the newly established RQM later on. To this end, we develop four distinct theoretical scenarios from the model which allow for identifying the pivotal players. Where exactly the pivots are located depends on how the member states are arrayed in this theoretical exercise. In the first scenario (left-hand side of Table 1), the largest member (Germany) is in the dock and all the other member states are arrayed by decreasing voting weight from left to right – the larger a member state, the less it will favour a strict enforcement of the SGP (see Irlenbusch and Sutter 2006). In this scenario and given the definition of the qualified majority, players 1 and 2 in Figure 2 represent France and Italy, which may form a blocking minority using their population share of more than 50 per cent. Given such an extreme preference order, no strict sanctions would be adopted. In the second scenario (right-hand side of Table 1), in which the smallest member states want to help Germany to avoid sanctions (the smaller a member state, the less it favours a strict enforcement), a blocking minority against a Commission proposal is formed by nine member states which accumulate 50 votes (48 out of a total of 184 Euro zone votes suffice to prevent the formation of a QMV in favour of strict sanctions). In the third and fourth scenarios (Table 2), the smallest Euro zone member (Malta) is in the dock and the blocking minorities again comprise either the two largest (now Germany and France) or the nine smallest member states. Under these extreme preference constellations, the pivotal member states are either players 2 or 9. Now, no matter what the empirical preference constellation (i.e. which of the numbers 1-16 on the line represent which of the member states) and which member state is under scrutiny – the pivots will always be between players 2 to 9 under the old voting rules. For now, we keep this theoretical finding in mind, as it will later be contrasted with first the theoretical and second the empirical setup under RQM.

Table 1: Voting in the Euro zone (Scenarios 1 and 2 – Germany in the dock)

|   | Scenario 1    | votes      | cum | population         | %             | cum   | Scenario 2     | votes      | cum | population         | %             | cum    |
|---|---------------|------------|-----|--------------------|---------------|-------|----------------|------------|-----|--------------------|---------------|--------|
| lax enforcement<br>(weak measures)      | 1 France      | 29         | 29  | 64,105,125         | 25.86         | 25.86 | 1 Malta        | 3          | 3   | 412,614            | 0.17          | 0.17   |
|   | 2 Italy       | 29         | 58  | 60,090,430         | 24.24         | 50.10 | 2 Luxemburg    | 4          | 7   | 491,702            | 0.20          | 0.36   |
|   | 3 Spain       | 27         | 85  | 45,853,045         | 18.50         | 68.60 | 3 Cyprus       | 4          | 11  | 801,622            | 0.32          | 0.69   |
|   | 4 Netherlands | 13         | 98  | 16,481,139         | 6.65          | 75.25 | 4 Estonia      | 4          | 15  | 1,340,274          | 0.54          | 1.23   |
|   | 5 Greece      | 12         | 110 | 11,262,539         | 4.54          | 79.80 | 5 Slovenia     | 4          | 19  | 2,053,393          | 0.83          | 2.06   |
|   | 6 Belgium     | 12         | 122 | 10,741,048         | 4.33          | 84.13 | 6 Ireland      | 7          | 26  | 4,517,758          | 1.82          | 3.88   |
|   | 7 Portugal    | 12         | 134 | 10,631,800         | 4.29          | 88.42 | 7 Finland      | 7          | 33  | 5,325,115          | 2.15          | 6.03   |
|   | 8 Austria     | 10         | 144 | 8,356,707          | 3.37          | 91.79 | 8 Slovakia     | 7          | 40  | 5,411,062          | 2.18          | 8.21   |
|   | 9 Slovakia    | 7          | 151 | 5,411,062          | 2.18          | 93.97 | 9 Austria      | 10         | 50  | 8,356,707          | 3.37          | 11.58  |
|   | 10 Finland    | 7          | 158 | 5,325,115          | 2.15          | 96.12 | 10 Portugal    | 12         | 62  | 10,631,800         | 4.29          | 15.87  |
| strict enforcement<br>(strong measures) | 11 Ireland    | 7          | 165 | 4,517,758          | 1.82          | 97.94 | 11 Belgium     | 12         | 74  | 10,741,048         | 4.33          | 20.20  |
|   | 12 Slovenia   | 4          | 169 | 2,053,393          | 0.83          | 98.77 | 12 Greece      | 12         | 86  | 11,262,539         | 4.54          | 24.75  |
|   | 13 Estonia    | 4          | 173 | 1,340,274          | 0.54          | 99.31 | 13 Netherlands | 13         | 99  | 16,481,139         | 6.65          | 31.40  |
|   | 14 Cyprus     | 4          | 177 | 801,622            | 0.32          | 99.64 | 14 Spain       | 27         | 126 | 45,853,045         | 18.50         | 49.90  |
|   | 15 Luxemburg  | 4          | 181 | 491,702            | 0.20          | 99.83 | 15 Italy       | 29         | 155 | 60,090,430         | 24.24         | 74.14  |
|   | 16 Malta      | 3          | 184 | 412,614            | 0.17          | 100   | 16 France      | 29         | 184 | 64,105,125         | 25.86         | 100.00 |
|   | <b>sum</b>    | <b>184</b> |     | <b>247,875,373</b> | <b>100.00</b> |       | <b>sum</b>     | <b>184</b> |     | <b>247,875,373</b> | <b>100.00</b> |        |



