The stability and growth pact : an eventful history

Geert Langenus [(1)]

Less than ten years ago the stability and growth pact was welcomed as one of the cornerstones of the monetary union. Together with the independence of the European Central Bank, it was to offer the necessary guarantees for the stability of the single currency. However, attitudes towards the pact gradually changed and some regarded it as too tight a straitjacket. The pact therefore came in for increasing criticism, confined at first to positions adopted by certain academics but later taken up by an ever broader group of policymakers ; it should be stressed that this development coincided with the cyclical downturn from the beginning of the present decade.

The criticism gave rise to a number of reforms proposals put forward both by the Member States and by the European Commission. Owing to the often conflicting concerns, however, it was difficult to reach agreement on exactly how the existing rules should be amended. Meanwhile, dissatisfaction with the pact rules, which were felt to be too stringent, continued and their application lapsed into interpretations which were contrary to the spirit of the pact, and in some cases even violated the letter of its constituent legal texts. Pressure to amend the rules therefore only increased.

Eventually, the debate over the budgetary rules ended for the time being with a political agreement reached on 20 March 2005 at the extraordinary meeting of the Council of the European Union, the so-called Ecofin Council, and confirmed by the heads of state and government at the European Council on 22 and 23 March 2005. This agreement announced a number of changes to the pact which are fairly radical in some respects, but the practical and technical details have yet to be worked out. By 20 April 2005 the European Commission had already submitted proposals for amendments to the relevant legislation.

This article places the debate on the pact and the recent reform in a broader context. It is organised as follows. Chapter 1 looks at some of the theoretical aspects of budgetary rules. Chapter 2 recounts the genesis of the pact and explains its specific provisions and field of application. This is followed by an account of experiences with the pact and an investigation into the possible reasons for its lack of success. Chapter 4 explains and assesses the changes introduced in March 2005. The article ends with a number of concluding remarks.

1. Theoretical background

In line with the provisions on public finances in the Treaty on European Union, the stability and growth pact consists of a set of rules restricting the fiscal policy of the EU Member States and, especially, that of the countries which have adopted the euro as their currency. These rules cover certain procedural aspects but also impose numerical norms for the budgetary outcomes. The theoretical background to such numerical budgetary rules is discussed below. First, the reasons for the rules are recounted. That is followed by a brief summary of the characteristics of optimum budgetary rules reported in the literature.

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1.1 Why are budgetary rules necessary ?

Budgetary rules are generally intended to prevent undesirable budgetary outcomes and an inappropriate fiscal policy. They are therefore necessary only if policymakers are inclined to deviate significantly from what is regarded as an optimum fiscal policy.

This can happen if the time horizon of policymakers is too short because, in principle, it seems desirable that an optimum fiscal policy take account of the interests of future generations as well. However, policymakers are only dependent on current generations for maintaining their position, e.g. by re-election in the case of a democratic government. There may therefore be a temptation to favour these generations by taking on excessive debts, the burden of such a policy being transferred to future generations. Budgetary rules may be adopted in order to protect the interests of those future generations.

In this respect, budgetary rules may also originate from *political economy* considerations as it will be easier for policymakers to take unpopular but necessary consolidation measures if they are able to blame them on existing budget rules, especially if those rules are "imposed" by another level of government.

In principle, financial markets may discourage an inappropriate fiscal policy – and thus reduce the need for budgetary rules – by imposing a higher risk premium on governments with fiscal problems when setting interest rates. However, there is a danger that the functioning of this disciplinary mechanism will be imperfect. First, it is possible that, owing to problems of asymmetric information, for example, the risk premium does not fully reflect the real budgetary situation. Second, a higher risk premium may not deter governments and cause them to adjust their policy.

In a monetary union with a fragmented fiscal policy, there are even stronger arguments for strict budgetary rules. In that situation an irresponsible fiscal policy on the part of one or more governments can have undesirable spill-over effects. These may arise both between the different governments taking part in the monetary union and between fiscal and monetary policy.

As regards the former effects, the main fear in EMU was that a local fiscal slippage in one or more Member States would have adverse effects on interest rate levels throughout the union[1]. This would mean that Member States pursuing an appropriate fiscal policy are punished for an irresponsible policy in other Member States through higher interest charges or other unfavourable effects of higher interest rates. In the event of a very serious local fiscal slippage, it is even possible that other governments might feel obliged to support the offender explicitly or implicitly – by making financial transfers or by purchasing the offending government's debt titles – in order to avoid a financial crisis. Such phenomena may of course impair the monetary union's cohesion. In that connection, it must be emphasised that the smaller Member States are, of course, particularly vulnerable to spill-over effects triggered by fiscal problems in larger Member States.

In addition, there is a risk of undesirable spill-over effects on monetary policy because large government deficits or high debts can make that policy less effective. On the one hand, they may prompt the government in question to put more pressure on the central bank of the union to relax its monetary policy (and thus increase inflation, reducing the real value of the outstanding debts). On the other hand, this may distort the market's perception of a justified easing of monetary policy, causing it to be misinterpreted as motivated by the wish to reduce the real value of public debts. This can push up inflation expectations in the entire union. In the event of an impending financial crisis caused by a budgetary slippage, the monetary authority may come under irresistible pressure to take action.

However, the story does not end with the fact that a budgetary slippage in a monetary union with a fragmented fiscal policy can produce harmful spill-over effects, because it can also be argued that, in those circumstances, it actually becomes more attractive for governments to pursue an (over-)expansionary fiscal policy (Beetsma, 2001). First, it is a well-known fact that a Keynesian macroeconomic policy of demand management is more effective under fixed than under floating exchange rates. Second, the aforementioned spill-over effects mitigate the costs of such a policy since interest rates will not rise so steeply as they would if the government responsible were not a member of a wider monetary union.

In order to minimise these spill-over effects, it therefore seems advisable for the institutional architecture of a monetary union with a fragmented fiscal policy not only to provide the necessary guarantees concerning the central bank's independence and government's non-responsibility for the debts of other governments (the "no bail out" clause) but also to include strict rules which guarantee adequate budgetary discipline.

(1) However, this assumes that households do not proportionally increase their savings (e.g. for Ricardian reasons, which means that households save a larger proportion of their current disposable income, for precautionary motives, if they believe that the government will have to increase taxes or cut expenditure – including welfare benefits – e.g. in the face of a trend rise in the debt level).

1.2 How should budgetary rules be designed ?

The preceding section has argued that budgetary rules, which in general circumstances can be useful if the government's time horizon is too short, become more necessary in a monetary union with a fragmented fiscal policy. The next section examines the criteria which *good* budgetary rules must satisfy.

In the literature [1] there is a broad consensus on at least a number of requirements. It seems clear, for instance, that a good budgetary rule cannot be continually changed, must be simple to operate and transparent, should pertain to budgetary outcomes ex post (rather than budgetary targets) and must be enforced by an impartial authority which can impose effective sanctions.

However, additional requirements are often imposed upon budgetary rules in the literature : they must offer governments sufficient flexibility and should encourage growth to some extent, for example (Kopits, 2001). As regards the first point, it is typically meant that budgetary outcomes should be assessed on the basis of the policy pursued and that – when the rules are applied – account should therefore be taken of the budgetary impact of fluctuations in economic growth or of unforeseen and exogenous shocks. The growth-promoting character on the other hand pertains to the avoidance of conflicts between the application of the budgetary rules and the government's action to support economic growth.

However, it must be stressed that all these characteristics can not be easily combined in a single rule. Thus, the rule will become less simple as more flexibility is structured in. On the other hand, a very simple rule which makes no distinction between the policy and the budgetary impact of phenomena which are beyond the direct control of the government may prove difficult to enforce. Finally, there is no easy way of establishing simple, transparent rules which take proper account of the growth-promoting character of government action. The simple golden rule whereby larger budget deficits are permissible the greater is the government's expenditure on fixed capital formation, is a good example here, the implicit assumption being that all public investment projects make an equal contribution to the economy's potential growth, but that the same does not apply to expenditure on education and capital transfers or tax reductions for private-sector investments, for example.

