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# THE REFORM AND IMPLEMENTATION OF THE STABILITY AND GROWTH PACT

by R. Morris,
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**Address**
Kaiserstrasse 29
60311 Frankfurt am Main
Germany

**Postal address**
Postfach 16 03 19
60066 Frankfurt am Main
Germany

**Telephone**
+49 69 1344 0

**Website**
http://www.ecb.int

**Fax**
+49 69 1344 6000

**Telex**
411 144 ecb d

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## ABSTRACT

Fiscal rules are instrumental for restraining deficit and spending biases in euro area Member States that could threaten the smooth functioning of Economic and Monetary Union (EMU). Ideally, fiscal rules should combine characteristics such as sufficient flexibility to allow for appropriate policy choices with the necessary simplicity and enforceability to actually discipline government behaviour. The Maastricht Treaty and the Stability and Growth Pact established such a rules-based framework for fiscal polices in EMU. However, the implementation of the Pact was less than fully satisfactory. One year ago, the Pact was reviewed and a reformed version adopted which emphasises more flexible rules and procedures, including more explicit room for judgement and discretion than in its original form. While its proponents argued that these revisions would strengthen commitment and implementation of the rules, others emphasised the risk of weakening the EU fiscal framework.

A year on from the SGP reform, this paper takes stock of how the EU fiscal rules have evolved and how they have been implemented from the Maastricht Treaty to the present day, including initial experiences with the implementation of the reformed Pact. The first indications are of a smoother and consistent implementation, but with consolidation requirements that are rather lenient while fiscal targets and projections point to only slow and back-loaded progress towards sound public finances in many countries. The assessment of the implementation of the revised rules is therefore mixed. It is of the essence that the provisions of the revised SGP be rigorously implemented in order to ensure fiscal sustainability.



JEL classification: E61, E62, H6

Key words: Stability and Growth Pact, Fiscal policy, Fiscal rules, EMU

# 1 INTRODUCTION

There is widespread consensus that sound fiscal policies are a precondition for sustainable economic growth. At the same time, there are well-grounded theories and ample evidence to suggest that governments do not always have the right incentives to pursue an appropriate fiscal course, or that they avail themselves of the means to do so. Unless restrained in some way, governments tend to spend beyond their means and incur large deficits and rising debt, which risks undermining economic stability and growth.

In recent decades fiscal rules have been adopted by a number of countries as a means of correcting such deficit and spending biases. In the euro area, an additional rationale for such rules stems from the increased potential for fiscal policy spillovers. The Maastricht Treaty and the Stability and Growth Pact (henceforth "the SGP" or "the Pact") provide a rules-based framework which is designed to prevent and eventually correct excessive government deficits and ensure that Member States' fiscal policies support the smooth functioning of EMU. However, the European fiscal rules came under increasing strain when a number of Member States – in particular the larger ones – incurred excessive deficits as defined by the Treaty. In March 2005 the EU's finance ministers agreed on a number of changes to the SGP, with the stated aim of strengthening it and improving its implementation.

While the basic rules, notably the 3% and 60% limits on deficit and debt in relation to GDP, have remained in place, the reformed Pact is more flexible and provides more explicit scope for exercising judgement and discretion than in its original version. However, enforcement provisions, considered by many to be the main shortcoming of the Pact, were not improved. Reactions to the reformed Pact have been mixed. Proponents of the reform consider that better adaptation of the rules to differing economic circumstances and needs will enhance commitment to them and thereby facilitate their enforcement. Opponents, by contrast, have criticised the changes as representing a watering-down of the rules, making them more complex and less transparent, and as a sign of a lack of commitment to fiscal discipline on the part of the Member States of the European Union. The ECB saw some of the changes as potentially helpful but also expressed serious concerns that other changes risked weakening the SGP. It therefore called for a rigorous and consistent implementation of the revised rules that would be conducive to fiscal discipline and would help restore the credibility of the EU fiscal framework.[1]

A year on from the SGP reform, this paper takes stock of the evolution of the EU fiscal rules and their implementation, and examines initial experiences with the revised framework. Section 2 provides some background to the SGP by recalling the basic rationale for fiscal rules, together with some of the issues related to their design and enforcement that have been highlighted in the literature. Section 3 then gives an overview of the EU fiscal rules and their implementation since the signing of the Maastricht Treaty up until the reform of the Pact. Section 4 provides an overview and brief assessment of the reform, while Section 5 examines initial experiences with the implementation of the new framework in the light of the updated stability programmes submitted by Member States and ongoing Excessive Deficit Procedures.[2] Finally, Section 6 concludes.

# 2 SOME BACKGROUND TO THE SGP: THE POLITICAL ECONOMY OF FISCAL RULES

## 2.1 DEFICIT AND SPENDING BIASES

The primary rationale for fiscal rules such as those prescribed by the SGP relates to the observation that, unless restrained in some way,

1 See ECB (2005).

2 In this paper, our analysis focuses on the experience of euro area countries, although most of the provisions of the SGP also apply to the non-euro area Member States.

**Table 1 Deficit and spending biases: fiscal developments in the euro area, United States and Japan, 1977-1991**

(as a % of GDP)

| | Average budget balance | Debt | | | Total expenditure | | |
|---|---|---|---|---|---|---|---|
| | 1978-1991 | 1977 | 1991 | *Change* | 1977 | 1991 | *Change* |
| Belgium | -8.0 | 59.5 | 127.1 | *67.6* | 50.7 | 52.4 | *1.8* |
| Germany | -2.2 | 26.8 | 39.5 | *12.7* | 46.7 | 45.8 | *-1.0* |
| Greece | -8.7 | 19.9 | 82.2 | *62.3* | 28.8 | 44.7 | *15.9* |
| Spain | -3.9 | 12.9 | 43.4 | *30.5* | 25.6 | 42.6 | *17.0* |
| France | -1.9 | 19.8 | 36.2 | *16.4* | 42.4 | 49.4 | *7.1* |
| Ireland | -8.1 | 60.0 | 94.4 | *34.4* | 40.1 | 38.4 | *-1.7* |
| Italy | -10.3 | 54.8 | 98.0 | *43.3* | 38.3 | 52.3 | *13.9* |
| Luxembourg | 1.9 | 11.9 | 4.1 | *-7.9* | 39.7 | - | - |
| Netherlands | -4.3 | 38.3 | 73.7 | *35.3* | 47.4 | 51.2 | *3.8* |
| Austria | -2.7 | 28.5 | 56.1 | *27.6* | 44.1 | 49.5 | *5.4* |
| Portugal | -6.4 | 27.3 | 57.7 | *30.3* | 28.9 | 38.9 | *10.0* |
| Finland | 2.9 | 7.8 | 22.4 | *14.6* | 39.9 | 54.0 | *14.1* |
| **Euro area** | **-4.2** | **29.9** | **57.4** | ***27.5*** | **42.2** | **48.2** | ***6.0*** |
| Japan | -1.4 | 34.9 | 64.8 | *29.9* | 28.3 | 30.2 | *1.9* |
| US | -4.1 | 47.3 | 72.0 | *24.7* | 32.7 | 36.6 | *3.9* |

Source: European Commission, AMECO database. Data for general government.

fiscal policies are prone to deficit and spending biases. Evidence for such biases can clearly be seen in the fiscal performance of most industrialised countries in recent decades, with those in Europe being no exception. Between 1977 and 1991, when the Maastricht Treaty was signed, all of the current euro area countries except Finland and Luxembourg ran persistent budget deficits (see Table 1).[3] The aggregate deficit of the euro area countries was, on average, above 4% of GDP during this period, while deficit ratios in Belgium, Greece and Italy typically approached or exceeded 10%. As a consequence, government debt increased significantly, with the euro area aggregate debt-to-GDP ratio virtually doubling from 30% in 1977 to almost 60% in 1991. Meanwhile, expenditure-to-GDP ratios also increased sharply in most countries. Such developments were not confined to Europe: the US and Japan also ran persistent deficits, and witnessed similarly large increases in their debt ratios as well as, to a lesser extent, their spending ratios.

Over time, persistently high deficits and rising debt levels such as those experienced in the late 1970s and 1980s are likely to have a detrimental impact on economic stability and growth. From the point of view of a central bank, profligate fiscal policies can also make it more difficult to conduct a stability-oriented monetary policy. Among other things, high deficit and debt levels may reduce the scope for governments to use fiscal policy as a tool for stabilising domestic demand, since deficits that are increasing from already high levels could spark fears concerning the sustainability of public finances. Excessive government borrowing may contribute to inflationary pressures and put upward pressure on interest rates, which would crowd out private investment. Higher debt also increases the interest payment burden, which for the euro area rose from around 2% of GDP in 1977 to around 5% in 1991, with the result that government spending tends to be diverted from more productive uses.

The economic literature has identified a number of reasons why deficit and spending biases are persistent, notwithstanding the well-understood benefits of fiscal discipline.[4] Such biases

3 The start of this period, 1977, marks the first year for which data for government debt according to Maastricht definitions are available for all euro area countries.

4 For surveys, see Alesina and Perotti (1995b), Mueller (2003) and Schuknecht (2005); for new evidence in industrialised countries, see Balassone and Francese (2004).

ultimately derive from a combination of myopic behaviour and transaction costs in the political process. In democracies voters are represented by politicians who are in turn aided by administrations. The resulting institutional set-up, while varying across countries, generally gives rise to principal-agent relationships in which moral hazard and asymmetric information can easily lead to suboptimal spending and taxation decisions.

Within this framework, the first well-known origin of deficit bias is *fiscal illusion*. Voters do not fully understand the intertemporal budget constraint (i.e. the extent to which today's tax and spending decisions will require future tax increases or expenditure reductions) because their so-called "information costs" are too high. Higher spending and/or lower taxes are therefore popular, even if they are not sustainable, and this creates an incentive for politicians to behave myopically. This is especially true in the period preceding an election, which can give rise to *electoral cycles*. Such behaviour is also likely to lead to asymmetric stabilisation, with higher deficits during recessions and more limited or no surpluses in booms (Buchanan and Wagner, 1977).[5] The problem of myopic behaviour may be exacerbated if governments alternate frequently, since a political party that does not expect to be re-elected will most likely assign very little weight to the future costs of its decisions. In fact, an incumbent government may even be interested in expanding the deficit, as this may force its political opponents to take unpopular decisions to deal with its consequences.

Spending biases can result from what is known as the *common pool problem*. The costs of public spending are borne primarily by the national (or in some countries the regional) tax base. The costs are thus widely spread, both geographically and across interest groups. By contrast, the benefits of individual spending programmes are often focused on a particular local constituency or sector (e.g. a decision to build a new road). Interest groups are therefore formed to lobby for such spending, while politicians that represent particular constituencies or have links to the particular sectors concerned will tend to vote for inefficient spending ratios (Buchanan, Rowley and Tollison, 1986; von Hagen and Harden, 1994; Persson and Tabellini, 2000). Problems of *representation and distribution* can also exacerbate such biases. Fiscal policy may be impeded by "wars of attrition" across interest groups (Alesina and Drazen, 1991), while public debt may be seen as a means of distributing money from tomorrow's rich (taxpayers) to today's poor (recipients of benefits), as children and the unborn do not have lobbying power in that they cannot vote, and are thus underrepresented in the political process (Cukierman and Meltzer, 1989).

