

## Europe's Dog in the Nighttime

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The new European Commission headed by Jean-Claude Juncker is off to a rocky start. But one would not know it from reading the news headlines. As Sherlock Holmes understood well, a dog that does not bark in the nighttime is usually unnoticed. In Europe's case, the European Union's fiscal rules are at issue, and the Commission – in principle the EU's watchdog – should bark loudly when they are flouted.

Last month, howls seemed inevitable after two large EU countries, Italy and France, submitted budget plans for 2015 that clearly violated their governments' vows of continued austerity. At first, the Commission dutifully rejected the two budgets as incompatible with the rules of the EU's Stability and Growth Pact (SGP). But then something happened that was as "curious" as in Arthur Conan Doyle's story. Within days, both countries offered mini-adjustments to their budgets, worth about 0.2% of GDP, and their finance ministers wrote to the Commission that their budgets should now be approved. The Commission did not react, leaving French and Italian leaders to claim that they, not Brussels bureaucrats, had the last word.

In fact, the latest forecast reflects an even worse outcome for France and Italy this year than originally promised, with France's deficit set to increase slightly for 2015 and Italy's cyclically adjusted deficit expected to deteriorate. The Stability and Growth Pact prescribes an annual improvement of at least 0.5% of GDP.

The new Commission thus risks losing its authority from the very start of its mandate. Whether it does is a crucial question, because maintaining a high degree of credibility is essential to economic policy-making in the eurozone.

To see why, it is worth recalling that the SGP's original rules were judged "stupid" by one former Commission President (Romano Prodi), because the single-minded pursuit of a deficit below 3% of GDP could be inappropriate during recessions. That argument was accepted, and the SGP was supposedly rendered more 'intelligent' by, for example, permitting budget deficits to be adjusted for the economic cycle, adding medium-term objectives for expenditure, and introducing escape clauses.

But the new rules obviously require a strong institution to interpret them, and whose judgment is accepted by everybody. While checking whether a budget is below the SGP's ceiling of 3% of GDP may be a straightforward matter, there can be reasonable disagreement about whether

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the business-cycle adjustment should be estimated at 0.5% or 0.8% of GDP, or whether a country is adhering to its medium-term expenditure objective.

The Commission is supposed to have the last word, thereby ensuring the rules' credibility and consistency – and it seems to have lost this fight in the first round. One could, of course, argue that the SGP should be scrapped, because austerity makes no sense when the eurozone faces the risk of deflation. But the Commission, not fiscally louche member countries, should be the one to decide that.

The other problem for Europe is a dog that does bark, but for no reason. This is the case of the United Kingdom, which has been asked to pay an additional contribution to the EU budget of about €2 billion, which amounts to a rounding error of the UK's own budget.

The reason for this additional levy is that a few weeks ago the UK's Office for National Statistics announced, proudly, that it had discovered that the country's gross national income (GNI) had been much higher than previously assumed, not only in 2013, but also in all previous years. Including the revisions for the 2002-12 period, the difference comes to about €445 billion.

Because every EU member state is obliged to contribute about 1% of its GNI to the Union's budget, the UK's data revision had to lead to a back payment of billions of euros. But British Prime Minister David Cameron has declared that he does not intend to pay money that “the European Commission was not expecting or needing.”<sup>1</sup>

These two cases – the dog that should have barked but did not, and the dog that barked for no reason – threaten the EU's fundamental workings, which are based on a clear rulebook enforced vigorously by a strong Commission. Juncker's Commission risks losing its authority from the start if rules can be bent or broken to accommodate the larger member states' domestic political priorities.

The Commission must regain the political and intellectual leadership and make its choice: either explain why the SGP rules must be followed even now, in the face of deflation, or agree with those who argue that the current environment calls for a fiscal stimulus. It cannot avoid taking sides by insisting publicly on austerity rules but then acquiescing when member states break them.

Leaders in member states have to play their part as well. Pandering to populists may be attractive in terms of short-term electoral gains, but the long-term cost in terms of credibility, both their own and that of the EU, will be very high.

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<sup>1</sup> See <http://www.reuters.com/article/2014/10/24/us-eu-britain-budget-idUSKCN0ID14720141024>.