Blocking minority (percentage of votes) 26.09  
 Votes required for blocking minority (without Germany) **48**  
 Population for blocking minority (without Germany) 38%

QMV (percentage of votes) 73.91  
 Votes required to achieve QMV (without Germany): **136**  
 Euro zone population quorum (without Germany) 62%

Table 2: Voting in the Euro zone (Scenarios 3 and 4 – Malta in the dock)

|   | Scenario 3 |             |            |     |                    |               | Scenario 4 |            |             |            |     |                    |               |       |
|---|------------|-------------|------------|-----|--------------------|---------------|------------|------------|-------------|------------|-----|--------------------|---------------|-------|
|   | votes      | cum         | population | %   | cum %              | votes         | cum        | population | %           | cum %      |     |                    |               |       |
| strict enforcement<br>(strong measures) | 1          | Germany     | 29         | 29  | 82,062,249         | 24.90         | 24.90      | 1          | Luxemburg   | 4          | 4   | 491,702            | 0.15          | 0.15  |
|   | 2          | France      | 29         | 58  | 64,105,125         | 19.45         | 44.36      | 2          | Cyprus      | 4          | 8   | 801,622            | 0.24          | 0.39  |
|   | 3          | Italy       | 29         | 87  | 60,090,430         | 18.24         | 62.59      | 3          | Estonia     | 4          | 12  | 1,340,274          | 0.41          | 0.80  |
|   | 4          | Spain       | 27         | 114 | 45,853,045         | 13.91         | 76.51      | 4          | Slovenia    | 4          | 16  | 2,053,393          | 0.62          | 1.42  |
|   | 5          | Netherlands | 13         | 127 | 16,481,139         | 5.00          | 81.51      | 5          | Ireland     | 7          | 23  | 4,517,758          | 1.37          | 2.79  |
|   | 6          | Greece      | 12         | 139 | 11,262,539         | 3.42          | 84.93      | 6          | Finland     | 7          | 30  | 5,325,115          | 1.62          | 4.41  |
|   | 7          | Belgium     | 12         | 151 | 10,741,048         | 3.26          | 88.19      | 7          | Slovakia    | 7          | 37  | 5,411,062          | 1.64          | 6.05  |
|   | 8          | Portugal    | 12         | 163 | 10,631,800         | 3.23          | 91.41      | 8          | Austria     | 10         | 47  | 8,356,707          | 2.54          | 8.59  |
|   | 9          | Austria     | 10         | 173 | 8,356,707          | 2.54          | 93.95      | 9          | Portugal    | 12         | 59  | 10,631,800         | 3.23          | 11.81 |
|   | 10         | Slovakia    | 7          | 180 | 5,411,062          | 1.64          | 95.59      | 10         | Belgium     | 12         | 71  | 10,741,048         | 3.26          | 15.07 |
|   | 11         | Finland     | 7          | 187 | 5,325,115          | 1.62          | 97.21      | 11         | Greece      | 12         | 83  | 11,262,539         | 3.42          | 18.49 |
|   | 12         | Ireland     | 7          | 194 | 4,517,758          | 1.37          | 98.58      | 12         | Netherlands | 13         | 96  | 16,481,139         | 5.00          | 23.49 |
| lax enforcement<br>(weak measures)      | 13         | Slovenia    | 4          | 198 | 2,053,393          | 0.62          | 99.20      | 13         | Spain       | 27         | 123 | 45,853,045         | 13.91         | 37.41 |
|   | 14         | Estonia     | 4          | 202 | 1,340,274          | 0.41          | 99.61      | 14         | Italy       | 29         | 152 | 60,090,430         | 18.24         | 55.64 |
|   | 15         | Cyprus      | 4          | 206 | 801,622            | 0.24          | 99.85      | 15         | France      | 29         | 181 | 64,105,125         | 19.45         | 75.10 |
|   | 16         | Luxemburg   | 4          | 210 | 491,702            | 0.15          | 100.00     | 16         | Germany     | 29         | 210 | 82,062,249         | 24.90         | 100   |
|   | <b>sum</b> |             | <b>210</b> |     | <b>329,525,008</b> | <b>100.00</b> |            | <b>sum</b> |             | <b>210</b> |     | <b>329,525,008</b> | <b>100.00</b> |       |