Even if governments genuinely wish to correct fiscal imbalances, there are reasons why this may be difficult to achieve. Spending and deficit biases can be entrenched as a consequence of self-interested bureaucracies which, through various mechanisms, are able to secure budget allocations that are higher than would be economically efficient (Niskanen, 1971). Moreover, once fiscal imbalances have built up, their correction is likely to be marred by the problem of *time inconsistency* (Kydland and Prescott, 1977).[6] Ex ante the government may announce fiscal adjustment, but ex post there are likely to be economic or political reasons why it wants to renege on its promise and undertake additional spending. Hence economic actors have no reason to assume fiscal consolidation in their reaction functions.

5 There are numerous variants of election cycle models, and there is an increasing body of evidence on political business cycles. Recent empirical studies that are relevant in the EU context include Buti and van den Noord (2003) and von Hagen, Hughes-Hallet and Strauch (2001).

6 The problem of time inconsistency is typically used to explain the inflation bias of a government-directed monetary policy (Barro and Gordon, 1983). Even if the government commits itself ex ante to pursuing an anti-inflationary course, it will be tempted once wage contracts have been set to pursue an expansionary monetary policy that reduces real labour costs and stimulates additional employment. However, rational wage negotiators will ultimately anticipate this and money wages will adjust ex ante to the expected monetary expansion. The same logic can also be applied in the fiscal domain.

Most theories of deficit and spending biases focus on these kinds of relationships between politicians, bureaucracies and an under-informed public. More recently, however, another strand of the literature has developed regarding the role played by *financial markets* in monitoring public finances.[7] In principle, financial markets should exert discipline on governments by pricing government debt in relation to the perceived risks of government insolvency.[8] However, due to asymmetric information and incentive problems, there is a widespread perception that the reactions of financial markets to fiscal developments can be deficient (i.e. they exhibit delayed, volatile and non-linear behaviour). In this context, financial market monitoring of fiscal positions can be seen as suffering to a certain extent from the same problems as monitoring by voters.

In EMU the elimination of exchange rate movements between participant countries has arguably weakened one of the mechanisms through which financial markets can exert discipline on fiscal policies. The development of an integrated currency area-wide capital market also implies that the cost of additional borrowing in terms of higher interest rates is at least partly spread across the entire currency area rather than being confined to the Member State concerned. There may be some countervailing factors in EMU, such as the free movement of capital, which could subject euro area governments to more market pressure. However, there is at least potentially a further distortion of fiscal incentives stemming from the adoption of a single currency that could exacerbate deficit and spending biases.

The sharing of a single currency implies that the spillover effects of excessive borrowing in one country on other countries is likely to be greater than would otherwise be the case. In recent years a considerable literature has developed on the issue of such spillovers or externalities as a rationale for EMU wide-fiscal rules.[9] Given the combination of a single monetary policy with decentralised fiscal policies, fiscal rules in EMU provide a means of ensuring an adequate degree of fiscal policy co-ordination with a view to ensuring the overall cohesion of the euro area.[10]

## 2.2 THE ROLE AND DESIGN OF FISCAL RULES

Fiscal rules have been increasingly adopted in recent years as a means of constraining fiscal policy. Such rules can take many different forms and can consist of supposedly "hard" (i.e. legally binding) or "soft" (i.e. reputation-based) constraints on policymakers or some combination of the two. Fiscal rules supplement the monitoring of fiscal policy by voters and by financial markets. By providing a benchmark against which the actual course of fiscal policy can be assessed, a fiscal rule provides useful summary information which greatly reduces monitoring costs. This in turn should have a positive influence on the government's incentive structure (Schuknecht, 2005). Complying with the rule should be rewarded, as expectations of fiscal discipline are translated into better election prospects and more favourable financing conditions. By contrast, failure to comply provides a signal that fiscal policy is inappropriate, which should have a correspondingly detrimental impact on the government's fortunes.

The adoption of a fiscal rule per se is not, however, a sufficient condition for improving fiscal outcomes. The influence that a rule has on fiscal behaviour depends on its design and the way in which it is implemented. In particular, the rule and its rationale need to be understood and supported by all parties concerned (i.e. politicians, voters and markets), and credible enforcement mechanisms need to be in place.

7 For an overview of the links between fiscal policy and the financial markets, see ECB Monthly Bulletin, February 2006.
8 Some evidence of financial market monitoring has been found (Afonso and Strauch, 2004; Bernoth, von Hagen and Schuknecht, 2004; Faini, 2004; Balassone, Franco and Giordano, 2004). An implicit assumption is that markets do not expect a (full) bailout.
9 See for example Detken, Gaspar and Winkler (2004).
10 See ECB (2001).

In recent years it has become customary to assess the quality of fiscal rules in relation to a set of criteria, of which the most frequently cited are those proposed by Kopits and Symansky (1998). According to Kopits and Symansky, optimal fiscal rules should be:

- *Well-defined*. The indicators that serve as targets, their institutional coverage (e.g. general versus central government) and the specification of escape clauses should be clear in order to facilitate monitoring and prevent creative accounting.

- *Transparent*. Accounting, forecasting and institutional arrangements should be clearly communicated, thereby reducing the scope for creative accounting or misrepresentation of facts.

- *Adequate*. The rule should be geared to the corresponding policy objective. For example, a rule aimed at ensuring the sustainability of public finances would preferably target the primary surplus or the debt-to-GDP ratio.

- *Simple*. Rules should be simple in order to enhance their appeal to politicians and the public. This favours rules expressed in terms of the actual (nominal) budget balance, as opposed to structural deficits that depend on more complex theoretical concepts.

- *Flexible*. Not all circumstances that affect public finances can be anticipated, and some flexibility is desirable to accommodate exogenous shocks beyond the control of the authorities, for example by allowing the operation of the automatic stabilisers.

- *Consistent*. Fiscal rules should be consistent both internally and with other macroeconomic policies or policy rules. For example, the fiscal rules should not promote an expansionary fiscal stance when there are already inflationary pressures.

- *Enforceable*. Fiscal rules need to be backed by appropriate constitutional or legal norms, and the consequences of non-compliance, whether in the form of financial, judicial or reputational sanctions, should be clearly agreed upon.

- *Efficient*. Fiscal rules should be supported by efficient policy actions, for example, by making structural adjustments rather than having recourse to one-off measures.

As Kopits and Symansky point out, however, no fiscal rule can fully combine all desirable attributes. For example, a rule specifying that the overall budget should always be in balance would be very simple and easy to understand for politicians and voters. However, this may not be consistent with macroeconomic stabilisation objectives if it results in a pro-cyclical fiscal policy (tightening in recessions and loosening during booms) which then places greater strain on monetary policy. A rule that takes into account the impact of the cycle on the budget balance might be more consistent and more flexible, facilitating the operation of the automatic fiscal stabilisers. However, it may be less transparent and harder to enforce, since estimates of the cyclically adjusted budget balance may be subject to considerable ex post revisions, which would then create uncertainty as to whether the rule is actually being complied with. Inevitably, some trade-offs between these optimal characteristics have to be made and priorities have to be balanced.

Regarding implementation and enforcement, a useful checklist is provided by Inman (1996) (see also Buti, Eijffinger and Franco, 2003). Adequate enforcement requires that compliance with the rule is assessed ex post and not only ex ante. It is not the setting of the budget but the actual execution of the budget in line with the rule that matters. In this context, the missing of targets should not easily be excusable. Enforcement should be undertaken by an independent agency, and compliance with the rules should be open to scrutiny by individual citizens or groups, who should be able to request an investigation. Penalties for non-compliance should be sufficiently large. It should also be

difficult for politicians to change the rules themselves. Only if these conditions are mostly in place are fiscal rules likely to deter profligate fiscal behaviour. By contrast, fiscal rules are unlikely to have much of an influence on the government if the latter concludes that it will be easy to justify non-compliance.

In particular, the effectiveness of a fiscal rule crucially depends on how it deals with non-compliance or the missing of targets. Most fiscal rules include some element of conditionality, for example allowing deviations from the rule in the case of adverse surprises (e.g. a natural disaster or a severe recession). However, if such conditionality goes too far, it is liable to raise monitoring costs and invite moral hazard. For example, if compliance is conditional on a certain growth outcome projected by the government, the latter may be tempted to overestimate economic growth. If, as is then likely, growth turns out to be lower than projected, the government can argue that the failure to meet its fiscal target was due to exogenous factors beyond its control. Since the monitoring authority's information set is usually inferior to that of the government, it is often difficult to challenge the latter's version of events. In order to be effective, therefore, a fiscal rule needs to include an element of enforcement in terms of some target that must be achieved except in the most extreme circumstances, even if it could be argued that this might lead to some ex post inefficiencies, such as less fiscal discretion.

In the multilateral setting of EMU, some further considerations regarding the design of fiscal rules also need to be taken into account. Fiscal rules at the EU level need to constrain deficit and spending biases while also respecting the principle of subsidiarity and the fact that Member States remain fundamentally responsible for the conduct of their own fiscal policies. The EMU fiscal rules therefore need to be adequate with respect to securing the objective of sound public finances that support the smooth functioning of EMU, but should not further impinge on domestic policy choices. This partly explains why the EMU fiscal rules focus on deficit and debt levels as opposed to, for example, expenditure even though excessive spending may be at the root of high deficits in some countries. The EMU fiscal rules also need to be robust with respect to the different economic and institutional characteristics of the various Member States, while also guaranteeing equal treatment.

There are therefore many factors to be taken into consideration when designing or assessing the appropriateness of fiscal rules for EMU. The following sections provide an overview of the EMU fiscal rules, their evolution, and the implications for fiscal policies in the euro area.

# 3 THE EMU FISCAL RULES AND THEIR IMPLEMENTATION: FROM MAASTRICHT TO THE SGP REFORM

## 3.1 FROM MAASTRICHT TO THE SGP

To address concerns that large deficits and rising debt could threaten the smooth functioning of EMU, the Maastricht Treaty introduced into the European Community Treaty (henceforth "the Treaty") a number of rules aimed at disciplining EU Member States' fiscal policies. These include the prohibition of monetary financing of deficits by the European System of Central Banks (ESCB) (Article 101) and the so-called no-bail-out clause, which states that European institutions or Member States shall not be liable for or assume another Member State's financial obligations (Article 103). The former contributes to a clear separation between monetary policy and fiscal policy, which should ensure that a stability-oriented monetary policy is not directly compromised by excessive government borrowing. The latter makes clear that in EMU, Member States do not have to bear the cost of financing other Member States' debt, which should encourage financial markets to distinguish between different euro area governments' debt instruments, thereby

strengthening financial market discipline on fiscal policies.

