Reform of the Stability and Growth Pact

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The objective of the Stability and Growth Pact is to secure sound fiscal policies, which have remained a national responsibility in Economic and Monetary Union. Ever since it first took effect, the Stability and Growth Pact had been subject to a reform debate, ultimately leading to its redesign in 2005. The debate intensified in 2002, when several European countries suffered from growing budgetary problems, and culminated in November 2003, when the Ecofin Council decided not to act upon European Commission recommendations to move to the next steps of the excessive deficit procedure for France and Germany and instead adopted conclusions putting the procedures in abeyance subject to certain undertakings by the countries concerned. Consequently, the Commission brought an action before the European Court of Justice. The conflict surrounding the correct procedure in line with the provisions of the Treaty establishing the European Community (the Treaty) and the Stability and Growth Pact, i.e. the correct interpretation and implementation of the procedural and factual steps laid down therein, brought to light differences of opinion between the EU Member States and the European Commission as well as among the Member States themselves.

Against this background, the European Commission presented concrete proposals to reform the Stability and Growth Pact in the fall of 2004. At an extraordinary Ecofin meeting on March 20, 2005, the EU finance ministers reached a compromise on the reform of the Stability and Growth Pact. The reform includes measures applicable to both the preventive and the corrective arms of the Stability and Growth Pact. The top priority of the reform was to enhance Member States' national ownership of the fiscal framework and hence to safeguard the sustainability of public finances in the Economic and Monetary Union in the long run.

Experience to date does not allow for a final assessment, but from the vantage point of monetary policy, certain weaknesses remain that had already been pointed out during the reform debate.

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1 Introduction

At an extraordinary Ecofin meeting on March 20, 2005, the EU finance ministers reached a compromise on the reform of the Stability and Growth Pact (SGP). At its Spring Summit of March 22 and 23, 2005, the European Council endorsed these fundamental changes to the SGP.

The SGP is considered a crucial coordination element for sustaining and preserving sound national fiscal policies within Economic and Monetary Union (EMU). Next to a stability-oriented monetary policy, the maintenance of budget discipline in EMU member countries is considered to be an essential prerequisite for a well-functioning monetary union. Hence, the Maastricht Treaty (Treaty on European Union – TEU) contains provisions for the surveillance and coordination of EU Member States' fiscal policies. First of all, it commits all Member States to avoid excessive public deficits (i.e. deficits exceeding 3% of GDP). In this respect, the Treaty establishing the European Community (the Treaty) contains provisions both to prevent excessive deficits from arising and to initiate a procedure to correct any excessive deficits which do arise. Second, the TEU commits Member States to strive for government debt ratios below 60% of GDP. The SGP, which originally consisted of two Council Regulations and a European Council Resolution adopted in 1997, sought to strengthen the fiscal framework of the Treaty by laying down more detailed rules and procedures for budgetary surveillance, and by speeding up and clarifying the implementation of the excessive deficit procedure (EDP).

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Policymakers, academic circles, the European Commission and the European System of Central Banks (ESCB) each had very different opinions about the original design of the SGP. Academic researchers, in particular, sharply criticized the objectives and the sanctions contained in the SGP. Hence, from the very outset, there were calls to reform the SGP, which became louder in 2002 (only three years after the full provisions had taken effect) when a number of European countries – notably Portugal, Germany and France – experienced growing budgetary problems. In the course of this debate, both the effectiveness and the very substance of the SGP's design were questioned, and the competent EU bodies, the Economic and Financial Committee and the Ecofin Council, discussed first concrete reform measures.

The growing crisis of the European fiscal framework became starkly evident when the economy began to slow down in 2001. To reach the medium-term budget objectives prescribed by the SGP, countries whose consolidation efforts in the preceding high-growth years had been insufficient would have had to undertake increased fiscal retrenchment measures with a procyclical effect. Yet France and Germany, above all, were not willing to take measures that would have reinforced the impact of the economic downturn in the short run. The conflict culminated in November 2003, when the Ecofin Council decided not to act upon European Commission recommendations to move to the next steps of the EDP for France and Germany. Instead of giving these two countries notice[2] pursuant to Article 104 (9) as a necessary prerequisite for implementing excessive deficit procedures, the Ecofin Council adopted "conclusions" putting the procedures in abeyance subject to certain undertakings by the countries concerned. Consequently, the Commission brought an action before the European Court of Justice challenging procedural aspects of the Ecofin Council's conclusions. The European Court of Justice indeed annulled said conclusions in July 2004, but at the same time confirmed the prerogative of the Ecofin Council to exercise discretion in the implementation of the procedure. The conflict surrounding the correct procedure in line with the provisions of the Treaty and the SGP, i.e. the correct interpretation and implementation of the procedural and factual steps laid down therein, brought to light differences of opinion between the EU Member States and the European Commission as well as among the Member States themselves.[3]

Against this background, the European Commission therefore made concrete proposals to reform the SGP in the fall of 2004. These proposals were aimed primarily at preventing procyclical fiscal policy, allowing for more country-specific circumstances in defining medium-term budget objectives, giving increased attention to debt levels and economic developments and clarifying the implementation of the

[2] *Article 104 (9) states that "[i]f 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."*

[3] *In particular, the conflict laid open the differences of opinion between small countries applying strict fiscal discipline and the large Member States Germany, France and Italy.*

SGP. One often cited goal of the reform was also to strengthen the economic underpinnings of the SGP and enhance "national ownership," i.e. the Member States' identification with the European fiscal policy framework, in order to prevent the SGP from being sidelined as increasingly politically meaningless.

Conversely, the ESCB saw no fundamental need to reform the SGP, just a need to improve implementation. From the vantage point of monetary policymakers, the changes to the SGP represent quite a substantial weakening of the EU's fiscal policy framework, together with the danger of jeopardizing the long-term sustainability of the national fiscal policies and of complicating the stability-oriented monetary policy.

In section 2, the original setup of the SGP is presented. Section 3 discusses the advantages of sound public finances and the rationale for a rules-based fiscal policy. Section 4 deals with the criticism leveled at the EU's fiscal policy framework. Section 5 evaluates the effectiveness of the original SGP. Sections 6 and 7 present the reform of the SGP adopted in 2005. Section 8 rounds off the study with a critical assessment of the reformed SGP taking into account the experience up to now.

2 Original Design

On June 17, 1997, at the Amsterdam Summit, the European Council adopted the SGP by resolution. The new framework substantiated and strengthened the Treaty provisions on fiscal discipline foreseen by Article 99 (coordination and multilateral surveillance of the national fiscal policies) and Article 104 (corrective measures and sanctions). With this initiative the European Council responded to concerns about the inadequacy of the existing legal instruments to guarantee compliance with the fiscal criteria quantified by the TEU[4] and thus to safeguard the sustainability of public finances after the introduction of the euro.

As it would have been too complicated to amend the TEU – any amendments would have required unanimity and, depending on national rules, ratification by an act of parliament or by national referendum – the SGP was implemented on the basis of Articles 99 and 104 of the Treaty by means of detailed secondary legislation (Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, and Resolution of the European Council on the Stability and Growth Pact Amsterdam, 17 June 1997). The SGP defines the objective of sound public finances in detail and basically serves to accelerate or clarify the EDP. To do so, the SGP contains a "preventive early warning mechanism" and "corrective and dissuasive elements" (Bayer et al., 2000; Part, 1998).

[4] *TEU provided for maintenance of fiscal discipline for all Member States by introducing two quantitative reference values that both reflect policy choices: as a rule, the general government deficit ratio of a Member State was to be below 3% of GDP, and the government debt ratio was to be below 60% of GDP (or to be sufficiently diminishing and approaching the reference value at a satisfactory pace). Moreover, the TEU enshrined the prohibition of monetary financing of government debt and a "no bailout" clause in order to prevent moral hazard behavior. It was agreed that only those countries would be able to move to the third stage of EMU that actually met the Maastricht criteria.*

To better enforce fiscal discipline, the instruments and the procedures of the SGP were successively refined from the time the SGP went into effect (Singer, 2005, p. 47f). These refinements applied among other things to the format and content of the stability and convergence programs (establishment of a code of conduct), a clarification of the medium-term objective of achieving a budgetary position ("close to balance or in surplus")[5] and the determination of a uniform method to measure cyclically adjusted budget balances. Additionally, the EU began to deal systematically with the consequences of aging populations on the long-term sustainability of public finances within the existing EU framework for budgetary surveillance. However, the European Council's requirement for the surveillance of the quality of public finances has not been met yet.

3 The Objectives of the SGP – Fiscal Discipline and Sound Public Finances

The objective of the original SGP was to continue to guarantee sound public finances and hence fiscal discipline in the Member States after the introduction of the euro. Sound fiscal policy secured by a rules-based fiscal policy framework fosters macroeconomic stability and creates favorable framework conditions for sustainable high economic growth. It strengthens market participants' trust and reduces the risk involved in long-term decision-making, e.g. for investment. Moreover, lower budget deficits and the achievement of primary surpluses make it possible to reduce the debt ratio; the lower interest payments they entail broaden the scope for fiscal maneuver.

Conversely, permanent structural budget deficits exercise upward pressure both on short-term interest rates (if the central bank feels compelled to counteract inflationary effects by raising interest rates) and on long-term interest rates (as a result of changes in inflationary expectations) and, in a regime of flexible nominal exchange rates, push currency appreciation. While the resulting appreciation dampens export demand, high interest rates affect private investment demand above all and also detract from the long-term income outlook for an economy as a result of reduced capital accumulation.