|  |           |  |            |
|--|-----------|--|------------|
| Blocking minority (percentage of votes)              | 26.09     | QMV (percentage of votes)                      | 73.91      |
| Votes required for blocking minority (without Malta) | <b>55</b> | Votes required to achieve QMV (without Malta): | <b>155</b> |
| Population for blocking minority                     | 38%       | Euro zone population quorum                    | 62%        |



## The SGP in Practice

When considering actual violations in terms of the reference values, several member states were constantly running deficits beyond three per cent and/ or the 60 per cent debt criterion even before the actual crisis – most prominently Germany and France between 2002 and 2005 (Eurostat 2012a). Consequently, the Commission has initiated deficit procedures on a regular basis. Ever since the introduction of the Euro in 1999, 36 excessive deficit procedures have been launched, three of which ended as early as the very first stage with only a Commission report being issued (Eurostat 2012b). Only two member states, Sweden and Estonia, have never been subject to a deficit procedure, while Portugal is the front-runner with three procedures. At the beginning of 2012, 23 procedures were pending, i.e. of the 27 Member States, only four were not under scrutiny. Turning to the individual procedural steps (cf. Figure 1), the Council abided by the Commission's recommendation to approve the existence of an excessive deficit in every single case. Thus, at this stage, the Council does not see any margin of discretion for itself towards the Commission. It should be noted though, that it is hardly possible to argue credibly against such a Commission proposal, given that the reference values are clearly stated.<sup>5</sup>

In the next two procedural steps, the Council did not always follow the Commission's proposal. In 2003, France and Germany were able not only to accumulate a blocking minority against the Commission's proposal for a decision on inadequate means and to issue notice. They also managed to convince the Council to hold both procedures in abeyance. For both these actions the Commission took the Council to the European Court of Justice (Case C-27/04). Following the ruling, the strategic situation between the Commission and the Council has not improved: the Commission is the only actor which can initiate a procedure and propose sanctions. Any such proposal may not be altered by the Council as attempted by Germany and France. On the other hand, the Council can freely decide (or not) to adopt the Commission's proposal (Heipertz and Verdun 2010: 169). The treaty simply did not create any sort of automatism for sanctions, as the Commission had argued before the Court.

Empirically, all procedures have either been formally abrogated or been held in abeyance – independent of the member states' size. But, as illustrated above, the occurrence of substantial sanctions crucially depends on where the pivotal member state stands. In the procedures observed empirically so far, the right-most pivot has agreed only to issue notice, but not to sanction in terms of deposits or fines. However, given the numerous violations of the reference values, it becomes obvious that the existing mechanism is to a large extent subject to political discretion (Leblond 2006; Alves and Afonso 2007; Beetsma and Debrun 2007) and that the SGP itself has not forced member states fundamentally to alter their budgetary policies (Bofinger and Ried 2010: 203; de Haan *et al.* 2004; Fatás *et al.* 2003).<sup>6</sup>

Overall, this evidence from the past as well as the actual situation of several heavily indebted member states leads us to the conclusion that there was and still exists a fundamental problem of compliance with the SGP rules. Because member states have – not least due to the financial crisis – seen the need to reform the SGP, several reform proposals have been on the agenda since 2010. They are introduced in the next section.