In addition to these basic safeguards, the Treaty obliges Member States to avoid "excessive deficits" assessed against the reference values of 3% of GDP for the deficit and 60% of GDP for debt (Article 104). The sustainability of a government's financial position, in the sense of not having a deficit that is excessive as defined by Article 104 of the Treaty, is one of the convergence criteria for adoption of the euro. Moreover, breaches of the reference values result in the initiation of an Excessive Deficit Procedure (EDP) with the aim of examining and, if necessary, correcting the situation. For Member States that have adopted the single currency, this procedure can ultimately lead to financial sanctions. However, the procedure as laid down in the Treaty is in no sense mechanistic, and ultimately leaves it to the discretion of the EU Council of Ministers of Economic Affairs and Finance (henceforth the "ECOFIN Council") to decide whether to take action.

In the years that followed the signing of the Maastricht Treaty, the 3% reference value served as a simple yardstick of the success of fiscal policy and received considerable prominence in the public debate. It greatly facilitated monitoring of fiscal performance by the public and by financial markets, since in most countries the objective of qualifying for adoption of the euro attracted widespread support, and discussion of the costs and benefits of being "in or out" was very prominent in the political debate. Indeed, a number of governments staked their reputations on bringing deficits below 3% in time to be among the first wave of euro area countries and, as a consequence, fiscal balances in most EU Member States improved significantly in the run-up to monetary union (see Table 2).[11] For the euro area as a whole, the general government deficit was reduced from 4.5% of GDP in 1991 to below 3% in 1997. The structural improvement

11 For a more detailed overview of fiscal developments since the early 1990s, see Briotti (2004).

**Table 2 Fiscal consolidaton in the run up to the single currency**

(as a % of GDP)

| | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|---|
| **General government budget balance** | | | | | | | |
| Belgium | -6.0 | -6.8 | -7.0 | -4.7 | -4.4 | -3.8 | -2.0 |
| Germany | -3.2 | -2.7 | -3.4 | -2.5 | -3.2 | -3.3 | -2.6 |
| Greece | -11.4 | -12.6 | -13.6 | -9.9 | -10.2 | -7.4 | -6.6 |
| Spain | -4.2 | -3.9 | -6.6 | -6.0 | -6.5 | -4.8 | -3.1 |
| France | -2.0 | -3.8 | -5.6 | -5.6 | -5.5 | -4.1 | -3.0 |
| Ireland | -2.2 | -2.4 | -2.3 | -1.5 | -2.1 | -0.1 | 1.1 |
| Italy | -9.7 | -9.2 | -9.1 | -8.8 | -7.4 | -6.9 | -2.6 |
| Luxembourg | 1.5 | 0.6 | 1.3 | 2.3 | 2.3 | 1.1 | 3.5 |
| Netherlands | -2.7 | -3.6 | -3.0 | -3.5 | -4.0 | -1.7 | -1.1 |
| Austria | -2.9 | -1.9 | -4.1 | -4.8 | -5.6 | -3.9 | -1.7 |
| Portugal | -5.5 | -2.7 | -5.6 | -5.6 | -5.2 | -4.5 | -3.4 |
| Finland | -1.5 | -5.7 | -7.8 | -6.0 | -6.2 | -3.5 | -1.2 |
| **Euro area** | **-4.5** | **-4.7** | **-5.5** | **-4.9** | **-5.0** | **-4.2** | **-2.6** |
| **Cyclically adjusted budget balance** | | | | | | | |
| **Euro area** | **-5.4** | **-5.2** | **-4.6** | **-4.3** | **-4.5** | **-3.4** | **-2.0** |
| **General government debt** | | | | | | | |
| **Euro area** | **57.4** | **59.2** | **65.0** | **67.6** | **72.2** | **73.9** | **73.5** |

Source: European Commission, AMECO database.
Note: The figures presented in the table are those that are currently available under the ESA 95 accounting framework. They show that in 1997, the government deficit stood above the 3% of GDP reference value in two countries that entered EMU in 1999 (Spain and Portugal). The figures available at the beginning of 1998, when the decision on the countries entering EMU was taken, were based on ESA 79. Those figures showed deficits that complied with the 3% of GDP limit.

in the budget balance was even more significant, amounting to more than 3 percentage points of GDP.

Nonetheless, concerns remained that the fiscal rules as set out in the Maastricht Treaty would not provide enough of a "stick" to ensure fiscal discipline once the "carrot" of participation in the single currency had been eaten. There were also concerns that mere compliance with the 3% of GDP reference value may not be sufficient to maintain or reduce debt to reasonable levels. Moreover, pro-cyclical fiscal policies would be the result if Member States were forced to increase taxes or reduce spending during recessions in order to keep their deficits below 3% of GDP. In terms of the Kopits and Symansky criteria, the 3% deficit rule was simple; however, on its own it was neither fully efficient nor adequate from a longer-term perspective. Such concerns led to the negotiation and signing of the SGP, which sought to put more flesh on the bones of the fiscal framework of the Maastricht Treaty.

## 3.2 THE "ORIGINAL" STABILITY AND GROWTH PACT

The SGP aims to prevent excessive deficits through policy surveillance and coordination, and to deter as well as correct excessive deficits by providing clear rules for the application of the EDP. It is primarily based on two Council Regulations, which in accordance with their aims and functions are often referred to as the "preventive arm" and the "corrective arm" (or "deterrent arm") of the Pact.[12] These were backed by a solemn declaration of the European Heads of State or Government, which expressed Member States' political commitment to implementing the rules in a strict and timely manner.[13]

Under the preventive arm, Member States submit annual stability programmes, which present information regarding their economic and fiscal policies.[14] These programmes include in particular the "medium-term objective" of fiscal policy and, where applicable, the adjustment path towards it. In its original form, the SGP specified that the medium-term objective should be a budget that is "close to balance or in surplus". The rationale was both to ensure fiscal positions that would be sustainable in the long run while also creating sufficient room for fiscal policy to help smooth output fluctuations in the short run without breaching the 3% of GDP deficit ceiling.[15] The generic term "close to balance or in surplus" reflected the fact that while budgets close to balance should, as a rule, be sufficient to ensure sustainable fiscal positions, some countries might wish to target surpluses with a view to reducing debt ratios more rapidly and preparing for the costs of ageing populations.

The Member States' stability programmes are assessed by the Commission and may be examined by the ECOFIN Council, which can choose to make public its opinion on each programme. The preventive arm also includes an early-warning device whereby the Council can issue recommendations to Member States to take corrective measures if budgetary developments point to the risk of an excessive deficit. Overall, however, the emphasis of the preventive arm is on "soft" procedures which foster fiscal discipline and policy coordination through multilateral surveillance and peer pressure.

By contrast, the corrective arm relies on stricter and more formal procedures designed to enforce fiscal discipline in countries where deficits

12 The two Council Regulations are Council Regulation 1466/97 "on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies" (the preventive arm), and Council Regulation 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure" (the corrective arm). These are supplemented by a European Council Resolution on the Stability and Growth Pact and a Code of Conduct, although these are not legally binding.
13 Resolution of the European Council on the Stability and Growth Pact, Amsterdam, June 1997.
14 Non-euro area Member States submit convergence programmes.
15 On the role of budgetary policy in responding to cyclical developments in the context of the SGP see Stark and Manzke (2002).

have become excessive and are therefore giving rise to greater concern. To this end, the EDP already outlined in the Treaty was clarified and "speeded up", in particular with regard to the following:

– *Exceptional circumstances*: The conditions under which a deficit above 3% could be deemed exceptional and temporary (and therefore not excessive) were defined strictly as cases in which a country experiences an annual fall in real GDP of at least 2%. A fall in real GDP of between 0.75% and 2% could also be deemed exceptional in the light of supporting evidence submitted by the Member State in question regarding the accumulated output loss and the abruptness of the downturn.

– *The deadline for the correction of excessive deficits*: It was specified that the correction of an excessive deficit should be completed "in the year following its identification unless there are special circumstances", although the nature of such special circumstances was not explicitly defined.

– *The timing of procedural steps*: A timetable with precise deadlines for the various steps of the procedure was laid out whereby, in the event of non-compliance by a Member State with the recommendations and decisions of the Council, the time between the reporting of a deficit above 3% of GDP and the imposition of sanctions should be no more than ten months.

– *The nature of sanctions*: It was clarified that, if the Council were to impose sanctions on a Member State, a non-interest bearing deposit would be required which, in the event of a further two years of non-compliance, would be converted into a fine.

With these clarifications, the corrective arm of the SGP provided for a strict and timely application of all elements of the EDP. Nonetheless, it fell short of the original proposal of the German government, which had supported a fully automatic sanctioning mechanism outside the standard Treaty framework (Stark, 2001). Such automatism was considered inappropriate by some Member States. The SGP that was finally agreed instead took the form of EU secondary legislation with decisions to be taken within the standard legislative framework (i.e. Council recommendations or decisions, adopted by qualified majority, on the basis of recommendations by the Commission). The Commission therefore preserved its "right of initiative", while the Council ultimately retained discretion in taking decisions within an overall rules-based framework.

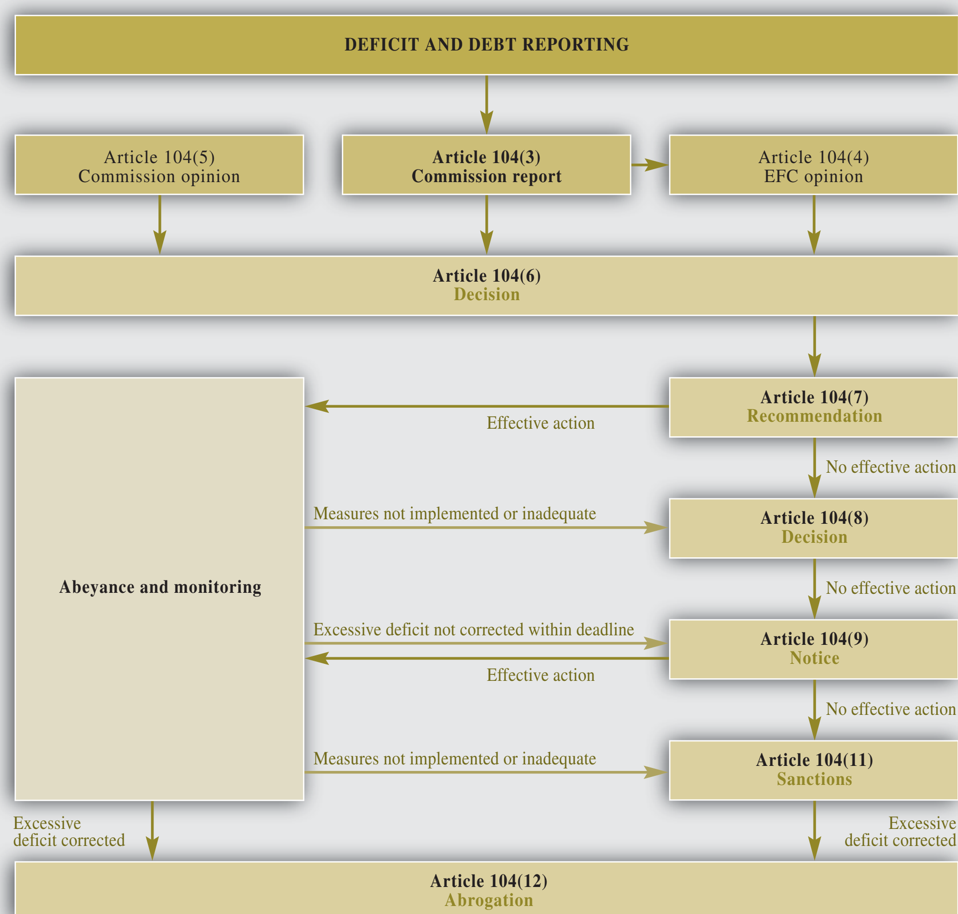
Box 1

### THE EXCESSIVE DEFICIT PROCEDURE

An EDP is triggered whenever a country's planned or actual deficit-to-GDP ratio exceeds the reference value of 3%. In addition, an EDP can be launched in the case of a debt-to-GDP ratio that is above 60% unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

*Identifying excessive deficits (Articles 104(3)–(6))*: The procedure is initiated by the preparation of a Commission report (in accordance with Article 104(3) of the Treaty) on the economic and budgetary situation in the Member State concerned. This report examines, among other things, whether the breach of the reference value is exceptional (i.e. due to an unusual event outside the control of the Member State concerned, or because of a severe economic downturn) and

## The main steps of the Excessive Deficit Procedure




temporary (i.e. it would be corrected following the end of the unusual event or severe economic downturn). The Economic and Financial Committee and the Commission then give their opinions (in accordance with Articles 104(4) and 104(5) respectively) as to whether or not the deficit is excessive.[1] On the basis of the Commission's report and the aforementioned opinions, the ECOFIN Council then decides whether or not there is an excessive deficit (Article 104(6)).