Fiscal discipline helps improve the economic environment in the short term by creating the proper framework conditions which allow for the full operation of the automatic stabilizers and which provide for sufficient fiscal policy leeway for anticyclical action during an economic slump. In this manner, it supports short-term economic growth without risking a breach of the 3% reference value.

The pursuit of a stability-oriented monetary policy is only possible if budget policy is geared toward fiscal discipline. High or growing debt ratios involve the risk that central banks are forced to follow a more accommodative monetary policy to reduce the real value of outstanding government debt through higher inflation.

[5] *See Part (2000).*

In a monetary union, the arguments in favor of rules-based fiscal policies become even stronger, as the deficit incentives for fiscal policymakers change. The incentive to take deficit-financed measures rises, exacerbating what is referred to as the deficit bias of fiscal policy.[6] The "sanctioning" effects of deficit-financed national policies disappear, as exchange rate developments and short-term interest rates are geared to the economic conditions prevailing throughout the entire monetary union. Moreover, the costs of deficit spending are spread among all monetary union member countries, whereas the advantages are not equally distributed.[7] Should any doubts about a monetary union member country arise, the risk premia increase for every member country, especially if the financial markets question the credibility of no bailout clauses.

Consequently, the original and the reformed SGP aim at preventing such negative spillover effects on Member States bound to fiscal discipline. The SGP is additionally aimed at protecting the Eurosystem from having to answer a call for an ex ante bailout by loosening monetary policy or for an ex post bailout by monetary financing of government debt. Hence, European fiscal policy rules are designed to reduce the danger that countries simply reap the benefits of other countries' good behavior without following the rules themselves, and above all the danger of moral hazard practices.

4 Criticism of the Fiscal Framework

From the outset, the fiscal criteria quantified by the TEU and the design of the SGP were subject to lively discussion and criticism, which intensified in the wake of the slowdown in economic growth from 2001 onward.

Since the quantification of the fiscal rules in the TEU, the criticism has focused mainly on two issues, namely the lack of a theoretical basis for politically determined fiscal reference values and the lack of enforceability of these rules. When the SGP was introduced, this criticism intensified. In particular, the critics questioned whether uniform quantitative rules were suited to preventing a rise in public debt. Moreover, they pointed out that the quantitative rules had a detrimental impact on the economy.[8]

The criticism that the chosen fiscal rules lacked a foundation in economic theory applies to both the politically determined general government deficit and gross debt ceilings (Buiter et al., 1993; Wyplosz, 2002) and to the definition of the medium-term objective of a budgetary position close

[6] *However, in line with the tax-smoothing theory (Barro, 1979), it makes economic sense to accept deficit spending to finance temporary increases in expenditure (e.g. military spending occasioned by an international conflict) rather than to raise taxes abruptly, which would entail high welfare losses. It also makes economic sense to pursue an expansive fiscal policy during phases of pronounced or protracted capacity underutilization to reduce the deviation of actual from potential output. Permanent structural deficits and the rapid rise in European countries' debt ratios in the 1980s and at the beginning of the 1990s cannot be seen simply as a result of anticyclical budget policy and tax-smoothing efforts, though. Much rather, they were the outcome of a budget policy with an immanent deficit bias for which there are numerous reasons (Calmfors, 2005). Fiscal policy rules are aimed at reducing or getting under control the deficit bias of fiscal policy to all Member States' advantage and to secure the stability orientation of monetary policy. See also Beetsma (2001).*

[7] *However, growing integration also lets trade partner countries benefit from deficit-increasing demand-stimulating discretionary measures.*

[8] *However, by drawing up a list of arguments, we do not intend to compare the given fiscal framework in Europe with an ideal model.*

to balance or in surplus. The critics argue that since there is no generally accepted theory stating the optimal level of public debt, the convergence of the debt ratio toward zero implied by the medium-term objective lacks theoretical justification.[9] Furthermore, one cannot deduce from economic theory exactly how large a debt ratio is no longer sustainable in the long run.[10] The acceptance of temporary deficits in times of an economic downturn or of temporary expenditure hikes (tax smoothing) may, moreover, be welfare enhancing.

Moreover, critics argue that the demand for attainment of specific annual deficit targets forces Member States to resort to one-off and temporary measures more frequently. Allsopp and Artis (2003, p. 29) assert that the target implies that "the SWP may force adjustments that are not necessary for sustainability and that it may rule out policies that are desirable for the functioning of the system as a whole."

Critics also questioned the choice of gross debt standards, which only take into account general government financial liabilities, i.e. overstate total public sector liabilities by not correlating them with the public sector's assets (Buiter, 1985). At the same time, this approach understates the true extent of public debt because it does not consider future "implicit" expenditure, such as future pension payments or government guarantees.

The impact of a uniform deficit target for all Member States on debt levels attracted especially great criticism. With the growth performance differing among Member States, the uniform deficit target results in completely different debt dynamics (Buiter et al., 1993). While targeting the uniform deficit ratio, the new Member States in particular will achieve debt ratios substantially lower than 60% of GDP, given comparatively high output growth rates (Buiter and Grafe, 2004). Critics challenged the rationale of having a uniform deficit target also with reference to the wide range of debt ratio. Member States with lower debt ratios should be conceded more generous deficit targets (EEAG, 2003; Pisani-Ferry, 2002) and hence greater room for budgetary policy maneuver.[11] This consideration, as well as the consideration of taking into account differences in growth performance, have been integrated into the reformed SGP by allowing for more country-specific circumstances in defining the medium-term objective.[12]

Other experts (IMF, 2001; European Commission, 2003) would choose expenditure rules over deficit rules, as the emergence of budget deficits that would not be sustainable in the long run could be ascribed mainly to uncontrolled expenditure growth.

[9] *De Grauwe (2004), Canzeroni and Diba (2001) and Pisani-Ferry (2002) argue that it would make more economic sense to focus on a debt ratio target rather than a specific debt ceiling to be reached every year. To secure the long-term sustainability of public finances, Member States should be obligated to comply with a specific debt ratio whose size is determined commensurately with the implicit obligations the respective countries have.*

[10] *Basically, the accumulation of public debt presents no problem as long as the debt can be assumed to be repaid with future income (primary surpluses). However, even the achievement of a low deficit or a low debt at a particular time does not guarantee the future long-term sustainability of fiscal policy.*

[11] *Conversely, considering that high deficits have a certain inertia, as their reduction involves high political costs, the emergence of structural deficits should be prevented as a matter of principle.*

[12] *The critics also proposed linking the deficit ceiling to the dept levels (EEAG, 2003; Walton, 2004; Calmfors and Corsetti, 2003). Another strand of the discussion was to allow countries with a low debt ratio more time to correct excessive deficits.*

Admittedly, in a supranational context, such rules would tie individual Member States' hands even more than deficit rules. Furthermore, uniform expenditure rules for all Member States would be accompanied by substantial welfare losses, if the Member States had very different preferences regarding the composition of their expenditure.

Academics and policymakers alike also pointed out the negative side effects of quantitative fiscal rules and the rigid requirements of the SGP, such as a lack of flexibility, the dampening of government investment,[13] the hindrance of structural reforms – which entail short-run costs and long-run benefits – and the relinquishment of the stabilization function of the state as well as the prevention of a tax-smoothing strategy of benefit to the economy.

The cutback of investment expenditure is associated with temporarily lower political costs than a cut in social security payments, subsidies or spending on public employment.[14] Inasmuch as cutbacks of public investment spending would impair Member States' long-term growth prospects, fiscal policy targets under the SGP would contradict the other policy goals of the EU which are aimed at making the EU the most competitive region in the world by 2010. Therefore, academics (Blanchard and Giavazzi, 2004; Creel, 2003) suggested the introduction of a "golden rule" according to which the medium-term deficit target of the SGP should refer to current government expenditure including depreciation and maintenance costs and excluding net public investment. The amount of government borrowing would be limited to net government capital formation. The intergenerational advantage of this approach would support the financing of government capital formation by borrowing, as future generations would benefit from the higher productivity and the higher per capita income generated by current public investment.[15] Buiter and Grafe (2004), in turn, draw attention to the special position of the new Member States, where public investment is in fact associated with an even higher rate of return than in the EU-15.

The TEU take account of the golden rule only insofar as it states that an EDP report prepared under Article 104 (3) has to take into account whether the government deficit exceeds government investment. However, this note in the original SGP never really had any weight in the decision about the existence of an excessive deficit. Arguments against the application of a golden rule included data definition problems, the increased possibility of "creative accounting," the unequal treatment of expenditure on human and on physical capital and the economically unwarranted preference for real capital investment. At the same time it should be noted that that there is no conclusive empirical evidence

[13] *In fact, public investment (gross fixed capital formation) declined sharply in the course of 1990s – albeit not just in the EU Member States, but in all OECD countries. However, it has to be born in mind that sector reclassifications in ESA 95 also distorted downward public investment expenditure data considerably.*

[14] *The literature shows, however, that the most successful consolidations were based on reducing employment spending and transfers (Alesina and Perotti, 1995).*

[15] *A textbook on public finance theory authored by Lorenz von Stein as early as 1878 noted: "Ein Staat ohne Staatsschuld tut entweder zuwenig für seine Zukunft oder er fordert zu viel von seiner Gegenwart." ("A country that has no public debt is either doing too little for its future or is placing too high demands on its present;" German as cited in Nowotny, 1999, p. 428).*

supporting the proposition that public investment and infrastructure spending actually increase long-term growth (Easterly and Rebelo, 1993; Balassone and Franco, 2001; Perotti, 2005).