## The financial crisis as a catalyst

Regarding the overall dynamics of the reform of the SGP, we observe that the whole process is largely driven by several major events. One important consequence was that the dramatically increased deficits in 2009 led to higher interest rates and therefore increased costs for the governments to refinance themselves (Hodson 2010: 226; Verdun 2008 and 2009).<sup>7</sup> By 2010, this brought the topic of public deficits to the top of

the agenda of the regular EU summits as well as to those of the extraordinary crisis summits convoked to prevent a Greek state bankruptcy. It is very important to note that it was *neither* the general concern for high deficits and debts *nor* the fact that the EU Commission subsequently opened Excessive Deficit Procedures (EDP) against most of the member states that led to these intensive debates. Additionally, it would be misleading to assume that the market mechanisms (e.g. high spreads) are apt to resolve the problem. Rather, the extraordinary crisis summits were necessary because Greece was no longer able to assure the markets that it could manage its debt on its own. It was then that the massive intervention of all the other EU member states and the EU institutions, plus the International Monetary Fund (IMF) became vital.

The EDP therefore has a preventive function to avoid member states getting into this situation. Nevertheless one has to consider that the member states come under pressure in considerably different ways. Ireland came under pressure because of the huge losses of Irish banks during the financial crisis, while Greece had faced public budget deficits even before the introduction of the Euro. The conclusions then must also be different. Whereas the Irish case refers to the regulation of financial actors (Quaglia *et al.* 2009) and the amount of risks they are allowed to take (Basel III regulating own funds and the question of how large the balance of a single institute should be compared to the size of the national economy), the Greek case refers precisely to the inefficiency of the SGP in respect of avoiding excessive deficits and the consequences.

## RECENT REFORMS

In May and June 2010 the European Commission published two communications in which it announced plans for regulatory proposals. The actual legislative proposals which became known as the 'sixpack' were launched on 29 September 2010 (see Table 3) and came into effect on 13 December 2011 (Official Journal 2011).

Table 3: Overview on amended or new regulatory means

|                                      | Proposal number      | Subject matter  | Legal basis TFEU       | Final act   | Remarks                                 |
|--------------------------------------|----------------------|---|------------------------|---|---|
| <b>Stability and Growth Pact</b>     | COM (2010) 526 final | Surveillance of national budgets and economic policies ('preventive' arm) | 121 (6)                | Regulation 2011/1175<br>OJ L 306<br>23.11.2011, p. 12 | Amendment to Council Directive 1466/97  |
|                                      | COM (2010) 522 final | Implementation of the excessive deficit procedure ('corrective' arm)      | 126 (14), para 2 / 136 | Regulation 2011/1177<br>OJ L 306<br>23.11.2011, p. 33 | Amendment to Council Regulation 1467/97 |
|                                      | COM (2010) 524 final | Specifies sanctions in the 'preventive' and 'corrective' arms             | 136 / 121 (6)          | Regulation 2011/1173<br>OJ L 306<br>23.11.2011, p. 1  | new                                     |
|                                      | COM (2010) 523 final | Budgetary frameworks  | 126 (14), para 3       | Directive 2011/85<br>OJ L 306<br>23.11.2011, p. 41    | new                                     |
| <b>Excessive Imbalance Procedure</b> | COM (2010) 527 final | Prevention and correction of macroeconomic imbalances                     | 121 (6)                | Regulation 2011/1176<br>OJ L 306<br>23.11.2011, p. 25 | new                                     |
|                                      | COM (2010) 525 final | Enforcement measures to correct macroeconomic imbalances                  | 121 (6)                | Regulation 2011/1174<br>OJ L 306<br>23.11.2011, p. 8  | new                                     |

Three of the legislative acts are more directly connected with the existing SGP framework and focus on budgetary politics and the Excessive Deficit Procedure. A fourth proposal deals with an improved comparability of national budgetary frameworks. The last two acts establish a new procedure to monitor and sanction macroeconomic imbalances in the Euro zone ('Excessive Imbalance Procedure'), which is comparable to the reformed Excessive Deficit Procedure.