Budgetary rules will therefore inevitably represent an imperfect compromise between all the above concerns.

(1) Cf. for example Bohn and Inman (1996) and Inman (1996).

2. The original stability and growth pact

2.1 How was the pact created ?

In the framework of the convergence criteria which had to be met in order to qualify for membership of the monetary union, the Treaty on European Union lays down reference values for the budget balance and public debt. The budget deficit could not exceed 3 p.c. of GDP unless the excess was small and the deficit was declining substantially and continuously or the small excess was temporary and exceptional. The government debt could not exceed 60 p.c. of GDP unless the debt ratio was sufficiently diminishing and approaching the reference value at a satisfactory pace.

These criteria were also the cornerstones of the excessive deficit procedure which, after the creation of the monetary union, was to ensure permanent budgetary stability. Non-compliance would trigger a corrective procedure in which the Council, on the proposal of the European Commission, could decide that the budget deficit was excessive, could call on the Member States in question to adjust their fiscal policy and could even impose certain sanctions ; in this respect it was possible to ask the European Investment Bank to reconsider its lending policy towards the Member States concerned or to require non-interest-bearing deposits and impose fines. In that regard, the Council had very wide powers and could independently determine the measures to be taken.

However, it was feared that budgetary discipline would decline or even be lost once the monetary union was formed and not all the Member States considered that the above corrective procedure provided by the Treaty constituted an adequate deterrent.

The German government of the day took the lead in pushing for additional safeguards to ensure permanent budgetary discipline in the monetary union and in 1995 it already submitted the first proposals urging for clarification and reinforcement of the budgetary rules. Those proposals soon secured the support of certain smaller Member States. Germany's position should be viewed in the light of the German public's doubts about the stability of the new currency at that time (Stark, 2001). The German electorate had to be persuaded that the ECB's monetary policy aimed at price stability would not be undermined by fiscal problems in certain Member States. The German government's proposals were therefore based on concern about the above-mentioned spill-over effects between fiscal and monetary policy. The position of the smaller

Member States may be more to do with spill-over effects between different Member States, and more particularly, the greater vulnerability of those countries to budgetary slippages in the larger Member States.

The desired adjustments to the existing rules pertained to two main issues (Stark, 2001).

First, the budgetary rules must not impair the operation of the automatic stabilisers. In order to create the necessary budgetary scope for that, the deficit level of 3 p.c. of GDP had to be presented much more explicitly as an upper limit which must never be exceeded, other than in exceptional circumstances, rather than as an aim for fiscal policy; given neutral economic conditions, and even more so when activity is buoyant, the budgetary targets needed to be more ambitious. That was the only way of safeguarding the operation of the automatic stabilisers without risking an excessive deficit of more than 3 p.c. of GDP.

Second, the deterrent effect of the excessive deficit procedure needed to be reinforced. In that respect, the various stages in the correction procedure, up to and including possible sanctions, had to be initiated more automatically in the event of an excessive deficit and made less dependent on autonomous decisions of the Council.

The debate over the clarification and reinforcement of the budgetary rules in the monetary union dragged on for more than a year because certain Member States were opposed to any curtailment of the Council's powers via fixed and strict rules and procedures. Apart from the automatic entry into force of the sanction procedure, the main points of dissension were the amount of the fines and the definition of the "exceptional circumstances" in which the budget deficit could exceed the 3 p.c. of GDP limit without being regarded as excessive (Stark, 2001).

In the end, in December 1996 agreement was reached at the Dublin European Summit, where the new rules were given their final name: the stability pact of the original German proposals became a stability and growth pact. In this way European policymakers wanted to make fully clear that permanent budgetary discipline, combined with the price stability which the ECB had to watch over, would also create the necessary conditions for sustainable growth of activity because, obviously, it is only in a situation of monetary and budgetary stability that interest rates can be expected to remain low, ultimately also benefiting growth and employment. However, it was to be several months before the new rules were translated into legislative texts.

2.2 What are the provisions of the pact?

The stability and growth pact is formally set out in three separate European documents. These are the European Council Resolution of 17 June 1997 on the stability and growth pact, the Council Regulation (EC) no. 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure and the 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[1].

Without going too deeply into the legal, technical and administrative details, the essential provisions of these legal texts are set out below. The central requirement laid down in the Treaty on European Union, whereby the Member States must not run an excessive deficit, was naturally maintained in the pact. However, a series of preventive provisions and procedures was added to the existing rules. In addition, the definition of an excessive deficit was clarified. Finally, the correction mechanisms which operate once an excessive deficit is recorded, were tightened up.

2.2.1 The preventive aspects

The "preventive" part of the pact is intended to help the Member States to avoid excessive budget deficits. In that connection, the key aspect concerns the setting of the medium-term budgetary target which must be aimed at under neutral economic circumstances. In view of the said concern over the free operation of the automatic stabilisers, this medium-term objective must be sufficiently far removed from the deficit ceiling of 3 p.c. of GDP so that, during normal cyclical downturns, the deficit remains below that level regarded as excessive.

Both the aforementioned Resolution of the European Council and Regulation (EC) no. 1466/97 define that medium-term objective – which has to offer the necessary flexibility to cope with cyclical fluctuations – as a budgetary position which is close to balance or in surplus. This meant that the budgetary targets in the monetary union became more stringent, since in the run-up to the union it was still sufficient to maintain structural budget deficits of less than 3 p.c. of GDP.

However, the pact does not define in any more detail the concept of a budgetary position close to balance or in surplus. Nonetheless, on the basis of the cyclical fluctuations observed in the past, the European

(1) It should be pointed out that the last two documents are actual legal texts whereas, in principle, the Resolution of the European Council merely defines a political commitment.

Commission (1999) did calculate the "minimum benchmarks" intended to offer a technical safety margin for avoiding any breach of the deficit ceiling under normal economic conditions. In view of the variations in the cyclical sensitivity of the budgets of the various Member States, these benchmarks ranged from a significant cyclically adjusted surplus (for Finland and Sweden) to cyclically adjusted deficits of 1 to 1.5 p.c. of GDP (for France, Greece, Italy, Germany and Belgium). Later, however, the medium-term objective was given a stricter interpretation. Thus, the European Commission (2001) argued that all Member States must at least achieve a cyclically adjusted balanced budget, although allowance was made for a potential measurement error of 0.5 p.c. of GDP in the calculation of the cyclically adjusted budget balances (so that, in practice, cyclically adjusted deficits of up to 0.5 p.c. of GDP remained acceptable). Member States with more important cyclical fluctuations or a greater budgetary sensitivity to the economic cycle needed cyclically adjusted surpluses. This upward revision in the medium-term objective was related to the desire to create a buffer for unforeseen budgetary setbacks, to bring the debt ratios down faster and to prepare the budgets for the far-reaching effects of population ageing.

Apart from the new medium-term objective, the pact also provides for multilateral surveillance procedures to make it possible to check whether each Member State is duly respecting the European budgetary rules and to correct any slippage in a timely manner. In that connection, the key elements are the so-called stability and convergence programmes and the early warning mechanism.

In the stability programmes – or, in the case of the countries which have not yet adopted the euro, the convergence programmes –, which have to be updated annually, the course of public finances in the following years is outlined, and the Member States must show how their fiscal policy is complying with the medium-term objective defined in the pact. These programmes are assessed by the European Commission and are the subject of an opinion by the Council, which can ask a Member State to adjust its programme if, for example, the underlying economic assumptions are not sufficiently realistic or the proposed budgetary measures do not suffice to meet the pact's requirements.

If the Council considers that there is a risk of an excessive deficit in a particular Member State, an early warning must be issued, formally recommending the Member State concerned to adjust its fiscal policy. That is normally done on the basis of an opinion drawn up by the European Commission and a recommendation for a decision.