Another criticism stated that the SGP prevented governments from taking adequate measures to counteract cyclical fluctuations (Canzeroni and Diba, 2001). The SGP is focused primarily on the effect of the automatic stabilizers, which can operate fully when Member States observe the medium-term targets of achieving a budget close to balance or in surplus (Buti and Giudice, 2002; European Commission, 2002a; Artis and Buti, 2001; Buti and Franco, 2005). However, the automatic stabilizers can achieve only a certain amount of cyclical stabilization.[16] Tax reforms and reforms of the unemployment benefit systems may have reduced the effectiveness of the automatic stabilizers in the past decades. The concentration primarily on the automatic stabilizers has been identified as problematic above all because the single monetary policy of EMU has made fiscal policy more important (HM Treasury, 2003; Feldstein, 2002). The exceptionality condition allowing a temporary breach of the 3% GDP threshold during a severe economic downturn – defined as an annual fall of real GDP growth of at least 2% in the original SGP – was criticized as too harsh.

This criticism is closely linked to the reproach that the SGP has an asymmetric effect and does not provide any incentives for stepped-up fiscal consolidation during good times (Bean, 1998). As a result, Member States thus have to consolidate during downturns to comply with the deficit targets. This implies that the SGP was not suited to prevent procyclical behavior. In fact, from the public choice perspective, one could even draw the conclusion that the SGP tended to reinforce governments' deficit bias:[17] Greater consolidation efforts during high-growth phases not only reduce a government's chances of reelection, it also eases a new government's workload by sparing it the need to act procyclically if a downturn occurs.

Moreover, critics charged that as an instrument to coordinate European fiscal policy, the SGP did not guarantee an optimal fiscal stance for the euro area (Wyplosz, 2002; Casella, 2001). This charge has to be seen above all against the background of the juxtaposition of a single monetary policy with a fiscal policy that obeyed the subsidiarity principle and was thus still a national responsibility. According to Begg and Schelkle (2004, p. 90ff), "*. . .the Pact is a weak or even ill-conceived substitute for a central fiscal authority acting as a politically legitimate counterweight to the ECB. . . .There is no means of targeting the aggregate*

[16] *The concentration on the automatic stabilizers as a matter of principle must be interpreted against the background of the paradigm shift in fiscal policy. The ability of discretionary fiscal policy to stabilize output and employment was increasingly challenged on the one hand by the appearance of permanent structural budget deficits in the second half of the 1970s and in the 1980s and on the other hand by new economic theory findings (Barro, 1974). The discussion about possible non-Keynesian effects reinforced the doubts that had arisen (Blanchard, 1985, 1990; Giavazzi and Pagano, 1990; Bertola and Drazen, 1993; McDermott and Westcott, 1996; Sutherland, 1997; Perotti, 1999; Alesina et al., 2002). Taylor (2000) argues that monetary policy should principally be used for stabilization purposes.*

[17] *However, critics of the SGP and of rules-based fiscal policy consider the deficit bias and the tendency of governments to accumulate debt far less important than the need to react flexibly to short-term cyclical fluctuations and medium- to long-term challenges.*

fiscal stance and thus of establishing an appropriate policy mix to assure the macroeconomic stabilisation of the Euro area." Collignon (2003, p. 17) therefore concludes that *"only a full, democratic constitutional consensus would be able to give European stabilisation policies the coherence they need."*

The political experience gained since 1999 clearly revealed the weak enforceability of the SGP; the sanctioning mechanism also suffered from insufficient credibility.[18] The cascading procedure based on Council regulations is controlled by decision-making at the Ecofin Council level, which is characterized by an asymmetric incentive structure. The finance ministers who have to account for an excessive deficit and face possible sanctions have a greater interest to join forces to prevent sanctions than those of the other Member States do. However, in deciding on whether to impose sanctions, Member States which are not threatened by sanctions may take into account the possibility that they could in the future exceed deficit limits themselves.[19] Moreover, large countries have a greater incentive than small ones to join forces, because discretionary fiscal measures are much more effective in large and fairly closed economies than in small, open economies (Buti and Pench, 2004), where much of the impact of fiscal measures is channeled abroad through high imports. Hence, expansionary fiscal policy measures have a much lower impact on domestic production and employment in small, open economies than in large economies. In addition, the rigorous imposition of sanctions on a Member State raises the question of whether these sanctions might not detract from the political support of the EU itself, because the sanctions increase the fiscal problems of the countries concerned even more. *"The objective of heavy sanctions is to deter undesirable behaviour, but if the sanctions are too draconian, political decision makers will never dare employ them"* (Calmfors, 2005, p. 56).

18 When the original SGP was negotiated, in particular German experts pointed out that a lack of an automatic response to an existing excessive deficit could contribute to this problem (Stark, 2001; Costello, 2001).

19 This problem became clearly apparent in the decision about whether to issue a notice to France and Germany in 2003. Here, France and Germany supported each other; Portugal and Greece, Italy (EU presidency) and the United Kingdom were also against issuing a notice – partly because they were aware that they themselves might require German and French support in the future. Also, the termination of the excessive deficit procedure against Portugal despite a strongly rising debt ratio above the 60% reference value supports the suspicion of concerted collusion contrary to the spirit of the SGP. The proposal of revoking the right to vote of those finance ministers who are responsible for an excessive deficit does not provide a solution either, as it would call into question the legitimacy of supranational decision-making rules.

5 The Effectiveness of the Original Fiscal Policy Framework

Under the Treaty and the SGP, Member States have undertaken to pursue sound budgetary policies and in particular to avoid excessive public deficits. In principle, a deficit above 3% of GDP is considered excessive. A deficit overshooting the reference value would not be considered excessive if it is the result of an unusual event (an annual fall of real GDP of 2% or at least 0.75%)[20] or if the breach is judged to be minor, is only temporary and is caused by an unusual event outside the control of the Member State. To prevent excessive deficits during economic downturns, Member States have to strive to observe a "safety margin" between the current budget deficit and the reference value under normal cyclical circumstances.

The purpose of the SGP's objective of a budgetary position that is close to balance or in surplus is to ensure that no excessive deficits arise during phases of sluggish growth. The medium-term objective has been reinterpreted several times since the start of Stage Three of EMU. Initially, it was seen as the attainment of a budget literally in balance[21] or a surplus, while in recent years a cyclically adjusted deficit of 0.5% of GDP in view of measurement uncertainties has also been considered acceptable as "close to balance."

5.1 Early Warning System Proved Not to Be Very Effective

The so-called early warning procedure under the SGP aims as giving early warning to prevent the occurrence of an excessive deficit. The European Commission and the Ecofin Council assess the compliance of Member States' medium-term budget planning with the SGP on the basis of stability and convergence programs submitted annually by the Member States. If the actual budget course diverges from the medium-term budgetary objective, and hence jeopardizes attainment of the reference value, the respective Member State should be called on, by means of an early warning,[22] to take the necessary adjustment measures.

Admittedly, the early warning system was not effective in preventing the occurrence of excessive deficits in 6 of the 12 EMU member countries. Portugal was expected to have a deficit ratio of just over 4% of GDP already in 2001. Germany and France have exhibited an excessive deficit since 2002, the Netherlands in 2003. Portugal corrected its excessive deficit in 2002, resorting extensively to one-off and

[20] *Council Regulation (EC) No 1467/97 of 7 July 1997 clarifies that the European Commission when preparing a report under Article 104 (3) 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%. However, the Council when deciding, according to Article 104 (6), whether an excessive deficit exists, it 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% (but at least 0.75%) is 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.*

[21] *Interpretation of the Austrian authorities.*

[22] *The Ecofin Council addresses this early warning to a Member State on the basis of a Commission recommendation.*

temporary measures, so that the EDP was ended at the beginning of 2004.[23] In 2004, following a revised notification of data, Greece was found to have had an excessive deficit since 2000.[24] At the beginning of 2005, Italy was also found to have exceeded the 3% reference value in 2003 and 2004 (most recently also in 2005), again in the course of data revisions. Whereas the Netherlands had corrected its excessive deficit ahead of the deadline – just one year after its occurrence – by taking substantial adjustment measures, France and Germany failed to take sufficient measures even though their deadlines had already been extended to 2005 in the fall of 2003. Consequently, 6 of the 12 EMU member countries had already been subject to an EDP since the start of Stage Three of EMU. As Portugal decided not to take additional temporary measures to reduce its deficit in 2005, the country's deficit exceeded the reference value once again, and a new EDP was initiated. Outside EMU, both the United Kingdom (in 2003 and 2004) and 6 of the 10 new Member States posted deficits in excess of the 3% reference value. The United Kingdom was found to be running an excessive deficit in January 2006, when it became clear that the country's deficit would exceed the reference value again in the fiscal year 2005/06 (see annex table 1a and 1b).