The preventive arm (COM (2010) 526 final) provides for the introduction of a so called 'European Semester', which is a phase of economic policy coordination starting in January of each year and ending in July. To this end, it is envisaged that member states forward 'Stability Programmes' (Euro zone members) and 'Convergence Programmes' (non-Euro zone members) to the European Commission in mid-April (as opposed to the prior submission at the end of the year). The programmes are supposed to contain medium-term budgetary strategies. By mid-July, both Council and Commission should have commented on the programmes so that national governments can take into account possible suggestions in their national budget cycles. In the event of "persisting

or particularly serious and significant deviations from prudent fiscal policy-making (...)” (COM (2010) 524, Art. 3), the Commission proposes to impose the payment of an interest-bearing deposit of 0.2 per cent of GDP for Euro zone members. This is a newly introduced sanction which is supposed to function as an early warning.

Regarding the corrective arm of the SGP, Regulation 2011/1177 amends Council Regulation 1467/97 on ‘Speeding up and clarifying the implementation of the excessive deficit procedure’. The procedural innovation is to impose a sanction in the form of a non-interest bearing deposit of 0.2 per cent of GDP as soon as a member is placed in excessive deficit. This sanction is transformed into a fine once a decision has been taken in accordance with Art. 126 (8) TFEU, i.e. once the Council has approved “inadequate means”. This means that sanctions in the form of a fine can be applied much earlier than used to be the case. The idea to cut structural funds which the Commission had proposed in its communications (COM (2010) 367: 9-10) – just as the German government did – was not held up. At the heart of these legislative acts is the introduction of a reversed majority. Contrary to the existing provisions, the Council now has to *block* sanctions proposed by the Commission with a qualified majority, rather than *approve* them with a QMV (see Figure 1, step 4). This has far reaching consequences as we demonstrate in the next section.

## ANALYSIS: THE EFFECT OF THE REVERSED QUALIFIED MAJORITY

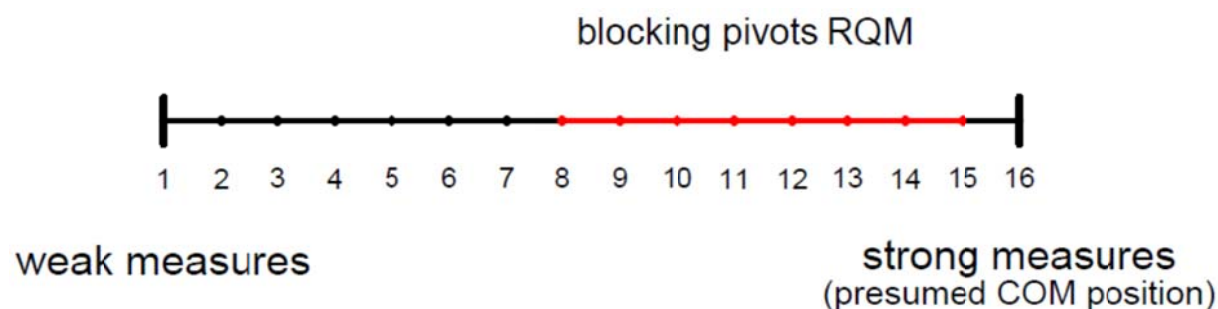
### Theoretical scenarios

Concerning the set of new instruments mentioned above, we believe that the reversed qualified majority is the most important one. The introduction of this voting rule is a substantial improvement compared to the status quo ante where true sanctions had to be approved by a qualified majority – which has never happened to date. The exact nature of sanctions is of minor importance, be they interest or non-interest bearing deposits or fines – if no effective action is taken by the member state. What is more important is *whether a decision* under the reversed majority *will be taken at all*.