2.2.2 Definition of an excessive deficit

The Treaty on European Union stipulated that, as a rule, a budget deficit of more than 3 p.c. of GDP is excessive and should be avoided. However, a small excess over the reference value which is of a temporary and exceptional nature, was allowed. Moreover, the assessment on the excessive character of the deficit rested with the Council, which had to take a decision on the basis of a report prepared by the European Commission. According to the Treaty, that report must also take account of whether the deficit exceeds government investment expenditure and of "all other relevant factors", including the medium-term economic and budgetary position. The Commission may also prepare such a report if it is of the opinion that there is a risk of an excessive deficit without the 3 p.c. of GDP limit being actually exceeded.

The Treaty thus left ample scope for interpretation regarding the definition of an excessive deficit. Especially the absence of any detailed definition of the temporary and exceptional circumstances justifying a small excess over the reference value of 3 p.c. of GDP could jeopardise legal security. The pact does much to address this problem.

Regulation (EC) no. 1467/97 stipulates that the exceptional and temporary circumstances must pertain to an unusual event which is outside the control of the Member State concerned and which has a major impact on the budgetary position, or to a severe economic downturn. As a rule, the Commission report only regards an economic downturn as exceptional if the annual fall in real GDP comes to at least 2 p.c. Nevertheless, the Council may also regard a smaller reduction in economic activity as exceptional in the light of further supporting evidence, in particular on the abruptness of the downturn or the accumulated loss of output relative to past trends. However, the Resolution of the European Council mentioned above specifies that in that case the annual fall in real GDP must come to at least 0.75 p.c. Therefore, under these rules, a smaller reduction and – even more so – a small but positive increase in activity can never justify a budget deficit of more than 3 p.c. of GDP.

This strict limitation of the concept of exceptional economic circumstances must be viewed in the light of consistency with the medium-term objective described above, namely a budget close to balance or in surplus. Only if economic activity has declined well below the trend level, e.g. as a result of a severe recession, can a cyclically adjusted budgetary position which is close to balance correspond to an actual budget deficit of more than 3 p.c. of GDP.

However, the "other relevant factors" which the Treaty requires the Council to take into account in its assessment and the degree to which they may justify a deficit of more than 3 p.c. of GDP, are not further specified in the pact either.

2.2.3 The correction mechanisms

As a rule, strict correction mechanisms are initiated if, despite the preventive aspects of the pact, a Member State still records a deficit which the Council regards as excessive. In contrast to the original excessive deficit procedure contained in the Treaty on European Union, the pact lays down a clear time schedule in this respect and failure to respect the rules should, in principle, automatically lead to sanctions.

As regards the time schedule, the basic principle is that, unless there are special circumstances, an excessive deficit must be corrected by no later than one year after its identification, otherwise sanctions will ensue. To that end, the Council must decide within three months of the official biannual reporting of budgetary data by the Member States to the European Commission (normally before 1 March and 1 September of each year) whether there are excessive deficits and, if so, recommend the Member States concerned to take effective action to eradicate them within a period to be determined by the Council of at most four months. If, by the stated deadline, the Member States fail to take effective action in compliance with the recommendations, the latter may then be published. If the Member States still fail to take effective action to comply with the recommendations, the Council will in principle issue an official notice one month later requiring that the necessary measures be taken to eliminate the excessive deficit. At this stage of the procedure, the Council may monitor the fiscal policy more closely and ask the Member States concerned to submit regular reports on the efforts made. If, within a period of two months, the Member States fail to act in compliance with the notice, then the Council must, in principle, impose sanctions. At that point, at most ten months will thus have elapsed since the official notification of the budget deficit.

The sanction first takes the form of a non-interest-bearing deposit which may vary in size from 0.2 to 0.5 p.c. of GDP, depending on the degree to which the deficit ceiling of 3 p.c. of GDP is exceeded. In addition, the Council may impose the additional sanctions specified in the Treaty on European Union, such as the obligation to publish supplementary information before issuing securities and a restriction on access to loans from the European Investment Bank. After this first sanction and until the abrogation of the decision concerning the existence of an excessive deficit, the Council assesses each year whether the Member States concerned have taken effective measures in compliance with the notice. If the excessive deficit has still not been eliminated two years after the imposition of the first non-interest-bearing deposit, these deposits may be converted into an actual fine. Hence, Member States have to record an excessive deficit for three consecutive years before an actual fine can be imposed.

2.3 To which Member States does the pact apply?

All the provisions of the stability and growth pact apply in full to the euro area countries. However, certain derogations apply in the case of the other Member States.

Roughly speaking, the latter Member States do have to avoid excessive deficits[1], but they cannot be ordered to take measures and they are not liable to the actual sanctions. Nevertheless, these Member States can still be punished in a different way if their fiscal policy is out of line with the provisions of the pact. Council Regulation (EC) no. 1264/99 of 21 June 1999, amending the rules on the Cohesion Fund, stipulates that no new projects or project stages can be financed out of this Fund if the Council, acting by a qualified majority on a recommendation from the European Commission, finds that the Member State concerned has not implemented the convergence programme "in such a way as to avoid an excessive government deficit".

3. The application of the pact: what went wrong?

Compliance with the convergence criteria for the monetary union set out in the Treaty on European Union was assessed on the basis of the macroeconomic figures for 1997. In that same year the stability and growth pact was translated into specific legal texts. This means that, from 1992 to 1997, government finances were influenced mainly by the convergence criteria concerning the budget deficit and public debt, laid down in the Treaty, whereas in the subsequent years the stability and growth pact should have served as the guiding principle. It therefore seems appropriate to compare budgetary

(1) In this connection there is a slight difference between the United Kingdom and the other Member States which are not in the euro area. Under a Protocol attached to the Treaty on European Union, the legal provision stipulating that Member States must avoid excessive deficits (Article 104 (1) of the Treaty) does formally not apply the United Kingdom (though it does apply to all other Member States). However, Article 116 (4) of that same Treaty, for which the United Kingdom did not obtain any derogation, stipulates that Member States must "endeavour" to avoid excessive deficits. The legal obligations concerning the avoidance of excessive deficits are therefore slightly less strict for the United Kingdom than for other Member States outside the euro area.

developments in those two periods. That analysis[1] is conducted below and shows that the application of the pact was certainly not an unqualified success, which is illustrated, for example, by the fact that in 2004 five euro area countries, including Germany, France and Italy, had deficits greater than or close to the reference value of 3 p.c. of GDP specified in the Treaty on European Union. This is followed by an investigation into the reasons for this lack of success.

3.1 Experiences with the pact

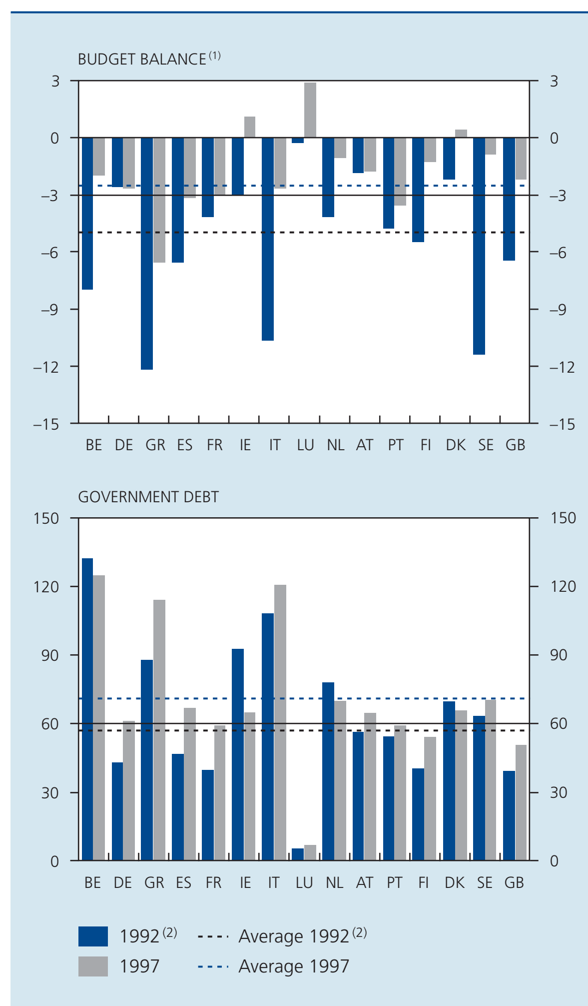
In 1992 a large majority of the then Member States still had a budget deficit far in excess of the reference value of 3 p.c. of GDP. At that time, the average deficit in the EU-15 was still around 5 p.c. of GDP[2]. Between 1993 and 1997 almost all countries improved their budgetary position, except for Germany where the deficit was already slightly below the reference value in 1992 and remained more or less unchanged thereafter. Apart from Greece, which in any case intended to join the monetary union only later, all the EU-15 Member States thus succeeded in bringing their budget deficit down to 3 p.c. of GDP or less on the basis of the statistical data available at that time (European Commission, 1998). The fact that the current statistical data for Portugal and Spain nevertheless indicate that the 1997 budget deficit exceeded the reference value (by 0.6 and 0.2 p.c. of GDP respectively) is due to later upward revisions resulting mainly from methodological changes in the calculation of these balances.