Although the European Commission had proposed giving early warnings to four countries since 2002 before an excessive deficit occurred, namely to Portugal and Germany (January 2002), France (November 2002) and Italy (April 2004), the Ecofin Council issued a recommendation only to France. In the other cases, the Ecofin Council was satisfied that the respective countries had agreed to make an effort to prevent an excessive deficit from occurring. Considering that the countries later breached the 3% deficit limit, early warnings would have been justified in all three cases.[25]

Judging from the experience with the procedures that the original SGP provided for, it appears that "the overall picture is thus one of weak enforcement of the earlier rules. The early warning mechanism has not been used as it should. The excessive deficit procedure has been initiated according to the book in case of deficits above three percent of GDP (except for the UK in 2004), but deviations from the stipulations regarding subsequent procedural steps have been notorious." (Calmfors, 2005, p. 37)

5.2 Maastricht Convergence Criteria Call for Deficit Shrinkage – But Countries Have Shown Less Consolidation Commitment since the Start of Stage Three of EMU

The degree to which the EU's fiscal rules have actually influenced the Member States' behavior in the past decade also says something about these

[23] *Albeit despite a sharply rising debt ratio linked to a breach of the reference value of 60% of GDP.*

[24] *The revision of Greece's fiscal data made manifest the problem of deficiencies inherent in statistical data and the fiscal indicators used, and showed up the problem of incorrect data reporting by individual Member States to Eurostat. In a rules-based system based on simple quantitative data, the correctness of the statistical database and reported data are pivotal to the entire framework. From the outset, critics had drawn attention to the possibility that deficient data would be reported and to the liability of Member States to resort to "creative accounting" to manipulate the relevant fiscal indicators. See also von Hagen and Wolff (2004).*

[25] *The early warning issued to Ireland in 2001 represented a special case in that Ireland violated the spirit of the SGP by exercising an expansionary fiscal policy.*

rules' effectiveness. In the 1980s and in the first half of the 1990s, many European countries posted permanent structural deficits and rapidly growing debt ratios, an unsustainable development in the long run. An adjustment of budgetary developments was inevitable. When the fiscal criteria were established under the TEU as a necessary prerequisite for EMU membership, it became easier to embark on a consolidation path. The substantially improved budget indicators for 1997 were used to assess fulfillment of the convergence criteria. In the following years, however, most countries reduced their efforts to meet the convergence criteria (annex tables 2a and 2b). The procyclicality of fiscal policies in some EU Member States, especially between 1998 and 2001, supported critics' claims that the SGP was not providing for sufficient incentive mechanisms (annex charts 1a and 1b). The SGP did not give Member States an incentive to reinforce their consolidation efforts during good economic times. To the contrary, higher revenues during high growth phases still enabled countries to take expansionary fiscal measures – in Germany's case even with the approval of the Ecofin Council.[26] Since the economy began to slow down in 2001, a number of EMU member countries have posted excessive deficits that are nearly completely structural in nature. Obviously, the consolidation measures taken during the second half of the 1990s were not sufficient. Moreover, the fulfillment of the Maastricht criteria had been based partly on temporary measures and "creative accounting." With the economy slowing down, especially Germany and France refused to act procyclically and to step up their consolidation efforts.

A large number of econometric studies analyzed to what extent the European rules-based fiscal policy framework had changed the reaction function of fiscal policy. Many analyses concluded that the framework had not caused fiscal policy to become less anticyclical (Balassone and Francese, 2004; European Commission, 2004; Posen, 2005). Gali and Perotti (2003) found that the sensitivity of budget deficits to cyclical fluctuations appears to have been stronger since the mid-1990s than in the preceding decades. According to Fatás and Mihov (2004), since the introduction of the European fiscal policy framework, the use of those discretionary fiscal policy measures which are not aimed at stabilization seems to have lost importance. This allows for the conclusion that the European fiscal policy framework indeed had some disciplining effect on Member States' fiscal policy.

6 The Key Changes of the SGP

6.1 Improved Governance

Cooperation and coordination between the Member States, the European Commission and the Ecofin Council play a decisive role for the effectiveness of the SGP and the European fiscal policy framework. Therefore, when the SGP was reformed, the Member States agreed to strengthen peer support rather than continuing to rely solely on peer pressure to induce Member States to act in the spirit of and in conformity with the SGP.

[26] *The fiscal cost of a tax reform does not become evident until a country's economic growth weakens; during high growth phases, this cost is masked by the high revenue collected during boom conditions.*

The publication of decisions and recommendations of the European Commission, improved delivery conditions and quality of statistical data and the strengthening of national budget processes are intended to foster the Member States' ownership of the new SGP. Complementary national budgetary rules, greater involvement of national parliaments and of the European Commission as well as greater continuity in drawing up stability programs aim at helping to achieve the fiscal targets.

6.2 Changes to the Preventive Arm of the SGP

The definition of the medium-term objective (MTO) and the adjustment path to the MTO represent the key changes to the preventive arm of the SGP. The MTO now refers to the cyclically adjusted budgetary position net of one-off and temporary measures.

The new SGP confirmed the reasons stated in the original SGP for having an MTO, i.e. (1) to provide a safety margin with respect to the 3% deficit limit; (2) to ensure a rapid reduction of the debt ratio and to guarantee the sustainability of public finances; and (3) to guarantee sufficient room for public investment.

The new MTO, though, is no longer uniformly defined, but rather differentiated for individual Member States to take into account the characteristics of their economies. Macroeconomic variables such as potential growth and the cyclical situation, specific structural reforms and fiscal sustainability in terms of the debt ratio and population aging[27] are taken into account in determining the country-specific MTOs. Depending on the size of a Member State's debt ratio and its potential growth, the MTO shall be specified with a corridor ranging from a deficit of 1% of GDP to a (small) surplus, cyclically adjusted and net of one-off measures. Member States state their MTOs in their stability and convergence programs. The MTOs should be revised when a major reform is implemented and, as a rule, every four years to reflect new developments.

The adjustment path to the MTO should be defined in conformity with the business cycle. However, the reform reaffirmed the commitment of euro area member countries, as stated by Eurogroup finance ministers in October 2002, to strive for an improvement of their cyclically adjusted budget balances (now excluding one-off and temporary measures) by at least 0.5% of GDP a year until they reached their country-specific MTOs.[28]

To refute the charge that they exercise a procyclical fiscal policy, the Member States have committed themselves to reinforce consolidation efforts during favorable cyclical phases. In turn, the need for consolidation during phases of weak economic growth is reduced. Economic "good times" are defined in the Code of Conduct on the content and format of the stability and convergence programmes as *"periods where output exceeds its potential level, taking into account tax elasticities."* (Code of Conduct, 2005, p. 5)

[27] *No agreed method to take into account the budgetary impact of population aging in countries' MTOs has been established yet.*

[28] *This obligation also applies to ERM II members.*

Deviations from the adjustment path to the MTO or from the MTO are permissible provided that they result from structural reforms, are temporary[29] and if an appropriate safety margin to the 3% reference value is preserved. Only structural reforms that represent a short-term burden on the budget but have a positive impact on the sustainability of public finances in the long run, e.g. by reducing future expenditure or raising potential growth, are considered, though.

A systemic pension reform, i.e. the switch from a pay-as-you-go to a funded pension scheme, may be cited as a prominent example of a structural reform. In the short run, such a switch involves additional costs because the payments are routed from the public pension scheme to a privately funded scheme, but in the long run, public commitments should contract.[30]

6.3 Changes to the Corrective Arm of the SGP

If the government deficit ratio exceeds the reference value of 3% of GDP, the European Commission is still obliged under the new SGP to prepare a report under Article 104 (3). In this report, the European Commission considers whether the excess over the reference value is only temporary, whether the ratio remains close to the reference value and whether the excess results from an unusual event outside the control of the Member State concerned. Under such circumstances, no EDP is initiated, just like under the old SGP.

As in the original SGP, a severe economic downturn – now defined as a negative annual GDP volume growth rate – qualifies as exceptional. Moreover, an accumulated loss of output during a protracted period of very low annual GDP growth relative to its potential is now also considered a severe economic downturn.[31] The Code of Conduct, which was also revised, determines that the indicator for assessing accumulated loss of output is the output gap, as calculated according to the harmonized method agreed in July 2002.

When assessing whether an excessive deficit exists, the European Commission report should take into account whether the government deficit exceeds government investment and should appropriately reflect developments in the medium-term economic position (e.g. potential growth and the implementation of policies in the context of the Lisbon agenda) and in the medium-term budgetary position (in particular, fiscal consolidation efforts in "good times," debt sustainability, public investment) and any other factors which, in the opinion of the Member State concerned, are relevant. These *other factors* comprise e.g. the cost of contributions to foster international solidarity and to achieving European policy goals, notably the unification of Europe. These costs refer mainly to the cost of German unification, but also the costs of reforming Eastern European economies and the volume of net payments to the EU budget.

29 *The budgetary position should return to the adjustment path toward the MTO or to the MTO within the period covered by the stability or convergence program.*

30 *However, these reforms cannot completely guarantee a lower future pension payment burden for the government.*

31 *Council Regulation (EC) No 1056/2005 Article 1 (1) ". . .if the excess over the reference value results from a negative annual GDP volume growth rate or from an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential."*

Just like for the review to assess attainment of the medium-term objective, the cost of pension reforms is taken into account for the decision on whether there is an excessive deficit. Consideration using a linear degressive formula will be given to the net cost of the reform for the initial five years after a Member State has introduced a funded system.[32] If the net cost causes the actual deficit ratio to exceed 3% of GDP only by a small margin, the deficit cannot be considered excessive, or an excessive deficit can be considered to have been corrected.