We now apply the spatial logic from above and the same fictitious preferences of the 17 Euro zone members to the reversed majority. In the first scenario, Germany is subject to an EDP. We assume that the larger the member state, the more it will oppose a strict enforcement of the SGP (see Table 1, first scenario). To form a QMV against a Commission proposal, 136 votes and 62 per cent of the population are required. In this case, the eight largest member states have to agree. In the second scenario, where the smallest member states are most sceptical towards a strict enforcement, a QMV requires the consent of the 15 largest member states because only this super-coalition meets the vote and the population criteria. In the third and fourth scenario, where Malta is in the dock, the same holds true (see Table 2).

In this purely theoretical exercise, the leftmost blocking pivot under all possible preference constellations is now member state eight. Recall from Figure 2 that previously, the two largest member states were able to block a Commission proposal. Therefore, outcomes are likely to be much closer to the European Commission’s presumed ideal point (see Figure 3). The latter can thus propose stricter measures than under the old system, whereby a better enforcement of the SGP becomes possible – at least theoretically. Finally, the analysis of the QMV and the RQM voting rules shows that the likelihood of a sanction against any member state is completely independent of its size. Consequently, the incentives to adopt the RQM were identical for small and large member states from this perspective. So far, we conclude that the RQM will in fact make a difference, no matter what the nature of the governments’ empirical positions.

Figure 3: Degrees of escalation EDP under the reversed qualified majority



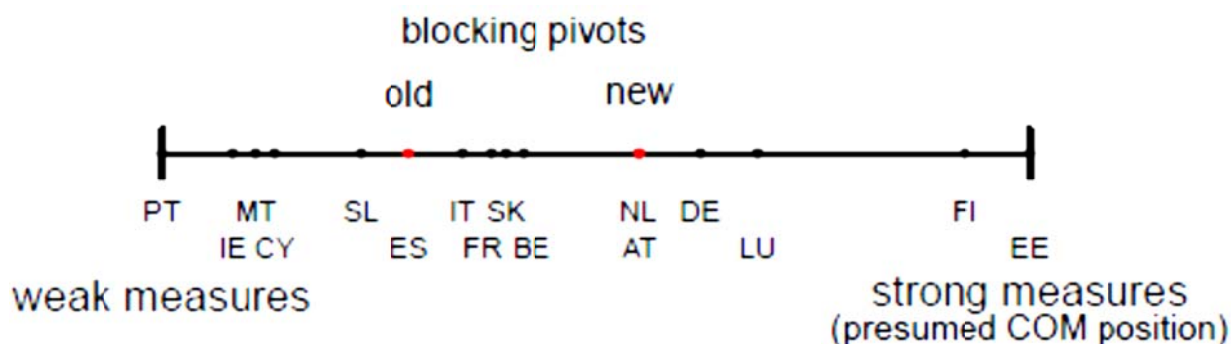
### Empirical scenarios

The above abstract scenarios were meant to illustrate the effect of changes on voting rules. We now turn to an empirically grounded evaluation of the voting rules. To this end, we plot the member states' presumed positions towards the enforcement of the SGP into the one-dimensional space.<sup>8</sup> While from a collective perspective, a strict enforcement of the SGP may be preferred by all member states, we assume that the individual member states that are less willing to sanction other member states are the more likely to themselves be subject to an EDP. To attribute positions to member states, we constructed an additive index consisting of economic and political indicators which affect a member state's attitude towards the SGP. The following indicators make up the index:<sup>9</sup>

- **Debt and Deficit:** The public debt and annual deficits are the two reference values that may trigger an EDP. The higher the public debt and deficits, the more likely a member state will be subject to sanctions and the more likely it will vote against a strict enforcement.
- **Average annual interest rates:** The interest rates of government bonds are essentially determined by market expectations about a member state's solvency. We chose 10-year bonds and employ them as a medium-term predictor of a member state's future financial situation that influences voting behaviour.
- **Aging-related expenditures in terms of GDP (European Commission 2009):** This indicator describes the predicted change in age-related expenditures of the member states until 2060. The higher the costs from an aging population, the greater the need for adjustments in the long run in order to avoid sanctions (see Beetsma and Oksanen 2007, 2008).
- **Violations of the deficit criterion:** This factor simply counts the number of years in which a member state violated the deficit criterion since its entry into the Euro zone. We assume that the more often a member state violated the deficit criterion in the past, the more likely it will vote against sanctions.
- **Commission recommendations (European Commission 2011):** The European Commission prepares comments on the 'Stability Programmes' submitted by the member states to the Council. These recommendations describe whether the proposed measures to consolidate national budgets are sufficient and evaluate the likelihood that these self-defined goals will be met. We used these assessments as a measure for potential future conflict between the European Commission and the member state. The values range from 1 for compliance with the SGP, e.g. Luxembourg, Finland and Estonia, to 5 for those states which actually receive transfers in order to avoid a state default, e.g. Greece, Ireland and Portugal.