*Council recommendation (Article 104(7))*: If the Council decides that an excessive deficit exists, the procedure then provides for a sequence of steps to be taken with a view to building up pressure on the Member State concerned to take corrective action. The first step consists of the issuance of a Council recommendation (Article 104(7)) to the Member State concerned, which follows immediately after a Council decision (under Article 104(6)) that a deficit is excessive. The recommendation sets, in particular, the deadline for the correction of the excessive deficit, which should be completed in the year following its identification unless

1 The Economic and Financial Committee is a committee of senior officials from national administrations and central banks which advises the Commission and the ECOFIN Council on economic and financial issues.

there are special circumstances. It also sets a deadline for the Member State concerned to take effective action in compliance with the Council's recommendation.

*Council notice (Article 104(9))*: If the Member State takes effective action in the form of announced fiscal measures in response to the Council's recommendation, the procedure is put in abeyance and the Commission and the Council then monitor the implementation of these measures and their effectiveness. If, by contrast, the Member State does not take effective action, the Council decides on this issue (Article 104(8)) and adopts a decision giving notice to the Member State to take measures to correct the situation (Article 104(9)). Council decisions under Articles 104(8) and 104(9) are also called for in case announced measures are subsequently not implemented or prove to be inadequate to correct the excessive deficit within the set deadline. Like the earlier Council recommendation, the notice sets a deadline for the correction of the excessive deficit and a deadline for effective action to be taken.

*Sanctions (Article 104(11))*: Once again, if effective action (in the form of announced measures) is taken in response to the Council notice, the procedure is put in abeyance and developments are monitored. If, by contrast, no effective action is taken, the Council then imposes sanctions. Sanctions are also imposed if announced measures are subsequently not implemented or prove to be inadequate. Sanctions consist of a non-interest-bearing deposit combining a fixed element (equal to 0.2% of GDP) and a variable element, equal to one-tenth of the excess over the reference value, with a ceiling for the overall deposit of 0.5% of GDP. As long as the excessive deficit is not corrected, further deposits equal to one-tenth of the excess over the reference value (up to the aforementioned ceiling) would be required. After two years, deposits would be converted into fines.

*Abrogation (Article 104(12))*: The procedure comes to an end when the Council considers that the excessive deficit has been corrected and abrogates its decision under Article 104(6).

### 3.3 EXPERIENCE UNDER THE ORIGINAL PACT

Notwithstanding the progressive fiscal consolidation made during the mid 1990s, by the time the SGP entered into force shortly before the introduction of the single currency in January 1999, most euro area Member States were still some way from achieving medium-term budgetary positions that were close to balance or in surplus. Further consolidation was therefore necessary in order to create room for the operation of the automatic fiscal stabilisers while maintaining a safety margin with respect to the 3% deficit ceiling (Buti, Franco and Ongena, 1998).

In the early years of the single currency, nominal budget balances generally continued to improve and, by 2000, the euro area budget deficit was reduced to just 1.0% of GDP. However, fiscal consolidation slowed down and, from 2001 onwards, the euro area budget balance ratio started to deteriorate, increasing to 3.0% of GDP by 2003, with only a marginal decline to below this level in 2004.

This return to higher deficits in the euro area needs to be seen in a context of persistently poor economic growth and, more importantly, consolidation fatigue, which started soon after the launch of the single currency. Moreover, improving nominal budget balances in the early years of the Pact's implementation initially contributed to the false perception that fiscal positions were also getting better. In fact in a number of countries, structural budgetary positions started to deteriorate as early as 2000 since, in a context of favourable economic

**Table 3 Fiscal developments under the Stability and Growth Pact**

(as a % of GDP)

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|---|---|
| **General government budget balance** | | | | | | | |
| Belgium | -0.8 | -0.5 | 0.1 | 0.4 | 0.0 | 0.1 | 0.0 |
| Germany | -2.2 | -1.5 | -1.1 | -2.8 | -3.7 | -4.0 | -3.7 |
| Greece | -4.3 | -3.4 | -4.0 | -5.4 | -4.9 | -5.8 | -6.9 |
| Spain | -3.0 | -1.1 | -0.9 | -0.5 | -0.3 | 0.0 | -0.1 |
| France | -2.6 | -1.7 | -1.5 | -1.6 | -3.2 | -4.2 | -3.7 |
| Ireland | 2.4 | 2.5 | 4.4 | 0.8 | -0.6 | 0.2 | 1.5 |
| Italy | -2.8 | -1.7 | -1.9 | -3.1 | -2.9 | -3.4 | -3.4 |
| Luxembourg | 3.2 | 3.3 | 5.9 | 5.9 | 2.0 | 0.2 | -1.1 |
| Netherlands | -0.7 | 0.6 | 1.5 | -0.2 | -2.0 | -3.1 | -1.9 |
| Austria | -2.3 | -2.2 | -1.8 | 0.0 | -0.5 | -1.5 | -1.1 |
| Portugal | -3.0 | -2.7 | -3.2 | -4.3 | -2.9 | -2.9 | -3.2 |
| Finland | 1.7 | 1.7 | 7.0 | 5.1 | 4.1 | 2.5 | 2.3 |
| Euro area | -2.2 | -1.3 | -1.0 | -1.8 | -2.5 | -3.0 | -2.8 |
| **Cyclically adjusted budget balance** | | | | | | | |
| Belgium | -0.4 | -0.6 | -0.9 | 0.0 | -0.2 | 0.4 | 0.0 |
| Germany | -1.7 | -1.1 | -1.7 | -3.3 | -3.7 | -3.4 | -3.4 |
| Greece | -3.4 | -2.6 | -3.5 | -5.4 | -5.0 | -6.2 | -7.7 |
| Spain | -2.6 | -1.4 | -1.9 | -1.4 | -0.8 | -0.2 | 0.0 |
| France | -2.5 | -2.1 | -2.6 | -2.6 | -3.8 | -4.1 | -3.6 |
| Ireland | 1.8 | 1.0 | 2.4 | -0.7 | -1.8 | -0.5 | 1.4 |
| Italy | -2.4 | -1.6 | -2.8 | -4.1 | -3.4 | -3.4 | -3.3 |
| Luxembourg | 4.0 | 2.9 | 4.1 | 5.2 | 1.7 | 0.9 | -0.5 |
| Netherlands | -1.5 | -0.8 | -0.3 | -1.3 | -1.9 | -2.1 | -0.9 |
| Austria | -2.4 | -2.7 | -2.8 | -0.3 | -0.3 | -1.0 | -0.8 |
| Portugal | -3.4 | -3.5 | -4.5 | -5.5 | -3.5 | -2.5 | -2.7 |
| Finland | 0.4 | 0.6 | 5.3 | 4.8 | 4.3 | 3.0 | 2.5 |
| **Euro area** | **-2.0** | **-1.5** | **-1.9** | **-2.6** | **-2.8** | **-2.8** | **-2.6** |
| **General government debt** | | | | | | | |
| **Euro area** | **73.0** | **71.7** | **69.2** | **68.3** | **68.1** | **69.3** | **69.8** |

Source: European Commission, AMECO database. Data exclude receipts from the sale of Universal Mobile Telecommunications System (UMTS) licenses.
Note: The figures presented in the table are those currently available under the ESA 95 accounting framework. They therefore include all the statistical revisions that have taken place since 1998 in the euro area countries (in particular, in Greece and Portugal).

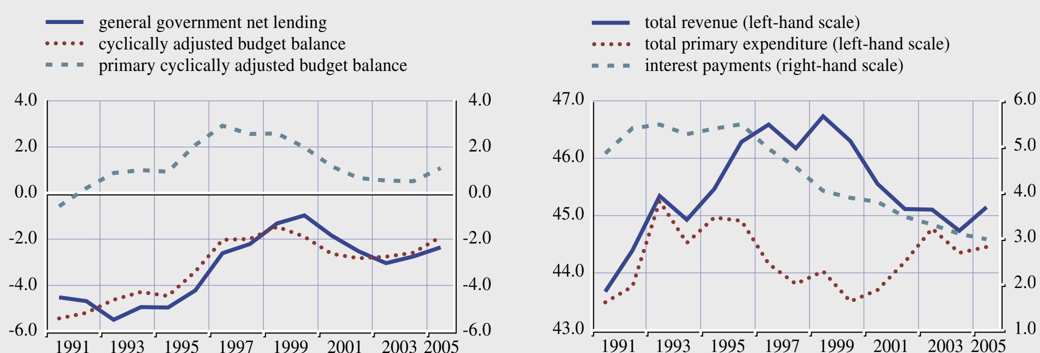
growth, tax cuts were not matched by equivalent expenditure reductions. The fiscal consolidation that was achieved during the 1990s was largely attributable to an increase in the revenue-to-GDP ratio, which, for the euro area as a whole, rose from 44% in 1991 to 47% in 1999 (see Chart 1). However, after 1999 about two-thirds of the earlier increase in the revenue-to-GDP ratio was reversed.[16] Meanwhile, primary expenditure, which had been reduced by more than 1% of GDP in the run-up to EMU, started to increase again after 1999.

These developments very quickly put the SGP to the test. Several countries consistently failed to attain close to balance budgetary positions, so that the first downturn (coupled with the above-mentioned tax cuts and, in some cases, statistical revisions) resulted in severe degradations of budget balances. Six euro area Member States have incurred excessive deficits since 1999: Portugal in 2001 (and again in 2005), Germany and France in 2002, the Netherlands and Greece in 2003, and Italy in 2004. Among these, only the Netherlands has in the meantime succeeded in correcting its

16 In this sense, recent experience in the euro area appears to support the findings of a growing body of literature on fiscal consolidation which argues that revenue-based fiscal adjustments tend to be less successful (i.e. less sustainable) than consolidations based primarily on expenditure restraint (Alessina and Perotti, 1995a; von Hagen, Hughes Hallet and Strauch, 2001). See also Briotti (2004) for an overview.