The reference value providing for a debt ratio of 60% or less of GDP has been accorded a greater importance in the new SGP.[33] The size of the national debt ratios influences the size of the respective countries' medium-term objectives. Under Article 104 of the Treaty, government debt ratios above 60% of GDP would have to be sufficiently diminishing and approaching the reference value at a satisfactory pace. "Sufficiently diminishing" was never defined in detail. Under the reformed SGP, the Member States agreed to take into account both macroeconomic conditions (GDP growth) and gross debt for the concept of a "sufficiently diminishing" debt ratio in qualitative terms. The Ecofin Council is entitled to formulate recommendations on the debt dynamics in its opinions on the stability and convergence programs that the Member States are required to submit every year.

Key Changes at a Glance

OLD	**NEW**
Preventive Arm	**Preventive Arm**
Medium-term objective:	
Cyclically adjusted budget balances	Cyclically adjusted budget balance, net of one-off and temporary measures
Applicable to all Member States: balance of –0.5% to surplus	Country-specific: range between –1% of GDP and surplus
Adjustment path:	
At least 0.5% of GDP (euro area)	Average of 0.5% of GDP depending on the state of the business cycle (euro area and ERM II)
Corrective Arm	**Corrective Arm**
Exceptional circumstances	
Severe economic downturn:	
Growth rate: principally less than –2%/less than –0.75%	Negative growth or negative output gap for a sustained period of low growth
	Other relevant circumstances:
	Extent of government investment relative to the government deficit, medium-term economic and budgetary position, other factors which are relevant in the opinion of the Member State concerned
	Systemic pension reforms
Deadlines:	
Clear deadlines for procedure steps and in particular for the correction of the excessive deficit[34]	General extension of the deadlines for procedures and for the correction of the excessive deficit by allowing for the repetition of procedure steps

32 *Consideration will be given to 100% (first year), 80%, 60%, 40% and 20%, respectively, of the net cost of the reform.*

33 *In principle, under Article 104 of the Treaty, exceeding the reference value for the debt ratio could entail a procedure like the excessive deficit procedure. However, this was in fact never considered, as the SGP focuses on the deficit ratio.*

34 *These deadlines were not enforceable, though.*

The reform of the SGP also covers the EDP deadlines. These deadlines – for the individual procedure steps and for the period granted to correct an excessive deficit – have been extended. Moreover, in the new SGP, Member States in excessive deficit have to make a minimum fiscal effort every year. The required improvement of the cyclically adjusted balance (net of one-off and temporary measures) is at least 0.5% of GDP as a benchmark in order to correct the excessive deficit within the deadline set.

As a rule, the deadline for correction of an excessive deficit is one year after its identification, but, in case of special circumstances, a two-year deadline may be granted. Moreover, a given deadline may be extended if unexpected adverse economic events occur during the period during which an excessive deficit is to be corrected. The prerequisite for such extension is that the Member State must have taken action in compliance with the recommendation of the European Commission. Generally, new Member States may be granted longer deadlines for the correction of excessive deficits, as may Member States which implement systemic pension reforms.

7 Unresolved Interpretation Issues of the Reformed SGP

The reformed SGP has also attracted considerable criticism, above all because it is more complex than its predecessor. The greater flexibility and the stronger economic foundation of the new SGP have come at the cost of transparency and simplicity. This reflects the fact that the new SGP has tried to strike a balance between consolidation requirements and the demand for sound fiscal policies on the one hand and country-specific economic developments and public debt levels on the other hand. The assessment of national budget policies by the European Commission and the Ecofin Council has to take into account medium-term economic developments, i.e. the development of output relative to potential output. Thus, cyclical impacts on budget developments will henceforth play a more important role in the assessment, as do structural measures and public investment. However, this approach entails new definition and measurement problems, which contradict the demand for transparency and simplicity. The quantification of unobservable variables such as potential growth and the resulting output gap, variables which are crucial for the calculation of cyclically adjusted balances, involve the greatest uncertainties. Even the use of a uniform method cannot eliminate these problems, but it can guarantee that all Member States are treated as equitably as possible.

The reformed SGP is based on a number of concepts, principles and variables that had not been fully clarified by January 2006. To ensure that the SGP is applied consistently and coherently in the future rather than in an ad hoc manner, expert discussions were held to clarify the following aspects:

- Specification of what in fact constitutes exceptional circumstances of an *"accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential"*:[35] Here, both the duration (*"protracted period"*) and the severity of the economic downturn (*"very low annual GDP volume*

[35] *Council Regulation No 1056/2005 Article 2(2).*

growth relative to its potential") must be clarified. The definitions must be chosen very carefully to prevent "exceptional" circumstances from becoming the rule.

- Definition of the terms *"one-off" and "temporary measures":* Adjusting fiscal positions for such measures is intended to encourage Member States to base their consolidation strategies on sustainable measures. Moulin (2005) shows that in the past countries have typically resorted heavily to one-off measures when they were close to the 3% reference value and during economic downswings. Cases in point are Portugal, Italy and Greece.
  Moreover, the definition of one-off measures given in the Code of Conduct (*"one-off and temporary measures are measures having a transitory budgetary effect that does not lead to a sustained change in the budgetary position"*) leaves substantial room for interpretation, which is why the European Commission suggested drawing up a list of measures for which fiscal positions should be adjusted.
  Furthermore, taking into account one-off and temporary measures in the assessment of the structural budget situation changes the incentive structure for using short-term measures. Up until now, Member States have resorted to temporary deficit reduction measures above all to make their fiscal positions appear rosier than they actually were. Now, they have an incentive to conceal their true structural budget situation by depicting structural deficit-increasing measures as temporary measures. Hence, the changed incentive structure should lead to a restrictive acceptance of temporary deficit-increasing measures.
- Specification of the term *"economic good times":* The key indicator of "good times" is a positive output gap but, as agreed in the Code of Conduct, the change in the output gap shall also be given due consideration. Additionally taking into account the output gap changes has the purpose of preventing strict consolidation demands during periods of below-average growth simply because the output gap is positive. The Code of Conduct, moreover, links the concept of "good times" to the idea of "tax elasticities," which have also yet to be clearly defined. Finally, the difficulty in clearly defining "good times" is compounded by what is referred to as the "real time problem." What this means is that the ex ante assessment of cyclical conditions (output gap) at times deviates quite strongly from the ex post situation.
- The definition of *"effective action"* and *"compliance with recommendations and notices":* Under the new SGP, the deadlines for eliminating the excessive deficit may be extended provided that Member States have respected the recommendations of the Council but were prevented from reaching their target by unexpected adverse economic events. In this respect, the difficulty in implementing the SGP lies in the ability to recognize whether the measures of the Member States are sufficient and whether they are in line with the recommendations. A purely qualitative analysis of the cyclically adjusted balances can only provide a guide and must be corroborated by additional indicators.

- Definition of *"structural reforms"*: The new SGP singles out structural reforms which cost in the short run but have a positive long-run effect on Member States. In this context, the question of which structural reforms fulfill these criteria arises. In addition, measurement problems arise because the long-term benefits of reforms are difficult to determine. This also applies to structural pension reforms, which are specially emphasized by the new SGP.
- Definition of the *"country-specific MTOs"*: It is still unclear to what extent and how the country-specific costs of population aging and hence implicit liabilities should be taken into account in determining the medium-term objectives. This issue is to be clarified in the course of 2006.

In assessing the stability and convergence programs of Member States with regard to compliance with the MTOs, the European Commission and the Ecofin Council must evaluate whether Member States have met their objectives adequately and consistently. If necessary, they can urge the Member States to adjust their MTOs. This provision is intended to ensure equitable treatment of all Member States.

8 A Critical Review of Early Experience and Conclusions

The reformed SGP addresses various complaints directed at the original framework, above all criticism of a uniform medium-term budget target for all Member States regardless of country-specific growth conditions, the size of the debt ratio as a percentage of GDP and the challenge of population aging. Moreover the reform deals with the reproach that the SGP did not provide enough incentives for an anticyclical budget policy supportive of short-term growth and for a policy that strengthened the long-term growth potential.

Opting to emphasize the country-specific situation more strongly makes sense in principle because a uniform debt target can trigger completely different debt dynamics in countries with different growth performances. The country-specific component now allows Member States with a lower debt ratio and a higher growth potential greater leeway for budgetary policy and hence more scope for structural reforms that can help improve the long-term sustainability of public finances.

The required path of adjustment toward the MTO has also been revised in a manner that should, in principle, discourage procyclical policies. It remains to be seen whether the changes to the SGP are in fact supportive of a budget policy that is symmetrically balanced across the business cycle.

Moreover, the stronger focus on underlying structural budget developments aims at encouraging Member States to take permanent rather than one-off or temporary consolidation measures.

The disadvantage of the changes to the *preventive* arm of the SGP is that the new design raises methodological issues that render implementation in line with the intention of the reformed SGP more difficult. Furthermore, greater country-specific room for maneuver with regard to the MTOs reduces the safety margin to the reference value, increasing the risk of an excessive deficit. Determining the long-term fiscal advantages and the short-term fiscal burdens that structural reforms may create also involves substantial methodological problems. While the differentiation across countries strengthens the preventive arm because the Member States will hopefully embrace the reformed SGP more wholeheartedly, the reformed SGP is also less simple, less straightforward and less transparent. Consequently, it becomes harder to treat Member States equitably, and the scope for implementing the SGP less strictly is greater.