This success needs to be qualified in two respects. First, a number of large Member States continued to record budget deficits which were only just below the reference value in 1997. As a result, the average budget deficit of the EU-15 was still 2.5 p.c. of GDP in 1997 according to the current statistical data. Moreover, in certain Member States the reduction of the deficit was bolstered by non-recurring measures, although their impact was fairly limited overall (European Commission, 1998). France can be used to illustrate both points, as this Member State only managed to reduce its budget deficit to exactly 3 p.c. of GDP in 1997, and then only thanks to a substantial one-off capital transfer from France Télécom, totalling around 0.5 p.c. of GDP, in exchange for the French government's assumption of that company's pension liabilities.

In 1992 the government debt worked out at around 57 p.c. of GDP in the EU-15 on average. However, some Member States, including Belgium, recorded debt ratios far in excess of the reference value of 60 p.c. of GDP. Despite the marked improvement in the budgetary positions between 1992 and 1997, government

CHART 1 IMPACT OF THE CONVERGENCE CRITERIA CONCERNING PUBLIC FINANCES LAID DOWN IN THE TREATY ON EUROPEAN UNION

(Percentages of GDP)



Source: European Commission.
(1) According to the methodology used in the framework of the excessive deficit procedure.
(2) For Spain 1995, for Sweden 1993; for the EU-15 the 1992 average is calculated without these two Member States.

debt increased sharply during that period: at the end of 1997 it was already over 71 p.c. of GDP in the EU-15. In Greece and Italy, where the debt ratio was already very high in 1992, the debt burden continued to rise in the subsequent years. In Belgium, Ireland, the Netherlands and Denmark the debt did decline but still remained above 60 p.c. of GDP. Finally, there were other Member States such as Germany, Spain and Austria whose government debt rose slightly above the reference value during

(1) Since ten of the present twenty-five Member States only joined the EU on 1 May 2004, this analysis is confined to the other fifteen Member States. This group will hereinafter, as usual, be referred to by EU-15.
(2) This average takes no account of Spain and Sweden since no data are available for 1992 for either of these countries.

TABLE 1 EVOLUTION OF THE BUDGET BALANCES [1] SINCE THE ENTRY INTO FORCE OF THE STABILITY AND GROWTH PACT

(Percentages of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004
Belgium	–2.0	–0.6	–0.4	0.2	0.6	0.1	0.4	0.1
Germany	–2.7	–2.2	–1.5	1.3	–2.8	**–3.7**	**–3.8**	**–3.7**
Greece	**–6.6**	**–4.3**	**–3.4**	**–4.1**	**–3.6**	**–4.1**	**–5.2**	**–6.1**
Spain	**–3.2**	–3.0	–1.2	–0.9	–0.5	–0.3	0.3	–0.3
France	–3.0	–2.7	–1.8	–1.4	–1.5	**–3.2**	**–4.2**	**–3.7**
Ireland	1.1	2.4	2.6	4.4	0.9	–0.4	0.2	1.3
Italy	–2.7	–2.8	–1.7	–0.6	–3.0	–2.6	–2.9	–3.0
Luxembourg	2.9	3.2	3.4	6.2	6.2	2.3	0.5	–1.1
Netherlands	–1.1	–0.8	0.7	2.2	–0.1	–1.9	**–3.2**	–2.5
Austria	–1.8	–2.4	–2.3	–1.5	0.3	–0.2	–1.1	–1.3
Portugal	**–3.6**	**–3.2**	–2.8	–2.8	**–4.4**	–2.7	–2.9	–2.9
Finland	–1.3	1.6	2.2	7.1	5.2	4.3	2.5	2.1
Euro area	–2.7	–2.3	–1.3	0.1	–1.7	–2.4	–2.8	–2.7
Denmark	0.4	1.2	3.3	2.6	3.2	1.7	1.2	2.8
Sweden	–0.9	1.8	2.5	5.0	2.5	–0.3	0.2	1.4
United Kingdom	–2.2	0.1	1.0	3.8	0.7	–1.7	**–3.4**	**–3.2**
EU-15	–2.5	–1.7	–0.7	1.0	–1.1	–2.2	–2.8	–2.6
p.m. Excluding UMTS proceeds	*–2.5*	*–1.7*	*–0.7*	*–0.3*	*–1.1*	*–2.2*	*–2.8*	*–2.6*
Cyclical component [2]	*–0.4*	*–0.1*	*0.2*	*0.8*	*0.6*	*0.1*	*–0.4*	*–0.3*
Cyclically adjusted budget balance [2]	*–2.1*	*–1.6*	*–0.9*	*0.2*	*–1.7*	*–2.3*	*–2.4*	*–2.3*

Sources: European Commission, own calculations.
(1) According to the methodology used in the framework of the excessive deficit procedure.
(2) According to the cyclical adjustment method used by the European Commission.

that period. Ultimately, however, none of the original eleven candidate members was excluded from the monetary union on the basis of the convergence criterion relating to government debt.

After 1997 the budget deficits continued to decline. In the year 2000 the EU-15 even recorded a surplus of 1 p.c. of GDP. However, this result was due largely to a specific non-recurring factor as in that year many Member States collected substantial proceeds from the sale of UMTS licences; according to the ESA 95 national accounts methodology those proceeds are recorded as non-recurring negative expenditure and therefore improve the budget balances. In Germany and the United Kingdom the amounts involved totalled some 2.5 p.c. of GDP. Corrected for this non-recurring factor, government accounts in the EU-15 showed a deficit of 0.3 p.c. of GDP on average in 2000. More generally, public finances benefited during that period from the upturn in the economic cycle. According to the cyclical adjustment method used by the European Commission (2005b), the cyclical component of the budget balances improved from –0.4 to 0.8 p.c. of GDP between 1997 and 2000, which means that – disregarding the UMTS proceeds – somewhat more than half of the deficit reduction during that period is attributable to the favourable economic environment.

When the cycle reached a turning point in 2001 and the UMTS proceeds had largely disappeared, the budget balances began to deteriorate again. In 2003, the EU-15 recorded an average deficit of 2.8 p.c. of GDP, with only a very small reduction in the following year. This cancelled out the entire deficit reduction achieved in 1997 to 2000, so that in 2004 the budget deficit in the EU-15 was even higher than in 1997.