**Chart 1 Euro area fiscal developments 1991-2005: determinants and components**

(as a % of GDP)




Source: European Commission, AMECO database.

excessive deficit in a durable manner. Some Member States increasingly resorted to temporary measures to comply nominally with the rules. Moreover, owing to large statistical revisions, some excessive deficits were only identified several years after the 3% of GDP reference value was breached from an ex post perspective, after statistical corrections led to upward revisions of earlier deficit figures.[17] Typically, this took place when initially reported deficits coincided with significant adverse deficit-debt adjustments, notably in Greece, Italy and Portugal.

Faced with deteriorating fiscal positions in a number of countries, the Council did not implement the Pact in the strict manner that was necessary. The first evidence of this came in early 2002 when the Council rejected Commission recommendations to issue early warnings to Germany and Portugal. Instead, the Council took the view that such a formal step was unnecessary in the light of commitments by these countries to take corrective measures.[18] In both cases, however, the 3% limit was breached and EDPs were subsequently launched.[19]

An even more significant deviation from the rules and procedures of the Pact came in November 2003 in the context of the EDPs against Germany and France. Having been given until 2004 to correct their excessive deficits, it became clear by autumn 2003 that the measures taken by both countries would not be sufficient to comply with the Council's recommendations. The Commission recommended that the Council should step up pressure on both countries by issuing "notices" (i.e. one step in the EDP before sanctions), while also suggesting an extension of the 2004 deadline by one year.[20] However, the Council failed to achieve the necessary qualified majority to adopt these decisions, and instead issued "conclusions" in which it put the procedures in abeyance in the light of commitments expressed by Germany and France to take effective action to correct their excessive deficits by 2005.[21] These conclusions were subsequently challenged by the Commission and annulled by the European Court of Justice (ECJ) on the grounds that the Council had not followed the rules and procedures as set out in the Treaty. In particular, the ECJ made clear that the Council could not, by itself, take

17 Regarding one-off measures and creative accounting see Koen and van den Noord (2005).
18 ECOFIN Council conclusions of 12 February 2002.
19 In the case of Portugal, a public finance audit in spring 2002 showed that the deficit had already exceeded 3% of GDP by a considerable margin back in 2001. Hence, the Commission's recommendation for an "early" warning actually came after the reference value for the deficit had already been breached.
20 Commission recommendations of 18 November 2003 for Council decisions giving notice to Germany and France to take measures to correct their excessive deficits.
21 ECOFIN Council conclusions of 25 November 2003.

initiatives in the absence of an appropriate recommendation by the Commission and could not replace a "procedure" with political "conclusions".[22] In the wake of these developments, many observers including the ECB started to express concerns about the credibility of the Pact and of EU fiscal policies.[23]

It would be wrong, however, to paint a totally negative picture of the experience under the original SGP. Fiscal deficit ratios in the euro area did not return to their pre-Maastricht levels and earlier trends of rapidly rising public debt and expenditure ratios were mostly brought to a halt. A number of countries did moreover succeed in complying with the rules. Among these, Belgium, Spain and Austria all consolidated their fiscal positions further and succeeded in reaching close to balance or in surplus budgets. Meanwhile, Ireland, Luxembourg and Finland, while loosening fiscal policy, did so having entered EMU with large budget surpluses, and their fiscal positions have remained broadly sound (although, deficits have recently re-emerged in Austria and Luxembourg). While overall fiscal consolidation may have largely stalled after 2000, there was no generalised loosening of fiscal policies in the euro area. It can therefore be argued that while the original SGP did not fully attain its objectives it did have a constraining effect on fiscal policies.

## 4 THE REFORM OF THE SGP

Criticisms of the SGP and proposals to reform it have been made ever since its inception. As actual fiscal developments moved further away from the Pact's requirements, and political commitment to the rules waned, some of these criticisms gained prominence and became more widely accepted.

A frequent criticism of the original SGP was that it placed too much emphasis on formal compliance with rules and took too little account of economic circumstances. In this context, it was argued that the close to balance or in surplus requirement, which was generally interpreted as implying the maintenance of a broadly balanced budget (in cyclically adjusted terms), failed to consider the specific circumstances of each Member State, in particular with regard to long-term fiscal soundness, public investment needs or the costs of structural reforms. According to this view, it does not make sense for countries with, for example, widely diverging debt levels to target exactly the same budget balance. The emergence of excessive deficits in a number of countries suggested that the mechanisms underlying the preventive arm (i.e. monitoring and peer pressure) were too weak to ensure progress towards sound fiscal positions. Meanwhile, when countries did incur excessive deficits, the Pact's corrective arm was criticised for requiring prompt corrective action regardless of economic growth considerations. In particular, some critics of the Pact considered it inappropriate to require Member States to correct excessive deficits by tightening fiscal policy during periods of low growth, since this could dampen prospects for economic recovery. The Pact was also criticised for not paying sufficient attention to debt developments, as it did not clarify the application of the debt criterion of the Treaty.

According to advocates of reform, such shortcomings contributed to a lack of commitment and ownership on the part of Member States, the Commission and the ECOFIN Council, which could partly explain difficulties in applying the rules and procedures. To address this, numerous proposals to improve or amend the rules were put forward. Prominent among these have been proposals to focus more on the quality of public finances (Blanchard and Giavazzi, 2004; Fitoussi and Creel, 2002), to shift the focus of the SGP away from deficits and onto debt and sustainability (Buiter and

22 Ruling of the ECJ of 13 July 2004 on the affair C-27/04 by the Commission of the European Communities against the Council of the European Union.

23 Statement of the Governing Council on the ECOFIN Council conclusions regarding the correction of excessive deficits in France and Germany, 25 November 2003.

Grafe, 2002, Pisani-Ferry, 2002), or to replace numerical rules with stronger fiscal institutions and market discipline (Wyplosz, 2005).

While some commentators called for a complete overhaul of the rules, others defended the status quo or at most called for more incremental adjustment (Buti, Eijffinger and Franco, 2003; Bini Smaghi, 2004). Defenders of the existing rules argued that they were sufficient to preserve the sustainability of public finances in EMU while also allowing room for the, full operation of automatic stabilisers (Marin, 2002). The importance of relatively simple rules and limited discretion under the original SGP was stressed in particular with a view to supporting market and public monitoring of fiscal policies (Schuknecht, 2005). According to this view, the problem was not the rules per se, but deficient enforcement that undermined the deterrent power of the Pact (such as the need for a qualified majority in the Council and the problem of "sinners judging sinners"). This called for improvements in the implementation and enforcement of the rules rather than changes in the rules themselves (Gros, Mayer and Ubide, 2004).

Prior to the SGP reform there had already been a number of incremental refinements to the way the Pact was implemented. Over time, more attention came to be paid to the influence of the cycle, with cyclical-adjusted budget balances acquiring greater prominence, at least under the preventive arm. In November 2002 the Commission issued a communication with a broad set of proposals, some of which were subsequently adopted by the Council.[24] In this context, the initial emphasis on setting target dates for the achievement of balanced budgets was replaced by a Eurogroup commitment to annual improvements of underlying fiscal balances by at least 0.5% of GDP (see section 5.1). Following the procedural impasse in the context of the EDPs against Germany and France, however, the Commission decided to launch a more wide-ranging discussion on reforming the SGP, including the option of changing the Council Regulations.[25] The Commission's proposals, along with other suggestions, were discussed at length by Member States in late 2004 and early 2005; the outcome of these discussions was an agreement to make changes to the SGP as set out in the ECOFIN Council Report of March 2005 and later implemented via amendments to Council Regulations 1466/97 and 1467/97.[26] Further specifications on the implementation of the reformed Pact were also included in the revised Code of Conduct. The reform adopted by the ECOFIN Council left the structure of the SGP in place, and did not alter the fundamental elements of the EU fiscal framework enshrined in the Treaty, such as the 3% and 60% reference values, which were outside the reform's scope. Within this overall framework, however, the reform did introduce a number of significant changes.

### 4.1 CHANGES TO THE PREVENTIVE ARM

Under the preventive arm, the reform has introduced various refinements to the earlier provisions concerning the setting of and progress towards sound medium-term budgetary positions and to the elements that are to be taken into account when assessing Member States' fiscal positions. These include:

– *The definition of the medium-term budgetary objective:* Rather than being required to target "close to balance or in surplus" budgetary positions, each Member State now presents its own country-specific medium-term objective (MTO) in its stability or convergence programme, which is then assessed by the Council. These country-

24 See the Commission Communication to the Council and the European Parliament of November 2002 on strengthening the co-ordination of budgetary policies, and the ECOFIN Council report of March 2003 on strengthening the implementation of the SGP.

25 See the Commission Communication to the Council and the European Parliament of September 2004 on strengthening economic governance and clarifying the implementation of the SGP. See also Deroose and Langedijk (2005) for an overview of the European Commission's motivations for and approach to reforming the SGP.

26 The changes are laid down in two new Council Regulations, No 1055/2005 and No 1056/2005 amending Regulations 1466/97 and 1467/97 respectively.

specific MTOs are differentiated and may diverge from a position of close to balance or in surplus. They should provide a safety margin with respect to the 3% of GDP reference value, ensure rapid progress towards sustainability and, taking this into account, should allow room for budgetary manoeuvre, particularly with regard to the need for public investment. For euro area and ERM II Member States, a range for country-specific MTOs, in cyclically adjusted terms and net of one-off and temporary measures, has been set between -1% of GDP and "in balance or surplus".

– *The adjustment path to the medium-term objective*: Member States that have not yet achieved their MTOs are expected to take steps to do so over the cycle. To this end, euro area and ERM II Member States should, as a benchmark, pursue an annual adjustment in cyclically adjusted terms, net of one-off and temporary measures, of 0.5% of GDP. The adjustment effort should be greater in good times, but could be more limited in bad times. Good times are defined as "periods where output exceeds its potential level, taking into account tax elasticities", while the Code of Conduct specifies that the "change in the output gap could also be considered, especially when the output gap is estimated to be close to zero". Member States that do not follow the required adjustment path should explain the reasons for not doing so in their programme update, and the Commission is entitled to issue "policy advice" to encourage Member States to stick to the adjustment path.

– *Taking into account structural reforms*: Member States may be allowed to deviate from the MTO or the adjustment path towards it if they undertake structural reforms, and in this context special attention is paid to pension reforms which introduce multi-pillar systems that include a mandatory, fully funded pillar. However, "only reforms which have direct long-term cost-saving effects, including by raising potential growth, and therefore a verifiable positive impact on the long-term sustainability of public finances, will be taken into account", and a safety margin with respect to the 3% reference value must be preserved at all times.

### 4.2 CHANGES TO THE CORRECTIVE ARM

With regard to the corrective arm, the changes introduced go in the direction of introducing more flexibility into the EDP, in particular by relaxing, adding specificity to or clarifying the availability of various escape clauses. The changes include:

– *The definition of a "severe economic downturn"*: The benchmark for a severe economic downturn is now a negative annual real GDP growth rate or an accumulated loss of output during a protracted period of very low annual real GDP growth relative to potential growth.