The reform of the *corrective arm* marks a move towards more flexible standards and a greater emphasis on discretion. The new rules relax the conditions for enhanced surveillance under the EDP. The modification of the "exceptional circumstances" clause for the existence of an excessive deficit increases the likelihood that deficits in excess of the reference value will not be considered excessive, even though it is understood that such breaches should remain small and temporary. The clarification of these options, which are in fact not new, increases the pressure on the Member States and the Ecofin Council, however. The reformed SGP also allows for more leeway in the timeframe for correcting excessive deficits, even though the "normal" one-year deadline following its identification has remained in place. There is also now more room for granting additional time to remedy an excessive deficit, and steps of the procedure may be repeated. The corrective arm still allows for a procyclical policy to help in correcting an excessive deficit; this procyclicality tends to be even stronger on account of the elimination of one-off measures, as the cases up to now have shown.

First experience with the reformed SGP indicates that the cyclical situation now plays a greater role in determining deadlines for the correction of an excessive deficit. In this vein, both Italy and Portugal were given a longer deadline to correct their excessive deficits (annex tables 3a and 3b) on account of "special circumstances." With regard to Italy, the Ecofin Council declared in July 2005 that Italy needed to correct its excessive deficit only by 2007, as the weak economy would have to be taken into account in implementing the severe consolidation requirement. Italy was called on to take the necessary measures to ensure a cumulative reduction in the cyclically adjusted deficit, net of one-off and other temporary measures, of at least 1.6% of GDP by 2007 relative to 2005 levels, and to deliver at least half of this correction in 2006.

In the case of Portugal, the Ecofin Council again decided that an excessive deficit existed and initiated an EDP in September 2005. Also on account of "special circumstances," Portugal was given a deadline up to 2008 to correct its excessive deficit. Both the size of the excessive deficit (after the ending of significant one-off measures), and consequently the size of the adjustment to bring the deficit below the reference value, as well as weak GDP growth were cited as special circumstances. Portugal has committed itself to achieving a structural improvement of 1.6% of GDP in 2006 and of 0.75% each in 2007 and 2008.

Indirectly, though, this concession – the higher the excessive deficit, the longer the deadline to eliminate it – is a questionable signal. Additionally, Portugal was rewarded for having declared that it would no longer resort to temporary measures. This approach reveals a possible weakness of the reformed SGP, as the Treaty actually permits both structural and temporary measures to remedy an excessive deficit.

The decisions about further procedural steps in the cases of Germany, France and Greece (originally scheduled for January 2006) are particularly crucial for the evaluation of the reformed SGP. Germany and France had obligated themselves to correct their excessive deficits by 2005. In the case of Germany, the European Commission concluded in its Autumn 2005 Forecast that the country would, nonetheless, post a deficit in excess of 3% in 2005 as well as in 2006. While the excess in 2005 may be partly explained by weaker-than-expected economic growth, the consolidation measures taken may also have been insufficient to reach the agreed target. This means that under the SGP, the European Commission would have to make a recommendation according to Article 104 (8) of the Treaty, which would establish that no effective action had been taken within the period laid down. Moreover, a recommendation to give notice to Germany under Article 109 (9) of the Treaty would be in order.[36]

In the case of France, the European Commission also expected the excessive deficit to continue to exist (Autumn 2005 Forecast). However, the excess is small at 0.2 percentage point, and can be attributed to weaker-than-expected growth. Consequently, there is no need to make recommendations pursuant to Articles 108 (8) and 108 (9) of the Treaty. However, France did not produce the agreed minimum improvement of its cyclically adjusted budget deficit; moreover, it is uncertain whether there will be a further improvement in 2006.

In July 2004 the Ecofin Council moreover identified an excessive deficit in Greece. In February 2005, Greece was given notice under Article 104 (9) of the Treaty to take measures to reduce the deficit by 2006. The Autumn 2005 Forecast of the European Commission anticipates that Greece will exceed the reference value for the deficit, which, however, will be close to the agreed target because Greece availed itself of substantial temporary measures. But the initial situation has changed on account of another substantial data revision. Now, the Ecofin Council must determine whether Greece is fulfilling its obligations under the EDP and whether it has taken sufficient action to correct its excessive deficit in 2006. If this is not the case, sanctions would have to be applied to Greece.

New Member States with an excessive deficit have been given until 2008 to correct their excessive deficits (as "special circumstances" are deemed to apply to them from the outset, with the exception of Cyprus (2005), Malta (2006), Poland (2007) and Slovakia (2007)).

The assessment of Hungary deserves special mention: Initially, the Ecofin Council allowed Hungary a deadline until 2008 to correct its excessive deficit. Upon determining that Hungary had taken insufficient measures, it subsequently issued a new recommendation under Article 104 (7) of the Treaty in March 2005. While the new recommendation retained the 2008 deadline for deficit correction, it contained a supplementary obligation for Hungary to reach interim budget targets. In November

[36] *Council On March 1, 2006, the European Commission recommended to the Ecofin Council to give Germany notice under Article 104 (9) of the Treaty to take measures to correct the excessive deficit by 2007 at the latest. The Ecofin Council adopted the relevant decision on march 14, 2006.*

2005, Hungary was once more found not to have taken effective measures to reduce its excessive deficit (pursuant to Article 104 (8) of the Treaty). In January 2006, finally, Hungary was asked to moreover submit a new convergence program by September 2006 because it had not specified the measures it would take to remedy its excessive deficit – which implies yet another recommendation by the Ecofin Council under Article 104 (7) of the Treaty.

The United Kingdom, finally, has been posting a deficit in excess of the 3% reference value since 2003. In March 2004, the European Commission drew up a report that rejected the existence of an excessive deficit on the grounds that the excess over the reference value was "small and temporary." After the United Kingdom announced in its notification of autumn 2005 that it would exceed the reference value marginally also in the fiscal year 2004/05, the European Commission drafted another report on the budgetary situation in the United Kingdom in September 2005. The Autumn 2005 Forecast of the European Commission also signaled that the deficit would remain above the reference value in 2005 and 2006, whereupon the Ecofin Council identified the existence of an excessive deficit in January 2006 and recommended that the United Kingdom put an end to the situation of excessive deficit by the fiscal year 2006/07.

Overall, one may conclude from the experience up to now that breaches of the deficit reference values will continue for some time. Budgetary discipline will tend to suffer from these breaches, and this would hamper stability-oriented monetary policymaking.

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Annex

Table 1a

Initiation of Excessive Deficit Procedures in the EU-15 since 1999

France	Germany	Greece	Italy
2002: –3.2 2003: –4.2 2004: –3.6 2005:[1] –3.2	2002: –3.8 2003: –4.1 2004: –3.7 2005:[1] –3.9	2000: –4.1 2001: –6.1 2002: –4.9 2003: –5.7 2004: –6.6 2005:[1] –3.7	2003: –3.2 2004: –3.2 2005:[1] –4.3
Report of the European Commission under Article 104 (3): April 2, 2003	Report of the European Commission under Article 104 (3): November 19, 2002	Report of the European Commission under Article 104 (3): May 19, 2004	Report of the European Commission under Article 104 (3): June 7, 2004
Opinion and recommendation of the European Commission under Articles 104 (5), 104 (6), 104 (7): May 7, 2003	Opinion and recommendation of the European Commission under Articles 104 (5), 104 (6), 104 (7): January 8, 2003	Opinion and recommendation of the European Commission under Articles 104 (5), 104 (6), 104 (7): June 24, 2004	Opinion and recommendation of the European Commission under Articles 104 (5), 104 (6), 104 (7): June 29, 2005
Decision under Article 104 (6) (and recommendation under 104 (7)) of the Ecofin Council on the initiation of a procedure to correct an excessive deficit by 2004: June 3, 2003	Decision under Article 104 (6) (and recommendation under 104 (7)) of the Ecofin Council on the initiation of a procedure to correct an excessive deficit by 2004: January 21, 2003	Decision under Article 104 (6) (and recommendation under 104 (7)) of the Ecofin Council on the initiation of a procedure to correct an excessive deficit by 2005: July 5, 2004	Decision under Article 104 (6) (and recommendation under 104 (7)) of the Ecofin Council on the initiation of a procedure to correct an excessive deficit by 2007: July 28, 2005
Assessment by the European Commission that the measures taken are inadequate; recommendation under Article 104 (8): October 8, 2003	Assessment by the European Commission that the measures taken are inadequate; recommendation under Article 104 (8): November 18, 2003	Assessment by the European Commission that the measures taken are inadequate; recommendation under Article 104 (8): December 22, 2004	Assessment by the European Commission that the measures taken are sufficient: March 14, 2006
Recommendation of the European Commission under Article 104 (9) to give notice to France: October 21, 2003	Recommendation of the European Commission under Article 104 (9), to give notice to Germany: November 18, 2003	Decision of the Ecofin Council under Article 104 (8) about the lack of effective action: January 18, 2005	
"Conclusions" of the Ecofin Council instead of giving notice and extension of the deadline for correction to 2005: November 25, 2003	"Conclusions" of the Ecofin Council instead of giving notice and extension of the deadline for correction to 2005: November 25, 2003	Recommendation of the European Commission under Article 104(9) to give notice to Greece: February 9, 2005	
Ruling of the European Court of Justice: annulment of the conclusions: July 13, 2004	Ruling of the European Court of Justice: annulment of the conclusions: July 13, 2004	Decision of the Ecofin Council under Article 104 (9) to give notice to Greece and to extend the deadline for correction to 2006: February 17, 2005	
Communication of the European Commission about the extension of the deadline for correction of the excessive deficit to 2005: December 14, 2004	Communication of the European Commission about the extension of the deadline for correction of the excessive deficit to 2005: December 14, 2004		
	Decision of the Ecofin Council to give Germany notice under Article 104 (9) of the Treaty and to extend the deadline for the correction of the excessive deficit: March 14, 2007		