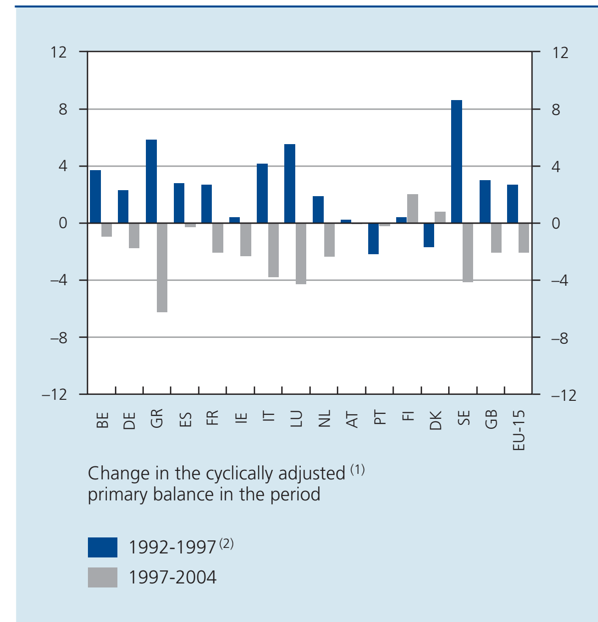
Moreover, according to the European Commission's cyclical adjustment method the influence of the economic cycle on the budget balances was slightly less unfavourable than in 1997. Hence, the cyclically adjusted deficit increased somewhat more than the actual deficit between 1997 and 2004.

These averages conceal divergent pictures for the individual Member States. Some Member States – such as Spain, Belgium, Finland and Sweden – have continued to reduce their budget deficits after 1997 and, in the case of the last three countries, even converted the deficit into a surplus. Other Member States, such as Germany, France, Greece, Portugal, the Netherlands and the United Kingdom, have recorded – in some cases persistent – excessive deficits in the past few years.

All in all, the budgetary developments in the years following 1997, when the stability and growth pact came into force, compare unfavourably to the substantial improvement in the budgetary positions during the period in which fiscal policy was guided by the convergence criteria concerning public finances laid down in the Treaty on European Union. This is due primarily to a marked reversal in the fiscal policy of almost all Member States. The differences in behaviour in the periods considered is most obvious from the change in the cyclically adjusted primary balances, which is an indicator of the fiscal policy stance.

CHART 2 FISCAL POLICY UNDER THE INFLUENCE OF THE CONVERGENCE CRITERIA LAID DOWN IN THE TREATY ON EUROPEAN UNION AND THE STABILITY AND GROWTH PACT

(Percentages of GDP)



Sources: European Commission, own calculations.
(1) According to the cyclical adjustment method used by the European Commission.
(2) For Spain 1995-1997; for Sweden 1993-1997; for the EU-15 the average is calculated without those two Member States.

The improvement in the budgetary positions between 1992 and 1997, averaging around 2.5 p.c. of GDP in the EU-15, is due entirely to a tighter fiscal policy because the cyclically adjusted primary surplus increased by around 2.7 p.c. of GDP during that period[1]. All Member States except for Denmark and Portugal, contributed to this increase. In Denmark, although the cyclically adjusted primary surplus declined by 1.7 p.c. of GDP during the period in question, it was still at a very high level of around 5 p.c. of GDP in 1997. In contrast, Portugal's cyclically adjusted primary surplus, that was still over 3 p.c. of GDP in 1992, fell to less than 1 p.c. of GDP in 1997. This clear loosening of fiscal policy, in stark contrast to developments in the other Member States, should be viewed in the light of the steep fall in interest charges in that country, brought about by convergence towards a lower level of interest rates: the amounts saved on interest charges were largely allocated to strong growth of primary expenditure (Cunha and Braz, 2003). Without that, Portugal might have been able to avoid the later budgetary problems. Other Member States did make substantial budgetary efforts during that period. In Sweden, for instance, the cyclically adjusted primary balance improved by around 8.6 p.c. of GDP between 1993 and 1997, Greece and Luxembourg increased this balance by more than 5 p.c. of GDP between 1992 and 1997 and in Italy and Belgium the improvement totalled roughly 4 p.c. of GDP over the same period.

(1) As stated in footnote 2 to charts 1 and 2, the comparison of the years 1992 and 1997 is hampered somewhat by the fact that no official data are available from the European Commission for Spain and Sweden for the former year. The averages stated for 1992 therefore disregard these two countries.

However, in the following years, all Member States except Finland and Denmark loosened budgetary discipline to some degree, although in many cases they had only just satisfied the convergence criterion for the budget balance laid down in the Treaty on European Union. From 1997 to 2004 the cyclically adjusted primary balance was reduced by more than 2 p.c. of GDP on average in the EU-15. In certain Member States, such as Germany, France, Greece, Italy and Luxembourg, the efforts made during the 1992 to 1997 period were more or less totally cancelled out.

Hence, the entry into force of the stability and growth pact, which added preventive elements, such as a more ambitious medium-term objective, to the budgetary rules and increased the deterrent effect of the excessive deficit procedure, certainly did not produce the desired effect on

the fiscal policy of all the Member States. Obviously, it is difficult to assess whether the budgetary slippage would not have been even greater without the pact. Be that as it may, the introduction of stricter budgetary rules was accompanied by a marked and strong loosening of fiscal policy.

3.2 Possible reasons for the lack of success

The reasons why many Member States have recorded excessive deficits despite the stability and growth pact lie in a combination of factors which are explained below.

3.2.1 A hiatus in the regulatory framework

When the pact entered into force, the budgets of quite a few Member States still showed significant cyclically adjusted deficits. In all the major Member States – Germany, France, Italy, Spain and the United Kingdom – they came to over 2 p.c. of GDP, while Portugal and Greece had even larger cyclically adjusted deficits. According to the new budgetary rules laid down in the pact, it was therefore necessary to make an additional effort to reduce those deficits further until the budget was at least close to balance.

However, the stability and growth pact does not formally specify the maximum length of that transition period. The aforementioned Regulation (EC) no. 1466/97 merely states that the stability and convergence programmes must cover at least the next three years, in addition to the current and the preceding year, and must describe the adjustment path towards a budget which is close to balance or in surplus. However, this provision did not explicitly refer to the actual budgetary outcomes and was too vague to provide a sufficiently stringent legal basis. Many Member States therefore delayed the full elimination of the remaining cyclically adjusted deficits as required by the pact, and often explicitly prioritised tax cuts or, in certain Member States, a looser expenditure policy.

Germany, France, Italy and the Netherlands, the largest Member States of the euro area in which the deficit reached or (substantially) exceeded the 3 p.c. of GDP ceiling, can be taken as an example here. In Germany and the Netherlands the cyclically adjusted deficit, according to current statistical data, continued to decline until around the turn of the century – in the Netherlands it actually came close to the medium-term objective of the pact – but after that it increased again to well above the 1997 level. In France and Italy the cyclically adjusted deficit never even fell below 2 p.c. of GDP.

Only much later was this institutional hiatus in the pact addressed. In a Eurogroup agreement dated 7 October 2002, which was confirmed on 7 March 2003 in a Council recommendation, the minimum adjustment speed was explicitly defined, at least for countries in the euro area: if they do not yet meet the requirements of the pact, they must achieve an annual reduction of at least 0.5 p.c. of GDP in their structural deficit. Obviously, Member States with excessive deficits, as a rule, have to make a bigger effort.

3.2.2 Over-optimistic growth expectations at the turn of the century

Another factor was that, in the years following the introduction of the stability and growth pact, the EU-15 enjoyed a very strong expansion in activity. Between 1998 and 2000, for example, the fifteen Member States recorded an average annual increase of more than 3.1 p.c. Conviction was growing that this strong activity increase was structural and that the *new economy boom* would generate higher economic growth over a long period. This lessened the pressure on governments to pursue a tight fiscal policy because the remaining deficits would be automatically eroded by the higher growth.