– *Specification of the "other relevant factors"*: The Treaty specifies that, in its report that constitutes the first step of an EDP, the Commission should take into account *"all other relevant factors, including the medium-term economic and budgetary position of the Member State"*. However, neither the Treaty nor the original SGP further elaborated what these other relevant factors might be. The reformed SGP now more explicitly spells out the relevant factors that should be taken into account. Regarding the medium-term economic position, these include, in particular, potential growth, the prevailing cyclical conditions, the implementation of the Lisbon Agenda, and policies to foster research and development and innovation. Relevant developments in the medium-term budgetary position include fiscal consolidation efforts in "good times", debt sustainability, public investment, and the overall quality of public finances. Consideration should also be given to any other factors which, in the opinion of the Member State concerned, are relevant to a comprehensive assessment of the excess over

the reference value in qualitative terms. Special consideration will be given to budgetary efforts towards increasing or maintaining a high level of financial contributions with the aim of fostering international solidarity and achieving European policy goals, notably the unification of Europe, if they have a detrimental effect on the growth and fiscal burden of the Member State.

However, when assessing whether or not a deficit above 3% of GDP is to be considered excessive, the other relevant factors are only taken into account if the general government deficit remains "close to" the reference value, and if the excess over the reference value is "temporary". If the Council has decided that an excessive deficit exists, the other relevant factors will be considered when issuing recommendations or notices to the Member State concerned.

– *Extension of procedural deadlines:* A number of procedural deadlines have been extended. These include the deadline for the Council to issue its recommendation to the Member State in excessive deficit (extended from three to four months after the date on which the relevant data were first reported), the deadline for effective action in response to a Council recommendation (extended from four months to six months), the deadline for the Council to issue a notice if it has established that no effective action has been taken in response to its recommendation (extended from one month to two months), and the deadline for taking effective action in response to a notice (extended from two months to four months).

– *Extension of the deadlines for the correction of excessive deficits:* The standard deadline for correcting an excessive deficit remains the "year following its identification unless there are special circumstances". However, the consideration of whether there are special circumstances justifying an extension by one year should take into account a balanced overall assessment of the "other relevant factors" mentioned above. Moreover, the initial deadline for correction should be set such that the Member State with an excessive deficit will have to achieve a minimum annual improvement in its cyclically adjusted balance of 0.5% of GDP as a benchmark, net of one-off and temporary measures.

– *Unexpected adverse events and repeated recommendations or notices:* The original SGP did not explicitly provide for the reissuance of Council recommendations or for the extension of deadlines for the correction of excessive deficits, and these issues were at the heart of the procedural deadlock in the EDPs for Germany and France. The SGP reform has now clarified such matters by explicitly stating that if effective action has been taken in compliance with a recommendation under Article 104(7) or a notice under Article 104(9), and if "unexpected adverse economic events with major unfavourable consequences for government finances" occur after the adoption of the recommendation or notice, the Council may decide to issue a revised recommendation or notice, which may also extend the deadline for the correction of the excessive deficit by one year.

– *Increasing the focus on debt and sustainability:* The ECOFIN Council report of March 2005 also called for a strengthening of debt surveillance, for example by applying the Treaty concept of a debt ratio that is "sufficiently diminishing and approaching the reference value at a satisfactory pace". However, no agreement could be reached on a quantitative definition of the satisfactory pace of debt reduction, as had been proposed by the Commission, and no changes to the Pact regulations were introduced.

### 4.3 GOVERNANCE

The reform of the SGP did not, in itself, introduce major changes in the area of governance. In particular, it did not change the

basic procedures and voting rules, which in any case would require changes to the Treaty. However, the ECOFIN Council report of March 2005 did make a number of proposals and suggestions for improving governance and strengthening national ownership of the rules. In this context, it called for closer cooperation between Member States, the Commission and the Council, as well as for improved peer support and peer pressure. It called for the development of complementary national budgetary rules, the continuity of budgetary targets when a new government takes office and greater involvement of national parliaments. It also stressed the importance of reliable macroeconomic forecasts and budgetary statistics.

### 4.4 ASSESSMENTS OF THE REFORM

Reactions to the reform of the SGP have been diverse. Several commentators have been rather critical. In particular, the proliferation of escape clauses under the EDP has led some to conclude that the reform represents a significant watering-down of the rules while not having addressed the essential problem of weak enforcement provisions (e.g. Deutsche Bundesbank, 2005; Calmfors, 2005; Feldstein, 2005; Diebalek, Köhler-Töglhofer and Prammer, 2006). Others have, however, emphasised positive elements in their assessment of the reform. The Commission considers that the reform has increased the economic rationale of the SGP and should therefore lead to increased ownership on the part of Member States, although it also points out that the Council deviated from the Commission's initial proposals in certain respects (Commission, 2005). The ECB noted that some of the changes to the preventive arm have the potential to strengthen the framework, but that the revisions to the corrective arm, in particular the greater emphasis on flexibility and discretion, risk weakening the SGP (see Box 2 and ECB, 2005).

Box 2

#### STATEMENT OF THE GOVERNING COUNCIL OF 21 MARCH 2005

*"The Governing Council of the ECB is seriously concerned about the proposed changes to the Stability and Growth Pact. It must be avoided that changes in the corrective arm undermine confidence in the fiscal framework of the European Union and the sustainability of public finances in the euro area Member States. As regards the preventive arm of the Pact, the Governing Council also takes note of some proposed changes which are in line with its possible strengthening.*

*Sound fiscal policies and a monetary policy geared to price stability are fundamental for the success of Economic and Monetary Union. They are prerequisites for macroeconomic stability, growth and cohesion in the euro area. It is imperative that Member States, the European Commission and the Council of the European Union implement the revised framework in a rigorous and consistent manner conducive to prudent fiscal policies.*

*More than ever, in the present circumstances, it is essential that all parties concerned fulfil their respective responsibilities. The public and the markets can trust that the Governing Council remains firmly committed to deliver on its mandate of maintaining price stability."*

Assessments of the SGP reform applying the Kopits and Symansky criteria for optimal fiscal rules produce rather mixed results (see, for example, Buti, Eiffinger and Franco, 2005). On the positive side, the differentiation of MTOs should make the rules more adequate in the sense of taking each Member State's individual situation more directly into account with regard to factors such as the sustainability of public finances and public investment needs. The possibility of considering the impact of structural reforms when assessing consolidation efforts could enhance the consistency between fiscal policies and other economic policies, for example in the context of the Lisbon Agenda. One can also argue that the new rules promote efficiency by, for example, distinguishing between structural adjustment efforts and temporary or one-off measures.

In addition, the revised Pact should allow more flexibility in adapting adjustment and reform requirements to the macroeconomic situation of each country. This would support fiscal policies that are not only sustainable, but also contribute to maintaining overall economic cohesion in the euro area by helping contain external imbalances or price pressures, for example. Greater focus on the economic rationale rather than on narrow compliance with numerical rules should provide more scope for calls by the Commission and the Council to tighten fiscal policies beyond minimum requirements. It should also create room to comment more on the quality of particular fiscal measures. The call in the ECOFIN Council report of March 2005 for more attention to be paid to national budgetary rules and institutions as a complement to the EMU fiscal rules is also positive and potentially significant, as effective national institutions and procedures are essential when seeking to tackle deficit and spending biases at their origin.

At the same time, the increased flexibility and room for discretion in the reformed Pact has several disadvantages. This explains the criticisms of many commentators as well as the concerns expressed about changes to the corrective arm of the Pact by the Governing Council of the ECB. In particular, the proliferation of escape clauses and the shift in emphasis towards conditional as opposed to unconditional compliance implies that the rules are now less well-defined and less simple. The new framework is also less transparent insofar as it is now harder for outsiders to assess whether or not decisions taken by the Council are consistent with a rigorous application of the rules. In addition, it has to be recalled that the reform has not changed the governance structure of the SGP in any fundamental way. The basic incentives for all parties involved and the voting rules in the ECOFIN Council remain as they were before the reform.

Overall, while the changes to the preventive arm could essentially be considered as a shift in favour of more sophisticated as opposed to simple rules, in the context of the corrective arm the increased flexibility is clearly associated with less stringent rules and procedures. Compared to the original framework, there are now more grounds for tolerating deficits above 3% of GDP and extending deadlines for their correction. In this sense, the Commission is explicitly requested to avoid a repetition of past procedural deadlocks and to use its agenda-setting power to propose and broker an acceptable implementation that would find a sufficient majority in the Council. All this does not, per se, impose a more lax implementation of the rules than in the past. However, the risk is that the combination of more flexibility, together with the need to find a qualified majority in the Council, leads to lenient decisions. If decisions do become more lenient and this is not compensated for by greater political commitment and improved compliance, the outcome is likely to be higher, more frequent and more persistent deficits above 3% of GDP. This is why, immediately following the reform, the Governing Council called on Member States, the Commission and the Council to implement the revised framework in a rigorous and consistent manner, conducive to prudent fiscal policies and in keeping with the Treaty requirement to avoid excessive deficits (see Box 2).

Box 3

### A RIGOROUS VERSUS A LAX IMPLEMENTATION OF THE REVISED SGP[1]

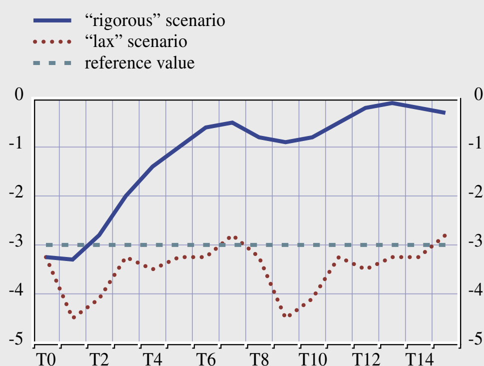
The importance of rigorously implementing the reformed SGP can be illustrated by simulating the effects of different procedural decisions and fiscal policy responses in the context of the SGP's corrective and preventive arms following an initial breach of the 3% reference value. Two extreme scenarios can be identified. Under a first "rigorous" scenario, the flexibility allowed under the rules is not exploited and fiscal policy reacts at all times in compliance with the SGP provisions. By contrast, under the second "lax" scenario[2], the (old and new) escape clauses are exploited excessively and fiscal policy responds opportunistically with a view to maintaining a high deficit while avoiding sanctions. It should be stressed that these are merely hypothetical examples intended to provide an idea of the possible range of outcomes under the revised rules, also assuming a minimal impact of fiscal policy on growth.