Source: Calmfors, 2005, S. 34ff; http://europa.eu.int/comm/economy__finance/about/activities/sgp/edp/edpfr__en.htm
[1] *Forecast values, European Commission Autumn 2005 Forecast of November 2005.*

Table 1a – continued

Netherlands	Portugal 1	Portugal 2	United Kingdom
2003: –3.2	2001: –4.2	2005:[1] –6.0	2003: –3.3 2004: –3.1 2005:[1] –3.4
			Report of the European Commission under Article 104 (3): April 28, 2004
Report of the European Commission under Article 104 (3): April 28, 2004	Report of the European Commission under Article 104 (3): September 24, 2002	Report of the European Commission under Article 104 (3): June 22, 2005	Report of the European Commission under Article 104 (3): September 21, 2005
Opinion and recommendation of the European Commission under Articles 104 (5), 104 (6), 104 (7): May 19, 2004	Opinion and recommendation of the European Commission under Articles 104 (5), 104 (6), 104 (7): October 16, 2002	Opinion and recommendation of the European Commission under Articles 104 (5), 104 (6), 104 (7): July 20, 2005	Opinion and recommendation of the European Commission under Articles 104 (5), 104 (6), 104 (7): January 11, 2006
Decision under Article 104 (6) (and recommendation under 104 (7)) of the Ecofin Council on the initiation of a procedure to correct an excessive deficit by 2005: June 2, 2004	Decision under Article 104 (6) (and recommendation under 104 (7)) of the Ecofin Council on the initiation of a procedure to correct an excessive deficit by 2003: November 5, 2002	Decision under Article 104 (6) (and recommendation under 104 (7)) of the Ecofin Council on the initiation of a procedure to correct an excessive deficit by 2008: October 7, 2005	
Recommendation of the European Commission under Article 104 (12) to conclude the EDP: May 18, 2005	Recommendation of the European Commission under Article 104 (12) to conclude the EDP: April 28, 2004		
Decision of the Ecofin Council to conclude the EDP: June 7, 2005	Decision of the Ecofin Council to conclude the EDP: May 11, 2004		

Table 1b

Initiation of Excessive Deficit Procedures in the New Member States since 2004

Cyprus	Czech Republic	Hungary	Malta	Poland	Slovakia
2004: –4.1 2005:[1] –2.8	2004: –3.0 2005:[1] –3.2	2004: –5.4 2005:[1] –6.1	2004: –5.1 2005:[1] –4.2	2004: –3,9 2005:[1] –3,6	2004: –3,1 2005:[1] –4,1
Report of the European Commission under Article 104 (3): May 12, 2004	Report of the European Commission under Article 104(3): May 12, 2004	Report of the European Commission under Article 104 (3): May 12, 2004	Report of the European Commission under Article 104 (3): May 12, 2004	Report of the European Commission under Article 104(3): May 12, 2004	Report of the European Commission under Article 104 (3): May 12, 2004
Opinion and recommendation of the European Commission under Articles 104 (5), 104 (6), 104 (7): June 24, 2004	Opinion and recommendation of the European Commission under Articles 104 (5), 104 (6), 104 (7): June 24, 2002	Opinion and recommendation of the European Commission under Articles 104 (5), 104 (6), 104 (7): June 24, 2002	OOpinion and recommendation of the European Commission under Articles 104 (5), 104 (6), 104 (7): June 24, 2004	Opinion and recommendation of the European Commission under Articles 104(5), 104(6), 104(7): June 24, 2004	Opinion and recommendation of the European Commission under Articles 104 (5), 104 (6), 104 (7): June 24, 2004
Decision under Article 104 (6) (and recommendation under 104 (7)) of the Ecofin Council on the initiation of a procedure to correct an excessive deficit by 2005 and to prevent a further rise in the debt ratio: July 5, 2004	Decision under Article 104 (6) (and recommendation under 104 (7)) of the Ecofin Council on the initiation of a procedure to correct an excessive deficit by 2008: July 5, 2004	Decision under Article 104 (6) (and recommendation under 104 (7)) of the Ecofin Council on the initiation of a procedure to correct an excessive deficit by 2008: July 5, 2004	Decision under Article 104(6) (and recommendation under 104 (7)) of the Ecofin Council on the initiation of a procedure to correct an excessive deficit by 2006 and to prevent a further rise in the debt ratio: July 5, 2005	Decision under Article 104(6) (and recommendation under 104(7)) of the Ecofin Council on the initiation of a procedure to correct an excessive deficit by 2007: July 28, 2005	Decision under Article 104 (6) (and recommendation under 104 (7)) of the Ecofin Council on the initiation of a procedure to correct an excessive deficit by 2008: July 5, 2005
		Assessment by the European Commission that the measures taken are inadequate; recommendation under Article 104 (8): December 22, 2004			
		Decision of the Ecofin Council under Article 104(8) about the lack of effective action: January 18, 2005			
		Recommendation of the European Commission under Article 104 (7): February 16, 2005			
		Recommendation of the European Commission under Article 104(7): March 8, 2005			
		Recommendation of the European Commission under Article 104 (8): October 20, 2005			
		Decision of the Ecofin Council under Article 104 (8): November 8, 2005			

Source: Calmfors, 2005, S. 34ff; http://europa.eu.int/comm/economy_finance/about/activities/sgp/edp/edpfr_en.htm

[1] *Forecast values, European Commission Autumn 2005 Forecast of November 2005.*

Table 2a

Deficit Ratios[1] in the EU Member States

% of GDP

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Belgium	−6.8	−7.4	−8.0	−7.3	−5.0	−4.3	−3.8	−2.0	−0.7	−0.4	0.2	0.6	0.0	0.1	0.0
Germany	×	−3.0	−2.5	−3.1	−2.4	−3.3	−3.4	−2.7	−2.2	−1.5	1.3	−2.9	−3.8	−4.1	−3.7
Greece	−15.4	−11.4	−11.1	−13.4	−9.4	−10.2	−7.4	−4.0	−2.5	−1.8	−4.1	−6.1	−4.9	−5.7	−6.6
Spain	×	×	×	×	×	−6.6	−4.9	−3.2	−3.0	−1.2	−0.9	−0.5	−0.3	0.0	−0.1
France	−2.1	−2.4	−4.2	−6.0	−5.5	−5.5	−4.1	−3.0	−2.7	−1.8	−1.4	−1.6	−3.2	−4.2	−3.6
Ireland	−2.8	−2.9	−3.0	−2.7	−2.0	−2.1	−0.1	1.1	2.4	2.4	4.4	0.8	−0.4	0.2	1.4
Italy	−11.8	−11.7	−10.7	−10.3	−9.3	−7.6	−7.1	−2.7	−2.8	−1.7	−0.6	−3.2	−2.7	−3.2	−3.2
Luxembourg	4.8	1.2	0.2	1.5	2.7	2.1	1.9	3.2	3.2	3.7	6.0	6.1	2.1	0.2	−0.6
Netherlands	−5.3	−2.7	−4.2	−2.8	−3.5	−4.2	−1.8	−1.1	−0.8	0.7	2.2	−0.2	−2.0	−3.2	−2.1
Austria	−2.4	−2.9	−1.9	−4.2	−4.9	−5.6	−3.9	−1.8	−2.3	−2.2	−1.5	0.1	−0.4	−1.2	−1.0
Portugal	−6.1	−8.1	−6.0	−8.9	−6.6	−4.5	−4.0	−3.0	−2.6	−2.8	−2.8	−4.2	−2.8	−2.9	−3.0
Finland	5.3	−1.1	−5.6	−7.3	−5.7	−3.7	−3.2	−1.5	1.5	2.2	7.1	5.2	4.3	2.5	2.1
EU-12	×	×	×	×	×	−5.1	−4.3	−2.6	−2.2	−1.3	0.1	−1.9	−2.5	−3.0	−2.7
Denmark	−1.0	−2.4	−3.3	−3.7	−3.2	−3.1	−1.9	−0.5	0.2	2.4	1.7	2.6	1.4	1.0	2.3
Sweden	×	×	×	−11.6	−9.3	−7.0	−2.7	−0.9	1.8	2.5	5.1	2.5	−0.3	0.2	1.6
United Kingdom	−1.5	−2.8	−6.5	−8.0	−6.8	−5.7	−4.3	−2.0	0.2	1.0	3.8	0.7	−1.6	−3.3	−3.1
EU-15	×	×	×	×	×	−5.2	−4.2	−2.4	−1.6	−0.7	1.0	−1.2	−2.2	−2.9	−2.6

Source: Eurostat.