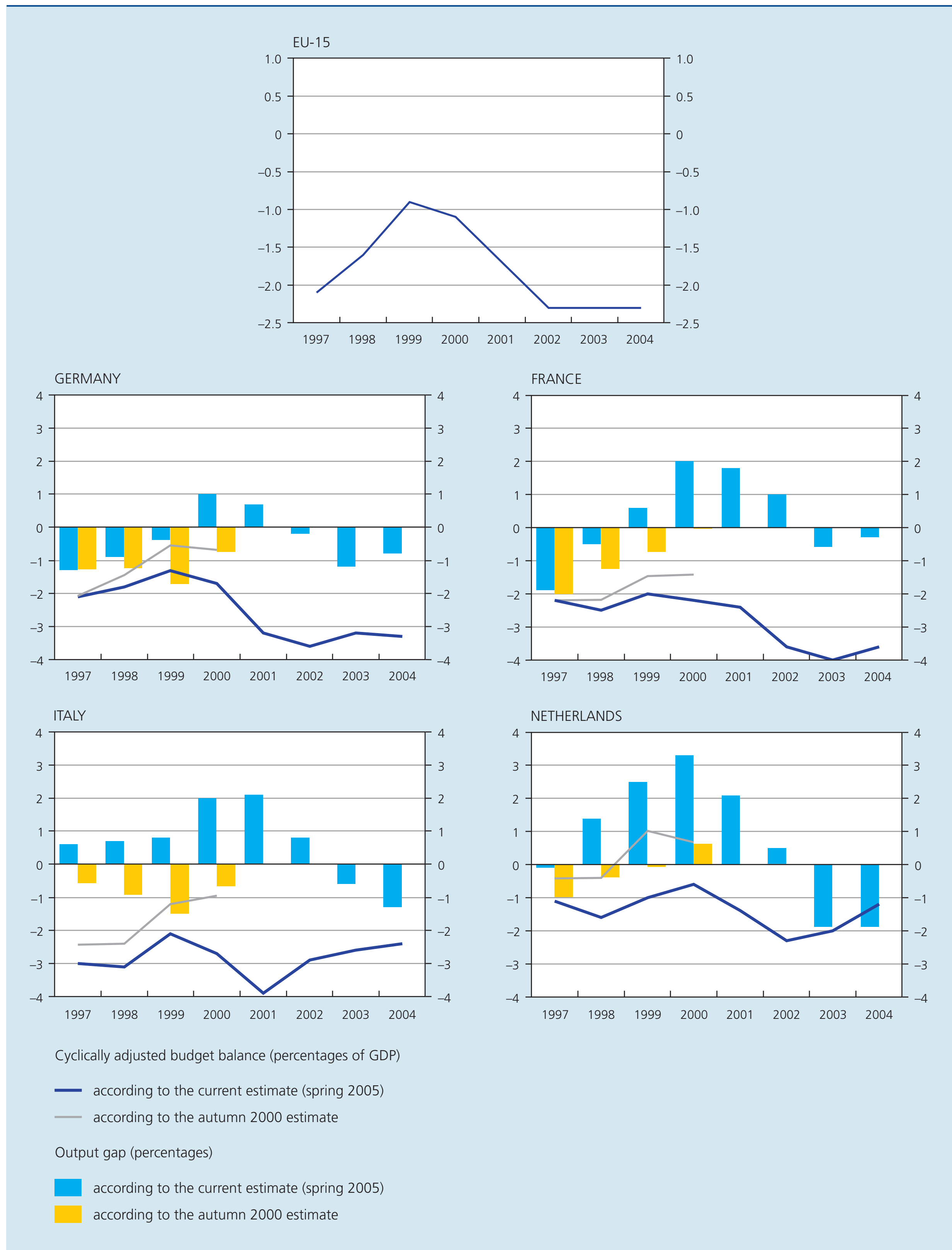
However, the protracted downturn in economic activity from the turn of the century made it clear that this optimism was not entirely justified. The over-optimistic growth expectations had two specific consequences.

First, governments based their budgets and stability programmes on macroeconomic assumptions which later proved to be far too favourable, so that the budgetary targets were often missed by a large margin. The German stability programme of October 2000 is an excellent example in this respect: that programme was based on activity growth of 2.75 p.c. in 2001 and 2.5 p.c. in subsequent years. In reality, Germany's economic growth averaged around 0.25 p.c. from 2001 to 2003.

Second, the belief in a higher trend or potential activity growth led to a misappraisal of the cyclical situation around the turn of the century. Thus, the European Commission's estimate, in the autumn of 2000, of the output gap for that year in the aforementioned four large Member States was far less favourable than is now the case [1]. The upward revisions come

(1) Mention should be made here of the fact that the method of cyclical adjustment then being used by the European Commission was still based on an estimate of the output gap derived by comparing the actual GDP with trend GDP (estimated via a Hodrick-Prescott-filter), whereas the Commission's present method of cyclical adjustment takes account of potential GDP (calculated via a macroeconomic production function). However, this methodological difference only explains a very small part of the upward revision of the output gap and, thus, the downward revision of the cyclically adjusted budget balances.

CHART 3 EVOLUTION OF THE CYCLICALLY ADJUSTED BUDGET BALANCES [1] IN THE EU-15 AND IN CERTAIN MEMBER STATES



Source: European Commission (2005b and 2000).
(1) According to the cyclical adjustment method used by the European Commission and excluding UMTS proceeds.

to 1.7 percentage points for Germany, 2 percentage points for France and as much as 2.7 percentage points for Italy and the Netherlands. This in turn led to an often substantial overestimate of the cyclically adjusted budget balances. Thus, the figures published by the European Commission in the autumn of 2000 relating to cyclically adjusted budget balances for 1997 to 2000 indicate much smaller deficits than the current estimates by that institution. In 2000, the European Commission was still assuming that France had reduced its cyclically adjusted deficit to less than 1.5 p.c. of GDP and that Germany and Italy had deficits of less than 1 p.c. of GDP and, for the Netherlands, surpluses were even reported. The overly optimistic growth expectations thus led to the wrong assessment that these four countries had already reached or were fast approaching the medium-term objective laid down in the pact.

3.2.3 The not particularly compelling corrective part of the pact

The potential penalty for failure to meet the convergence criteria set out in the Treaty on European Union was particularly severe: (temporary) exclusion from the monetary union. Although the pact specifically intended to reinforce the compulsory nature of the budgetary rules in the monetary union, the potential sanctions for an irresponsible fiscal policy in the monetary union are much lighter by comparison. Once that the monetary union is formed, the participating countries obviously cannot be expelled from it on grounds of failure to align their fiscal policy with the pact. Only in the case of deficits considered to be excessive (as a rule, higher than 3 p.c. of GDP) is it possible – following a long and difficult procedure – to impose financial penalties on them.

Furthermore, the success of a budgetary rule, as already remarked, depends on its correct implementation by an independent institution which actually imposes the prescribed sanctions. With the introduction of the pact, the policymakers of the time wanted to limit the freedom of action of the Council, the institution carrying ultimate responsibility concerning this issue, in that respect by increasing the automatic nature of the sanctions procedure for excessive deficits. Nevertheless, the pact still did not impose totally automatic penalties on Member States with excessive deficits and the progress of the corrective procedures remained dependent on formal decisions by the Council. Doubts over the strict and full application of the corrective rules and procedures and, particularly, the scope for imposing effective sanctions therefore could not be ruled out altogether.

In addition, some of the Council's decisions during the period in which the budgetary problems became fully apparent were unlikely to alleviate such doubts. In February 2002, for instance, the Council decided not to act on the recommendation by the European Commission and issue an early warning to Germany and Portugal in order to draw attention to the risk of an excessive deficit. Then in November 2003 it again failed to act on the European Commission's recommendation that France and Germany should be given notice to take measures to eliminate their excessive deficits, so that the procedure against these two Member States was de facto held in abeyance. Yet those recommendations by the European Commission already constituted a *flexible* application of the rules since both countries were given until 2005 to correct their excessive deficits whereas, according to a strict application of the time schedule defined in the pact, they should have done so by 2004 at the latest.