In Figure 4, the index is directly transformed into positions located in our one-dimensional space. The leftmost member state is Greece (not shown because it is under scrutiny and may not take part in the vote), followed by Portugal and Ireland. At the other extreme, Estonia, Finland, Luxemburg and Germany are the member states that might support a strict enforcement of the SGP.

Figure 4: Degrees of escalation in the EDP with member state positions



When sanctions against Greece are at stake, the remaining Council members accumulate 201 votes. According to the past voting rules, it took either 53 votes OR 38 per cent of the population represented to block a Commission proposal. In this configuration, Spain, in the centre of the policy space, is pivotal. Now, the new voting rule requires 149 votes AND 62 per cent of the population represented to block a Commission proposal. In this setting, Austria is pivotal - a member state much closer to the Commission's presumed ideal point than Spain. The Commission could therefore propose measures that are much stricter and still prevail. Picture another scenario: If Spain was subject to an EDP, Italy was previously pivotal, while under the new voting rule, Austria is again pivotal. In sum, in any empirically grounded constellation, the pivots move considerably to the right of the space. Substantially, this implies that those member states that generally prefer a stricter enforcement of the SGP become pivotal. Namely, those are Estonia, Finland, Luxembourg, Germany, Austria and the Netherlands, which, given the location of the other member states, broadly corresponds to a north-south cleavage.

Now, would the altered rules have made a difference before the financial crisis?

Figure 5: Degrees of escalation in the EDP with positions from 2008

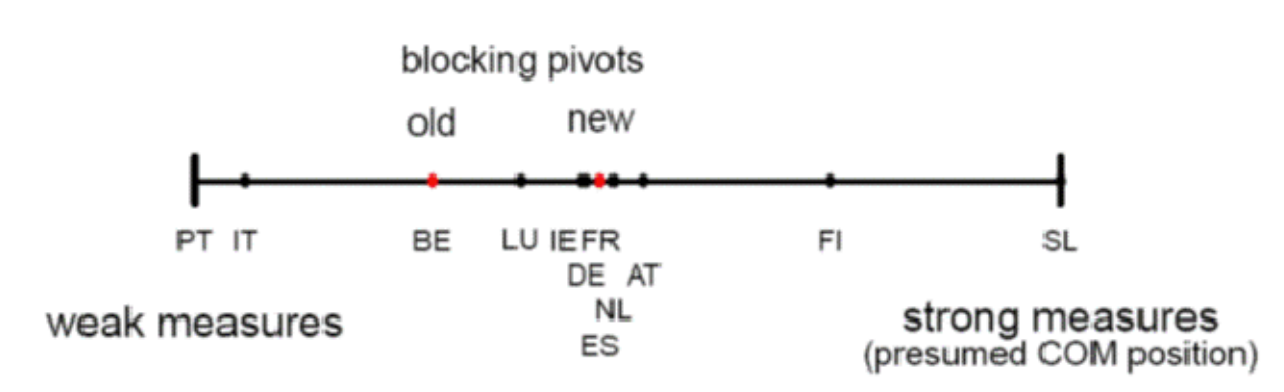


Figure 5 illustrates the effect of the RQM with positional data from 2008. Here, we simply re-calculated the index for the time period from 2005-2008, i.e. before the beginning of the financial crisis. Already before the crisis, Greece was the member state which according to our index should be least favourable towards sanctions. In this scenario, it is also the member state under scrutiny. Under the old rules, Belgium would have been pivotal in supporting (or avoiding) sanctions proposed by the Commission against Greece. Under the new rules, France would have been pivotal in 2008. This move of the pivotal member state implies that stricter sanctions would have been possible already in