[1] *Including UMTS license revenue.*

Table 2b

Debt Ratios in the EU Member States

% of GDP

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Belgium	129.2	130.6	132.2	137.9	135.9	134.0	130.2	124.8	119.6	114.8	109.1	108.0	105.4	100.0	95.7
Germany	×	40.4	42.9	46.9	49.3	57.0	59.8	61.0	60.9	61.2	60.2	59.6	61.2	64.8	66.4
Greece	79.6	82.2	87.8	110.1	107.9	108.7	111.3	108.2	105.8	105.2	114.0	114.4	111.6	108.8	109.3
Spain	43.6	44.3	46.8	58.4	61.1	63.9	68.1	66.6	64.6	63.1	61.1	56.3	53.2	49.4	46.9
France	35.1	35.8	39.6	45.3	48.4	54.6	57.1	59.3	59.5	58.5	56.8	56.8	58.8	63.2	65.1
Ireland	94.2	95.6	92.5	95.1	89.6	81.8	73.3	64.5	53.8	48.6	38.3	35.9	32.4	31.5	29.8
Italy	97.2	100.8	108.1	118.7	124.8	124.3	123.1	120.5	116.7	115.5	111.2	110.9	108.3	106.8	106.5
Luxembourg	5.4	4.6	5.5	6.8	6.3	6.7	7.2	6.8	6.3	5.9	5.5	6.7	6.8	6.7	6.6
Netherlands	76.9	76.8	77.9	79.3	76.4	77.2	75.2	69.9	66.8	63.1	55.9	51.5	51.3	52.6	53.1
Austria	56.1	56.1	55.8	60.5	63.4	67.9	67.6	63.8	64.2	66.5	67.0	67.0	66.7	65.1	64.3
Portugal	58.3	60.7	54.4	59.1	62.1	64.3	62.9	59.1	55.0	54.3	53.3	53.6	56.1	57.7	59.4
Finland	14.2	22.6	40.5	55.9	58.0	57.1	57.1	54.1	48.6	47.0	44.6	43.6	42.3	45.2	45.1
EU-12	×	58.5	60.3	66.2	68.9	73.6	75.2	74.9	74.2	72.7	70.4	69.3	69.2	70.4	70.8
Denmark	63.1	64.0	69.4	81.1	77.4	73.2	69.7	65.7	61.2	57.7	52.3	48.0	47.6	45.0	43.2
Sweden	×	×	×	×	73.9	73.7	73.5	70.6	68.1	62.7	52.8	54.3	52.4	52.0	51.1
United Kingdom	34.0	34.4	39.2	45.4	48.6	51.8	52.3	50.8	47.7	45.1	42.0	38.7	38.2	39.7	41.5
EU-15	×	×	×	×	66.4	70.8	72.6	71.0	68.9	67.9	64.1	63.1	62.5	64.0	64.3

Source: Eurostat.

Table 3a

Correction Periods for Excessive Deficits in the EU-15

		2001	2002	2003	2004	2005[1]	2006[1]	2007[1]	2008
Portugal	Deficit ratio	−4.2	−2.8	−2.9	−3.0	−6.0	−5.0	−4.8	
	Deadline		— until 2003 ⟶			— — — until 2008 — — ⟶			
	Extension/correction		ED corrected						
Germany	Deficit ratio	−2.9	−3.8	−4.1	−3.7	−3.9	−3.7	−3.3	
	Deadline			— until 2004 ⟶					
	Extension/correction					until 2005	until 2007		
France	Deficit ratio	−1.6	−3.2	−4.2	−3.6	−3.2	−3.5	−3.5	
	Deadline			— until 2004 ⟶					
	Extension/correction					until 2005			
Netherlands	Deficit ratio	−0.2	−2.0	−3.2	−2.1	−1.8	−1.9	−1.5	
	Deadline				— until 2005 ⟶				
	Extension/correction				ED corrected				
Greece	Deficit ratio	−6.1	−4.9	−5.7	−6.6	−3.7	−3.8	−3.8	
	Deadline				— until 2005 ⟶				
	Extension/correction						until 2006		
Italy	Deficit ratio	−3.2	−2.7	−3.2	−3.2	−4.3	−4.2	−4.6	
	Deadline					—— until 2007 ⟶			
	Extension/correction								
United Kingdom	Deficit ratio	0.7	−1.6	−3.3	−3.1	−3.4	−3.3	−3.0	
	Deadline						— — — until ⟶ 2006/07[2]		
	Extension/correction								

Source: Eurostat. OeNB.

Note: In the last year of the correction period, the deficit ratio is to have sunk below 3% of GDP.

ED = excessive deficit.

[1] The budget deficits are forecast values (Autumn 2005 Forecast of the European Commission of November 2005).

[2] Correction period: fiscal year 2006/07.

Table 3b

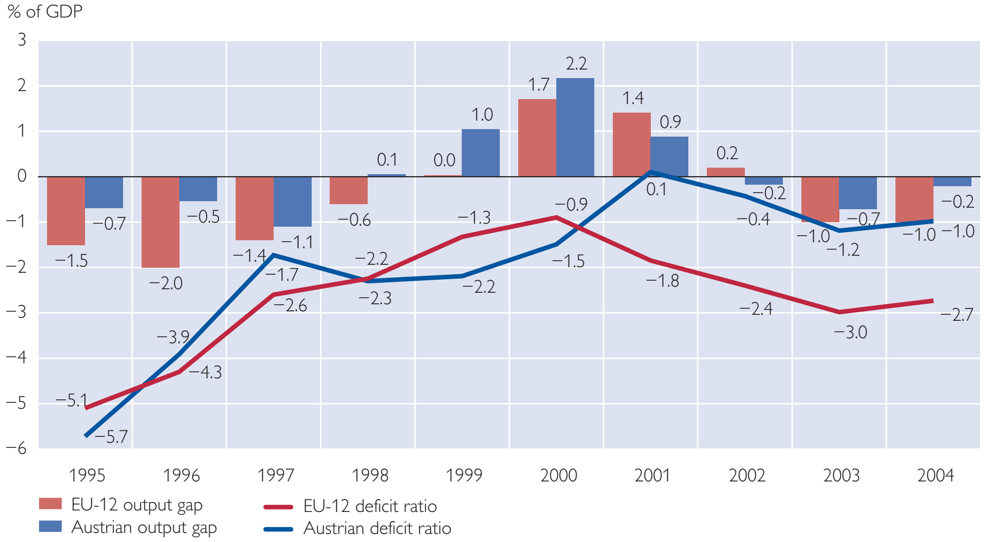
Correction Periods for Excessive Deficits in the New Member States

		2004	2005[1]	2006[1]	2007[1]	2008
Poland	Deficit ratio	**–3.9**	**–3.6**	**–3.6**	**–3.4**	
	Deadline	— — — until 2007 — — —→				
	Extension/correction					
Czech Republic	Deficit ratio	**–3.0**	**–3.2**	**–3.7**	**–3.3**	
	Deadline	— — — until 2008 — — —→				
	Extension/correction					
Hungary	Deficit ratio	**–5.4**	**–6.1**	**–6.7**	**–6.9**	
	Deadline	— — — until 2008 — — —→				
	Extension/correction					
Slovakia	Deficit ratio	**–3.1**	**–4.1**	**–3.0**	**–2.5**	
	Deadline	— — — until 2008 — — —→				
	Extension/correction					
Malta	Deficit ratio	**–5.1**	**–4.2**	**–3.0**	**–2.5**	
	Deadline	— — — until 2006 — — —→				
	Extension/correction					
Cyprus	Deficit ratio	**–4.1**	**–2.8**	**–2.8**	**–2.4**	
	Deadline	— — until 2005 — —→				
	Extension/correction					

Source: Eurostat, OeNB.
Note: In the last year of the correction period, the deficit ratio is to have sunk below 3% of GDP.
[1] *The budget deficits are forecast values (Autumn 2005 Forecast of the European Commission of November 2005).*

Chart 1a

Deficit Ratio[1] and Output Gap in Austria and in the EU-12

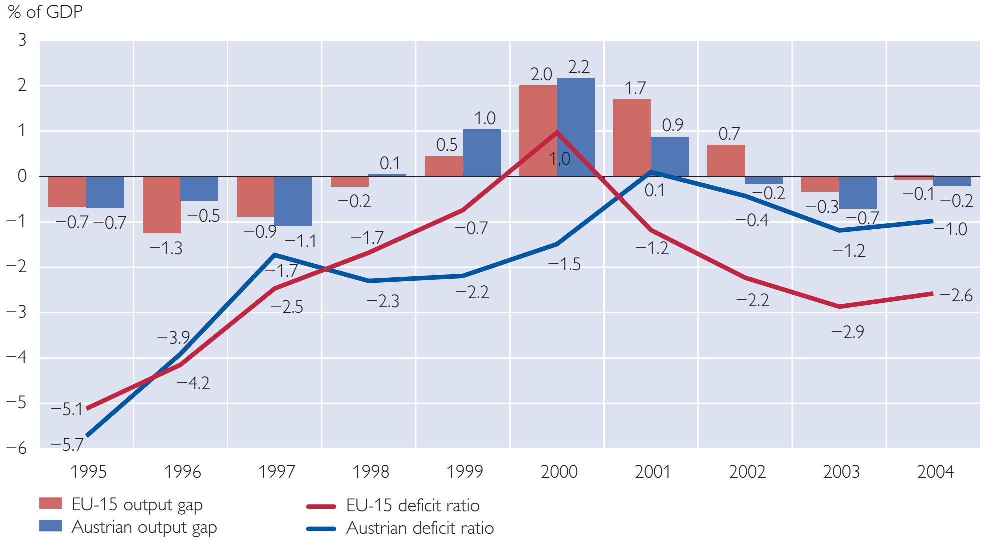


Source: AMECO database.

[1] *EDP notification.*

Chart 1b

Deficit Ratio[1] and Output Gap in Austria and in the EU-15



Source: AMECO database.

[1] *EDP notification.*