On 13 July 2004 the Court of Justice of the European Communities ruled that the Council, in its November 2003 decision, had breached the European Commission's right of initiative, since the Council resolutions formulated new demands which were not based on recommendations by the European Commission. However, this ruling, which mainly focussed on procedural matters, did confirm that the Council always has the right, in principle, not to act on the Commission's recommendations. Later, both the European Commission and the Council took further steps (such as the Commission's December 2004 proposal that no further action should be taken against the excessive deficits recorded by France and Germany, a proposal which the Council approved in January 2005) which weighed on the confidence in the sanction procedures. However, by that time the debate on comprehensive reform of the pact was already in full swing.

All in all, it is difficult to exclude the possibility that (sometimes justified) doubts about the effectiveness of the pact's corrective procedures contributed to the budgetary slippage in a number of Member States.

3.2.4 Problems in assessing budgetary positions

Any budgetary rule obviously depends on the correct reporting of budgetary positions. It is not possible to take prompt action against inappropriate budgetary developments if they are not reflected in the figures reported. In certain cases, however, there were clear shortcomings in the reporting of budgetary figures by the Member States and the verification thereof by the competent European institutions.

Thus, in Portugal and Greece the reported budgetary figures substantially underestimated the actual deficit. In the December 2001 stability programme and in the notification concerning the excessive deficit procedure dated March 2002, Portugal had announced a budget deficit of 2.2 p.c. of GDP for 2001. However, in the autumn of 2002 this figure was adjusted to no less than 4.1 p.c. of GDP (and later even 4.4 p.c. of GDP). In Greece's case, a similar notification in March 2004 still indicated a budget deficit of 1.7 p.c. of GDP for 2003. That figure has since been revised upwards in successive stages to 4.6 p.c. of GDP. The deficits for earlier years have also undergone substantial upward adjustment. Hence, excessive deficits have appeared in both Portugal and Greece without being expressed in the official budget statistics. When this article went to press, there were also still doubts about the accuracy of Italy's official budget figures since Eurostat had not yet approved the budgetary data notified for that country at the end of February and already revised upwards.

Assessment of the budgetary positions may also be hampered by the fact that the rules pertain mainly to the annual budgetary outcomes (and far less to the sustainability of public finances, for example), so that there may be a tendency for governments to take non-recurring measures, which in some cases improve the current budgetary balances to the detriment of future budgets. Obviously, the effectiveness and the relevance of the pact's budgetary rules is especially undermined in those latter cases.

As already remarked, in 1997 – when the budgetary outcomes were assessed in the light of the convergence criteria laid down in the Treaty on European Union – a number of Member States had made use of non-recurring measures but their extent was relatively limited overall. In the past few years, however, non-recurring measures have become particularly significant in some Member States, so that the actual budgetary outcomes are very different from the structural balances. This applies mainly to Portugal, Italy and Belgium (European Commission, 2004). In Belgium's case, for example, as far as the 2003 government accounts are concerned, there was the very substantial capital transfer from Belgacom, totalling 1.9 p.c. of GDP, in exchange for the government's assumption of the company's pension liabilities, which will therefore weigh on future budgets. Since then, however, the impact of these one-off measures has declined considerably, to an estimated 0.8 p.c. of GDP in 2004 and 0.4 p.c. of GDP in 2005.

4. The revised pact

After a prolonged debate, the Council reached agreement on 20 March 2005 on the reform of the stability and growth pact. That agreement, which was confirmed by the European Council of 22 and 23 March 2005, comprises certain changes to the pact, though the details have yet to be worked out and translated into actual amendments to the Council Regulations embodying the pact. On 20 April 2005, the European Commission proposed some specific amendments to those Regulations. When this article went to press, however, those amendments were not yet approved.

Below is a summary of the main charges followed by a brief assessment.

4.1 The main changes

The modifications approved by the Council pertain both to the preventive part of the pact and to the excessive deficit procedure. The Council also makes some proposals for an improved governance and a more correct implementation of the pact by the various institutions.

4.1.1 The preventive part

The main change to the preventive part of the pact concerns the definition of the medium-term objective of a budget close to balance or in surplus. From now on, country-specific objectives would apply depending on the debt ratio and potential growth. These targets may vary from a deficit of 1 p.c. of GDP for Member States with a low debt and high potential growth, to a balanced budget or a surplus for Member States with a high debt and low potential growth. These objectives should avoid that, in the case of a normal downturn in the cycle, the deficit exceeds the 3 p.c. of GDP level, improve the sustainability of public finances and, at the same time, allow room for budgetary manoeuvre, particularly for government investment. However, it still has to be examined how future liabilities arising from population ageing can be taken into account in the medium-term objectives; a European Commission study on this subject is requested by the end of 2006.

In addition, the rule concerning the transition to these medium-term objectives is changed slightly. Member States which belong to the euro area or take part in ERM II are asked to eliminate their deficits if their budgetary position does not yet meet the medium-term objective. In this respect, an annual reduction of 0.5 p.c. of GDP on average (instead of at least 0.5 p.c. of GDP

each year) should be taken as a benchmark. The effort should be greater when economic conditions are favourable – defined by the Council as years in which the output gap is positive[1] – as opposed to times when the cyclical situation is adverse. However, this does not appear to be a strict obligation, since Member States which deviate from the adjustment path described above are only required to explain the reasons for this in their stability or convergence programme. The European Commission can give policy advice[2] urging the Member States to follow the adjustment path.

Furthermore, deviations from both the medium-term objective and the adjustment path are permissible for the purpose of implementing certain structural reforms. In principle, the deviation must be temporary and the reforms must have a verifiable favourable impact on the sustainability of public finances. In addition, a safety margin must always be maintained to ensure that the budget deficit remains below the reference value of 3 p.c. of GDP.

Finally, the Council also explicitly states that both the medium-term objective and the speed of adjustment are measured without taking account of the influence of the economic cycle and temporary measures. The focus is therefore being shifted from merely cyclically adjusted balances to structural budget balances.

4.1.2 The excessive deficit procedure

The pact's corrective procedures are fundamentally changed. First, the definition of the exceptional circumstances in which a deficit of more than 3 p.c. of GDP is not regarded as excessive, is widened significantly. From now on, any negative activity growth and any long period in which growth is positive but substantially below the potential level would constitute an exemption.

Moreover, attention is now also explicitly paid to the "other relevant factors" which may justify a deficit of more than 3 p.c. of GDP. The Council lists a number of factors in this respect. Potential growth, the level of government investment, the sustainability of the debt, the budgetary efforts made when economic conditions were favourable and the quality of public finances, for instance, will be considered. In addition, account must be taken of all other factors which the Member State in question considers relevant, especially the "financial contributions to fostering international solidarity and to achieving European policy goals, notably the unification of Europe, if it has a detrimental effect on the growth and fiscal burden of a Member State". In all cases, the breach of the deficit limit of 3 p.c. of GDP must be limited and temporary.

In addition, the deadlines for completing the various stages in the correction procedure for excessive deficits, described in 2.2.3, are extended by one or more months. This concerns the period within which the excessive deficit must be identified (extended from 3 to 4 months), the recommended deadline for taking effective action to correct the excessive deficit (extended from 4 to 6 months) and the subsequent deadlines for giving official notice and complying therewith (extended from 1 to 2 months and from 2 to 4 months respectively).

Despite these extensions to the procedure, the Council confirms the general principle that excessive deficits must be corrected by no later than the year after they are identified[3], but the number of exceptions to this has been increased. The focus seems to have shifted somewhat away from a commitment on results to a commitment concerning means. The Member State in question is in principle required to reduce its structural deficit by at least 0.5 p.c. of GDP. It is clearly suggested, however, that the deadline for eliminating the excessive deficit may be longer if this minimum effort is not sufficient to reduce the deficit below the excessive level within the year following official identification of the problem. Moreover, the Council may decide to define the initial deadline as two years following the identification of the excessive deficit if special circumstances apply. In this respect reference is made to the aforementioned specification of the "other relevant factors". Finally, the original deadline set by the Council may be extended if the Member State fails to correct the excessive deficit as a result of unforeseen economic developments which have a significant adverse impact on the budget. However, this is possible only if the Member State took effective action in compliance with the Council's recommendations or notice.