The logic of the EDP is viable for transfer to the proposed 'European Semester', where the member states lay down their medium-term budgetary strategies. The fact that the documents have to be submitted earlier will be an advantage. However, it remains to be seen how much additional information these strategies will provide to make the national budgetary policies more transparent. Considering possible EU sanctions in case of significant deviations from prudent fiscal policy-making, these sanctions would also be subject to a Council vote with a RQM and hence the same considerations about the efficiency of the new sanction regime would apply.

## CONCLUSION

At the time of writing, the debates and negotiations about the rescue of highly indebted member states are ongoing and speculations about further catastrophes are still growing. Generally, the introduction of the reversed majority is an important innovation, as it raises the hurdles for member states seeking to obstruct the EDP and the sanctions proposed by the Commission. Therefore, the chances for the application of sanctions will increase – rendering the SGP more efficient – as sound budgetary policies and long term stability are in the interest of all member states. We demonstrated that the introduction of a reversed majority substantially increases the likelihood of the European Commission being able to sanction member states effectively. More concretely, we identified Estonia, Finland, Luxembourg, Germany, Austria and the Netherlands as the member states which may ensure that future Commission proposals will not be blocked.

Finally, at the summit of the European Council on 8/ 9 December 2011, the Heads of State and Government of the Euro zone members decided that the scope of the reversed qualified majority in the Excessive Deficit Procedure should be further enlarged

(European Council 2011: 4): While the six-pack adopted in November 2011 only foresaw a RQM for the imposition of sanctions, it shall now apply for all decisions in the EDP (see Figure 1, steps 1-3). This further highlights its relevance and the governments' willingness to commit themselves to stricter rules.

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<sup>1</sup> The theoretical foundation can be found in the idea of an "Optimum Currency Area" (Mundell 1961); see Heipertz and Verdun 2010 for a discussion of the SGP and its evolution from an integration theory perspective.

<sup>2</sup> Regulation (EC) No. 1467/97 was substantially amended by Regulation 2011/1177 (OJ L 306 23.11.2011, p. 33) in November 2011, as we outline below.

<sup>3</sup> In the following we refer to the Council's decisions in the later part of the EDP (issue notice and to impose sanctions) which only apply to the current 17 Euro zone members.

<sup>4</sup> The Nice definition of the qualified majority applies until 2014 and until 2017 respectively (Art. 238 (3) TFEU together with the "Protocol on Transitional Provisions"). For the 'regular' QMV the vote threshold, defined as 255 out of 345 votes, is approximately 74 per cent of the votes. For votes which do not include all Council members, which is the case in the corrective branch of the SGP, the same ratio applies. In addition, 62 per cent of the population have to be represented. The blocking minority is the inverse of both criteria. Note that to block a Commission proposal either criterion will suffice.

<sup>5</sup> For the issue of the submission of wrong figures see Gordo and Nogueira 2007.

<sup>6</sup> This claim can further be based on the assessment that the member states, in several instances, in fact did not lower their deficits and debts below the critical values though they had committed themselves to do so. For instance, in 2003 the Commission clearly stated on behalf of Germany "that the action taken by the respective government in response to article 104(7) recommendation has proved inadequate and recommends the Council to decide accordingly". In the case of France the Commission states that "[...] no effective action has been taken in response to the recommendations addressed under article 104(7) [...]".

<sup>7</sup> The Greek-German spread on 10-year bonds for instance reached a maximum of 973 basis points on 7 May 2010.

<sup>8</sup> See Blavoukos and Pagoulatos (2008) for a similar approach. Chang (2006) also tries to identify member states that may form alliances.

<sup>9</sup> The index is created with data from the six year period from 2005 to 2010. The individual indicators are normalised between 0 and 1 to avoid a bias stemming from the measurement level. In addition, we assume that more recent figures are more relevant than past ones and therefore we weight the figures by year: figures from earlier years enter the index to a lesser degree than those from more recent years.



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