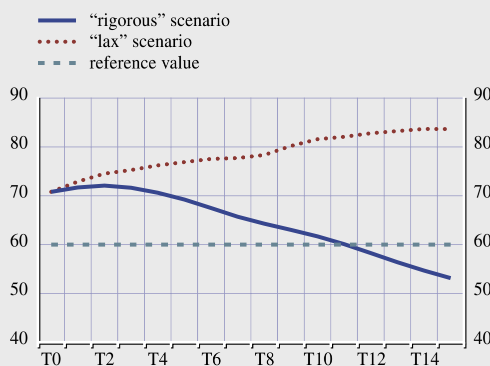
| **Year** | **Rigorous scenario** |
|---|---|
| T | The deficit breaches the 3% reference value. |
| T+1 | The Council decides that there is an excessive deficit and issues a recommendation to correct it in the "year after identification". |
| T+2 | The Member State complies with the Council recommendation, and the excessive deficit is corrected. |
| T+3 … | The 0.5% annual adjustment path is followed (as a minimum) until the MTO is reached. |
| | **Lax scenario** |
| T | The deficit breaches the 3% reference value. |
| T+1 | The Council decides that the breach is small and temporary and justified by "other relevant factors". However, the deficit situation (unexpectedly) deteriorates. |
| T+2 | The Council decides that the deficit is excessive, but by now a 0.5% annual adjustment would not be sufficient to correct the situation by year T+3. The Council decides that this constitutes special circumstances and recommends correcting the excessive deficit in year T+4. |
| T+3, T+4 | The procedure remains in abeyance pending the implementation of measures. |
| T+5 | The Council observes that the deficit remained slightly above 3% of GDP in year T+4, but concludes that although effective action was taken, there were unexpected adverse economic events. It therefore issues a repeated recommendation to correct the excessive deficit in T+5. |
| T+6 | The Council observes that the excessive deficit was not corrected in T+5 and issues a notice to correct the situation in T+6; but again the excessive deficit is not corrected. |
| T+7 | Citing unexpected adverse events in T+6, the Council issues a repeated notice with a new deadline of T+7. |
| T+8 | A deficit below 3% of GDP in T+7 is observed and the EDP is brought to a close. |
| T+9… | The deficit again breaches the 3% reference value and the experience of periods T+1 to T+8 is repeated, giving rise to a deficit that averages more than 3% of GDP over the long term. |

1 Adapted from ECB (2005). For an alternative exposition of theoretically possible scenarios under the EDP, see Calmfors (2005).
2 Note that outcomes akin to the "lax scenario" could also not have been excluded under the "old" Pact (e.g. in case of non-compliance and procedural breakdown or deliberately lax application of escape clauses).

**Chart 2 Scenarios for the implementation of the reformed SGP**

(as a % of GDP)




The implications of these hypothetical scenarios for deficit and debt developments are illustrated in Chart 2 for a country starting with a debt ratio of just above 70% of GDP, equivalent to the current debt ratio of the euro area, and trend nominal GDP growth of 3.5%, which is slightly below the current euro area average but broadly typical of countries in excessive deficit. Under the rigorous scenario, the debt ratio is gradually brought back on a declining path, until it falls below 60% after 12 years. By contrast, under the lax scenario the debt ratio continues its upward trend, rising by more than 10 percentage points of GDP within a decade.

## 5 THE IMPLEMENTATION OF THE REFORMED PACT: FIRST EXPERIENCES AND CHALLENGES

More important than the precise wording of the EMU fiscal rules is their effective implementation. As was noted in section 3, the implementation of the original SGP was not entirely satisfactory. Even if the new rules are, on the whole, more flexible and less stringent than the old ones, they can still enhance fiscal discipline if they are implemented in a rigorous manner. This will depend on whether the reform achieves the objective of renewing ownership and strengthening political commitment to the rules on the part of Member States, or whether the reform merely serves as a green light for opportunistic behaviour and minimalist efforts with decisions guided by political pressure and horse-trading (Coeuré and Pisani-Ferry, 2005; Buti, 2006). Bearing this in mind, this section examines the first experiences with the implementation of the new framework one year after the reform. It should be stressed, however, that at this stage any assessment of the implementation of the reformed Pact has to focus primarily on ex ante fiscal plans and decisions and in this sense has to be seen as preliminary. Ultimately, the success or failure of the reformed SGP will be judged on ex post fiscal outcomes, in particular on whether it actually delivers a timely correction of excessive deficits and the achievement of sound public finances in the euro area.

### 5.1 THE IMPLEMENTATION OF THE REFORMED PREVENTIVE ARM

Between December 2005 and February 2006, all euro area Member States submitted updated stability programmes. The content of these programmes and the assessment and opinions

**Table 4 Main elements of updated stability programmes and Council opinions**

| | MTO | Year in which MTO achieved | Sustainability risk | Recommendation on national institutions |
|---|---|---|---|---|
| Belgium | 0.5% surplus | 2007 | medium | no |
| Germany | budget balance | ~20011-12 | medium | yes |
| Greece | budget balance | ~2013 | high | yes |
| Spain | budget balance | Already | medium | no |
| France | budget balance | 2010 | medium | yes |
| Ireland | budget balance | Already | medium | no |
| Italy | budget balance | ~2011-2012 | medium | yes |
| Luxembourg | -0.8% deficit | 2007 | medium | no |
| Netherlands | -1% to -0.5% deficit | Already | medium | no |
| Austria | budget balance | 2008 | low | no |
| Portugal | -0.5% deficit or better | ~2011 | high | yes |
| Finland | 1.5% surplus | Already | low | no |

Sources: Updated stability programmes December 2005-February 2006, and Council opinions.

of the Commission and the Council provide initial indications as to the impact of the changes to the preventive arm on Member States medium-term fiscal plans.[27]

### MTOs IN THE UPDATED STABILITY PROGRAMMES

According to the revised SGP, MTOs should ensure rapid progress towards fiscal sustainability. As soon as an appropriately methodology has been agreed, MTOs should take into account implicit liabilities stemming from future age-related spending. In the meantime, however, and in accordance with the ECOFIN Council report of March 2005, MTOs are differentiated primarily in the light of countries' debt-to-GDP ratios and potential growth. With the exception of Ireland and Finland, which have high estimated potential growth rates and low debt ratios, potential growth rates in the euro area generally fall within a relatively narrow range of between 1.5% and 2.5%. Given this and the fact that the measurement of potential growth is also subject to a degree of uncertainty, it is appropriate to conclude that the debt ratio should be the overriding indicator.

Taking these considerations into account and given the predefined range for euro area MTOs of between -1% of GDP to "in balance or surplus", the following three reasonable working assumptions concerning the MTOs can be made. Firstly, only countries with debt-to-GDP ratios below the 60% reference value should be allowed to target deficits of up to 1% of GDP. Secondly, countries with very high debt ratios, say above 80%, should be required to target budgetary positions that are "in balance or surplus". Thirdly, countries with debt ratios of between 60% and 80% of GDP should at least target deficits that are close to balance (i.e. between "in balance" and a deficit of 0.5% of GDP). Note, however, that MTOs may need to be much more ambitious if population ageing is projected to lead to major fiscal costs in the future (see Box 4).

Adopting these working assumptions, the MTOs presented by euro area Member States in their stability programmes all seem to be consistent with the requirements of the reformed Pact (see Table 4). The two countries targeting deficits of up to 1% of GDP (Luxembourg and the Netherlands) all have debt ratios below the 60% reference value. Portugal is targeting a deficit of up to 0.5% of GDP, which is consistent with the fact that its debt ratio currently lies within a medium range of 60-80% of GDP. All the

27 As far as actual fiscal outcomes are concerned, 2005 budget balances turned out to be somewhat better than expected in the autumn of 2005 while falling marginally short of the targets implied by the 2004/5 vintage of stability programmes (see panel b of Chart 5). It seems premature to attribute this development to the reform of the SGP, however, since the relevant fiscal policy decisions and plans were adopted prior to the reform, while fiscal balances in some countries were boosted by unexplained, non-discretionary increases in tax revenues.

other countries are targeting budgets that are at least in balance if not in surplus. Among these, three (Spain, Ireland and Finland) clearly go beyond the minimum requirements, targeting in balance or surplus budgets even though their relatively low debt ratios suggest that they would be allowed to target small deficits.

The picture that emerges from the stability programmes in terms of actual and planned compliance with MTOs is less satisfactory, however. In 2005 only four out of 12 euro area Member States (Spain, Ireland, the Netherlands and Finland) reported outcomes that were in line with their MTOs. Three out of the remaining eight Member States (Belgium, Austria and Luxembourg) plan to achieve their MTOs by the end of the period covered in their stability programmes. Extrapolating planned consolidation progress towards the end of the programme periods into the future suggests that all countries that are currently in excessive deficit (Germany, Greece, France, Italy and Portugal) do not intend to achieve their MTOs until (in some cases well into) the next decade. This horizon clearly calls into question the relevance of these targets for policymaking (which typically looks at most at the next three to four years as the medium-term horizon) and, hence, for assessing medium-term fiscal positions.

It is also important to bear in mind that the MTOs presented in the recently updated stability programmes do not yet take into account implicit liabilities related to future ageing-related expenditures. At present, the Council opinions on the stability programmes provide an assessment of the sustainability of public finances in the light of such liabilities, and categorise countries as being either low, medium or high risk. As can be seen from Table 4, however, there is no obvious link between this assessment and the current MTOs.

Box 4

### MTOs, DEBT DEVELOPMENTS AND AGEING COSTS: A SIMULATION

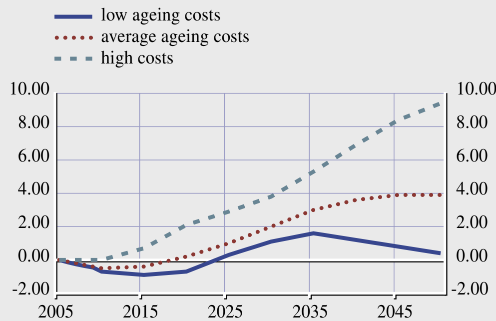
Under normal circumstances, continuous compliance with MTOs in a range of -1% to in balance or surplus should be sufficient to ensure low and/or declining debt ratios well below the 60% reference value. As already noted, however, a major consideration for Member States setting an MTO is the need to create room to cope with the future fiscal burden of an ageing population. This implicitly assumes that more ambitious budgetary targets are needed to reach sufficiently sound budgetary positions which, together with appropriate reforms (in particular of pension systems) would help to accommodate the increase in age-related spending without having to engage in significant tax increases or reductions in other expenditure outlays, and without endangering the sustainability of public finances. In this vein, it is envisaged that implicit liabilities stemming from ageing populations will be directly taken into account in the setting of Member States' MTOs as soon as an appropriate methodology for doing so has been agreed.