In addition, express account will be taken of the costs associated with pension system reforms when assessing the existence or correction of an excessive deficit. On 2 March 2004 Eurostat decided that funded pension schemes cannot, as a rule, be recorded in the social security sub-sector and fall outside general government[4]. When a funded scheme is introduced, the net revenue of the system, which is generally positive at the start, therefore cannot be included in the budget balance.

(1) The Council also states that tax elasticities must be taken into account here, which may be an implicit reference to the composition effects of the economic cycle.

(2) If the Treaty establishing a Constitution for Europe takes effect, this may be replaced by an early warning.

(3) The Council explicitly states that this normally corresponds to the second year after the emergence of an excessive deficit, which rules out the possibility of the problem being identified much sooner, particularly within the same year.

(4) Later, however, a transitional period was introduced: this decision is only to be complied with from the first official notification of budgetary data in the framework of the excessive deficit procedure in 2007.

Nevertheless, such a pension reform does improve the sustainability of public finances since it reduces the pressure on the traditional pay-as-you-go schemes managed by the government. The Council therefore considered it appropriate, when assessing the budgetary situation in the Member States, to pay particular attention to this element.

Finally, the Council also states that more attention should be paid to the evolution of government debt and the sustainability of public finances. Member States with high debt ratios which are being reduced too slowly, are primarily targeted here. However, the Council does not clearly quantify the pace at which the debt ratio should approach the reference value.

4.1.3 Better governance

Apart from the said changes to the preventive and corrective procedures of the pact, the Council also makes some suggestions which should improve the implementation of the pact. It calls for instance, for closer cooperation between all parties concerned, namely the Member States, the European Commission and the Council, and for a better multilateral surveillance (under the euphemism of "peer support"). It also advocates the development of complementary national budgetary rules and surveillance procedures, continuity of the budgetary objectives when a new government takes over, and greater involvement of the national parliaments in the drafting of the stability and convergence programmes. Finally, it refers to the importance of realistic macroeconomic forecasts in the stability and convergence programmes and the need for good quality, reliable statistics on public finances.

4.2 Assessment

Any assessment of the pact's reform must take account of the fact that the application of the original rules was certainly not an unqualified success, as already stated, and was by no means particularly strict, especially in recent months. A further drift towards a situation in which the budgetary rules exist on paper but do not entail any obligations for certain Member States, would probably have caused the most damage to the credibility of the institutional framework and the macroeconomic stability of the monetary union. A reflection on the European budgetary rules and, above all, on their application was therefore not inappropriate. Furthermore, it is undeniably beneficial that certain proposals, e.g. for sharply curtailing the powers of the European Commission and not including certain expenditure items in the calculation of the budget balance relevant for the application of the rules, were not accepted.

On the other hand, the reform described above makes the pact far more complex. Almost all the rules are encumbered with – in many cases numerous – exceptions. More generally, the reform constitutes a marked shift from an institutional framework based on the application of strict rules towards a framework in which the Council has far more scope for interpretation. To some extent, that means a return towards the situation which existed before the introduction of the pact which, as already stated, was specifically introduced to (further) limit that scope for interpretation. Moreover, the increased complexity will make it more difficult to monitor compliance with the rules of the pact.

In addition, the reform clearly implies a substantial and general relaxation of the existing rules. Most striking are the changes to the corrective procedures : substantial budget deficits will be considered as problematic in fewer cases and under the new rules Member States will be allowed more time to adjust their policy if a budgetary slippage is regarded as excessive. Moreover, the ultimate threat of sanctions seems to have faded somewhat into the background.

Nor can the changes to the preventive procedures be interpreted as a tightening of the budgetary rules, although a more qualified assessment is appropriate here. The clarification that the medium-term objective and the adjustment path towards that goal pertain to structural balances rather than merely cyclically adjusted balances (i.e. also corrected for the impact of non-recurring factors) implies a stronger recommendation for structurally sound public finances and is therefore to be welcomed[1]. In addition, country-specific differentiation of these objectives based on potential growth and the public debt could, in principle, anchor the pact more firmly in economic theory. On the other hand, this reduces transparency and may give rise to (legitimate) questions concerning the equal treatment of all Member States. Moreover, these objectives – or the adjustment path imposed – appear to be less binding than the earlier provisions on the matter since the Council explicitly states that in the event of a deviation it is sufficient to set out the reasons in the stability or convergence programme. This is remarkable since the absence of a clear rule on the transition period to the medium-term objective was precisely reported to be one of the reasons for the lack of success in applying the pact in section 3.2.1. Now, the agreement reached by the Council in March 2003[2] whereby the euro area Member States must reduce their cyclically adjusted

(1) According to the aforementioned Council recommendation of March 2003 it could be assessed on a case-by-case basis whether account was taken of temporary factors.

(2) It should be stressed, however, that this agreement did not entail any formal, legal obligation.

deficits by at least 0.5 p.c. of GDP per annum, appears to be weakened.

Finally, the proposals concerning better governance naturally indicate good intentions but provide little by way of practical solutions to the implementation problems experienced in the past[1]. In that respect it is telling, for example, that the Council rejected the proposal by the European Commission to automatically approve the early warnings recommended by the Commission and addressed to the Member States. The Treaty establishing a Constitution for Europe does stipulate, however, that the Commission, without official confirmation by the Council, may address early warnings to the Member States as soon as that Treaty takes effect. It is therefore somewhat surprising that this proposal, which would permit a more effective use of the early warning instrument already now, is not included in a reform intended to improve the implementation of the pact.

All in all, the reform of the pact therefore amounts to a weakening of the existing rules. Much will now depend on the way in which this new framework is applied by the Member States, the European Commission and the Council.

5. Conclusion

This article has explained why, in a monetary union with a fragmented fiscal policy, clear and strictly applied budgetary rules are even more necessary than in other circumstances. With the stability and growth pact, which was introduced primarily at the instigation of Germany and certain smaller Member States, the institutional architecture of EMU was therefore enhanced with an instrument that should offer the necessary guarantees for a permanent budgetary stability in the union. It limited the Council's scope for interpretation in the event of inappropriate budgetary developments in favour of strict rules and procedures and constituted a decent compromise between the various criteria which good budgetary rules must satisfy. If correctly applied, the pact was flexible enough, for instance, to absorb normal cyclical fluctuations via the operation of the automatic stabilisers.

However, especially following the downturn in the cycle at the turn of the century, the pact was felt to be too restrictive. Against that background, the budgetary positions of many Member States deteriorated to such an extent that certain countries have now been suffering persistent excessive deficits for quite some time. This article has shown that the main reason for this was the marked decline in budgetary discipline after 1997, which in many cases more or less cancelled out the efforts made in preceding years, and has argued that this was due to a combination of institutional, political and statistical factors.

The recent reform of the pact makes the budgetary rules more flexible and more complex and greatly increases the Council's scope for interpretation. All parties involved now have an important responsibility in regard to the correct and objective application of the new framework. This applies in the first place to Member States which are still running excessive deficits: they must bring that situation to an end as quickly as possible and define and follow a credible adjustment path to the new medium-term objective, based on realistic macroeconomic assumptions and clearly specified measures. As regards the monitoring of compliance with the new rules, the guiding principle can only be the concern for sound public finances in the European Union.

In the end, the exact nature of the budgetary rules is less important than the actual budgetary developments. The fact that the rules become more flexible will not necessarily cause a further deterioration in the budgetary situation in the EU but will only make it easier for that to happen. In that respect, it must be remembered that, quite apart from the monetary union and its budgetary rules, most of the Member States are in urgent need of a much sounder fiscal policy for other reasons too, such as population ageing, which will weigh much more heavily on their budgets in the near future. Hence, it remains to be seen whether those Member States which, in the past few years, have not managed to avoid excessive deficits despite strict budgetary rules, can rectify that situation in the context of more flexible rules.

(1) However, it should be added that specific improvements to the statistical framework are dealt with in a separate legislative initiative.

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