One way of analysing the implications of ageing costs for MTOs is to ask what path the budget balance should follow in order to keep the debt-to-GDP ratio below the 60% of GDP reference value until 2050, assuming that the primary balance net of the increase in ageing costs is kept at a constant level. For illustrative purposes, let us take as an example a country starting with a debt ratio of 70% of GDP and a potential nominal growth rate of GDP between now and 2050 of 3.5% – a scenario that is broadly consistent with the actual situation and estimates for the euro area. Moreover, let us consider three different scenarios for the increase in age-related expenditure based on those recently published by the Economic Policy Committee and the

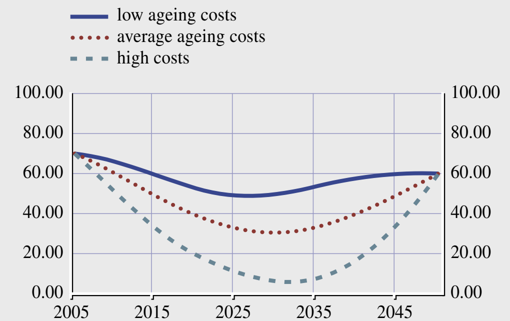
## Chart 3 MTOs, debt developments and ageing costs: a simulation

(as a % of GDP)

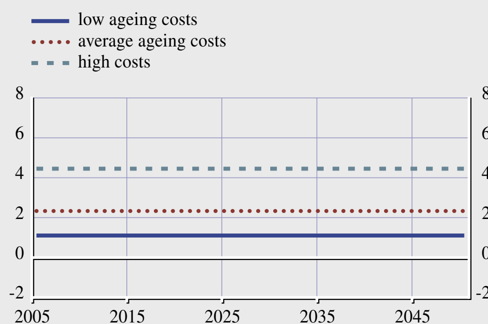
**a) Assumed increase in ageing costs**



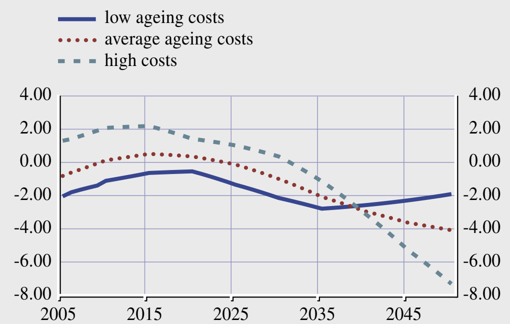

**c) Debt ratio**




**b) Primary balance, net of increased ageing costs**




**d) Budget balance / MTO**




European Commission[1]: firstly, an average increase in ageing costs that reflects the projections for increased age-related spending in the euro area (3.7% of GDP between 2004 and 2050); secondly, little or no increase in age-related spending (based on the projections for age-related spending in the euro area country with the lowest projected increase); and thirdly, a large increase in age-related spending (based on the projections for age-related spending in the euro area country with the largest projected increase). For each of these three scenarios, we can set the primary balance, net of the increase in ageing costs, at a constant level such that the debt ratio reaches 60% of GDP in 2050.

The results of the corresponding simulations are shown in the four panels of Chart 3. Panel a) shows the assumed increases in ageing costs over the next 45 years. Panel b) reports the necessary primary balance (net of ageing costs) that is needed to keep the debt ratio below 60% of GDP (the path of which is shown in Panel c). Finally, Panel d) reflects the resulting nominal budget balance path for the three types of countries.

In the case of little or no increase in ageing costs, a small primary surplus of just over 1% of GDP is sufficient to keep the debt ratio at around 60% of GDP. This corresponds to an MTO of just under -1% of GDP for most of the next two decades, which is broadly consistent with the floor for euro area and ERM II Member States' MTOs. In the case of an average increase

1 "The impact of ageing on public expenditure: Projections for the EU25 Member States on pensions, health care, long-term care, education and employment transfers", European Economy, Special Report No 1/2006.

in age-related spending, a primary surplus, net of ageing costs, of around 2.3% of GDP would need to be maintained. To this end, it would be necessary to comply with an MTO consisting of a small surplus of between 0 and 0.5% of GDP for most of the next 20 years before deficits could be incurred to accommodate the increased age-related spending. Finally, in the case of a large increase in ageing costs, a constant primary surplus, net of ageing costs, of around 4.5% of GDP would be necessary, which would imply targeting budget surpluses of up to and even above 2% of GDP for a number of years. Moreover, in this latter case (and also less dramatically in the intermediate scenario), the debt ratio increases rapidly as a result of very high deficits towards the end of the simulation period, which seriously questions the sustainability of public finances beyond the simulation horizon. This emphasises the need for further reforms to address the fiscal costs of ageing in countries where these costs are likely to be significant, which may need to be complemented by more ambitious MTOs than specified in the most recent round of stability programmes.

### THE ADJUSTMENT PATH TOWARDS THE MTO

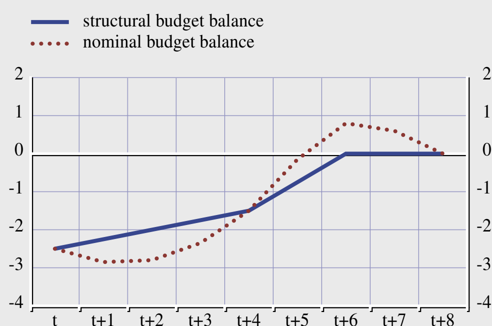
The benchmark adjustment path introduced by the new Pact represents a development of previous commitments rather than an entirely new initiative. Responding to proposals by the Commission, in October 2002 the Eurogroup agreed that euro area Member States with budgetary imbalances should improve their underlying fiscal positions by at least 0.5% of GDP per annum. At the time, it was hoped that expressing consolidation requirements in terms of an annual adjustment effort, rather than setting a date for achieving a close to balance budget, would prevent any undue back-loading of fiscal adjustment. Moreover, expressing the adjustment effort in structural terms was intended to ensure that consolidation would not compromise the stabilisation function of fiscal policy, since the automatic fiscal stabilisers can be allowed to operate around a predefined structural adjustment path (provided that there is a sufficient safety margin to prevent breaches of the 3% threshold).

The provisions introduced by the SGP reform differ slightly from the earlier Eurogroup agreement. It has now been made more explicit that the adjustment effort should be measured net of one-off and temporary measures, which can be seen as a strengthening of the adjustment requirement with the welcome intention of reducing, if not excluding, the recourse to measures that do not contribute to sustainable consolidation. At the same time, there is more

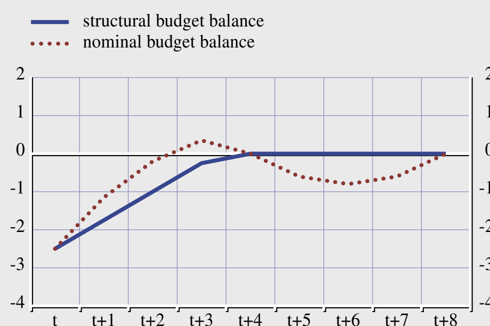
**Chart 4 Stylised representation of the adjustment path towards the MTO**

(as a % of GDP)

**a) Bad times followed by good times**




**b) Good times followed by bad times**



flexibility in that the 0.5% annual adjustment path is now described as a benchmark around which efforts can vary in good times and bad times. A reasonable interpretation of the reformed SGP provisions is that the overall adjustment effort should be the same over the medium term as in the case of a constant annual adjustment of 0.5% of GDP. However, fluctuations in the nominal balance could be greater, with more scope for differentiating consolidation efforts in response to the cyclical position of the economy. Chart 4 illustrates two scenarios with identical starting and end points, but with very different adjustment paths for the nominal and structural balance.

So far, the experience with the new adjustment path requirements is partially satisfactory. Table 5 provides an overview of the planned adjustment paths presented in the updated stability programmes of the seven euro area countries with budgetary imbalances. All at least plan to adhere to the 0.5% annual adjustment benchmark on average over the course of the programme period taking into account a (welcome) phasing out of temporary measures. In the cases of Greece, Italy and Portugal, planned consolidation is somewhat more ambitious than the benchmark adjustment path, reflecting the setting of fiscal targets to comply with Council recommendations and notices under the EDP. For the remaining four countries (Germany, France, Luxembourg and Austria), planned consolidation is in line with (but does not go far beyond) the 0.5% annual adjustment benchmark on average. However, compliance in individual years is much less satisfactory, with these four countries all aiming to adjust by less than 0.5% in 2006. This back-loading of consolidation efforts is not consistent with the spirit of the reformed Pact.

**Table 5 Adjustment paths towards MTOs in the 2005/6 updated stability programmes**

(as a % of GDP)

| | Levels | | | | Changes | | | |
|---|---|---|---|---|---|---|---|---|
| | 2005 | 2006 | 2007 | 2008 | 2006 | 2007 | 2008 | *Average* |
| **Germany** | | | | | | | | |
| Structural balance | -3,0 | -2,9 | -1,8 | -1,5 | 0,1 | 1,1 | 0,3 | *0,5* |
| Nominal balance | -3,3 | -3,3 | -2,5 | -2,0 | 0,0 | 0,8 | 0,5 | *0,4* |
| Output gap | -0,9 | -0,7 | -1,1 | -0,7 | 0,2 | -0,4 | 0,4 | *0,1* |
| **Greece** | | | | | | | | |
| Structural balance | -4,8 | -3,7 | -2,8 | -2,4 | 1,1 | 0,9 | 0,4 | *0,8* |
| Nominal balance | -4,3 | -2,6 | -2,3 | -1,7 | 1,7 | 0,3 | 0,6 | *0,9* |
| Output gap | 1,1 | 1,1 | 1,1 | 1,5 | 0,0 | 0,0 | 0,4 | *0,1* |
| **France** | | | | | | | | |
| Structural balance | -3,3 | -2,9 | -2,3 | -1,5 | 0,4 | 0,6 | 0,8 | *0,6* |
| Nominal balance | -3,0 | -2,9 | -2,6 | -1,9 | 0,1 | 0,3 | 0,7 | *0,4* |
| Output gap | -0,5 | -0,4 | -0,6 | -0,8 | 0,1 | -0,2 | -0,2 | *-0,1* |
| **Italy** | | | | | | | | |
| Structural balance | -4,1 | -3,2 | -2,3 | -1,7 | 0,9 | 0,9 | 0,6 | *0,8* |
| Nominal balance | -4,3 | -3,5 | -2,8 | -2,1 | 0,8 | 0,7 | 0,7 | *0,7* |
| Output gap | -1,5 | -1,2 | -1,0 | -0,8 | 0,3 | 0,2 | 0,2 | *0,2* |
| **Luxembourg** | | | | | | | | |
| Structural balance | -1,5 | -1,2 | -0,6 | 0,1 | 0,3 | 0,6 | 0,7 | *0,5* |
| Nominal balance | -2,3 | -1,8 | -1,0 | -0,2 | 0,5 | 0,8 | 0,8 | *0,7* |
| Output gap | -1,7 | -1,3 | -0,7 | -0,6 | 0,4 | 0,6 | 0,1 | *0,4* |
| **Austria** | | | | | | | | |
| Structural balance | -1,6 | -1,2 | -0,4 | 0,2 | 0,4 | 0,8 | 0,6 | *0,6* |
| Nominal balance | -1,9 | -1,7 | -0,8 | 0,0 | 0,2 | 0,9 | 0,8 | *0,6* |
| Output gap | -0,7 | -1,1 | -0,9 | -0,5 | -0,4 | 0,2 | 0,4 | *0,1* |
| **Portugal** | | | | | | | | |
| Structural balance | -5,0 | -3,4 | -2,6 | -1,8 | 1,6 | 0,8 | 0,8 | *1,1* |
| Nominal balance | -6,0 | -4,6 | -3,7 | -2,6 | 1,4 | 0,9 | 1,1 | *1,1* |
| Output gap | -2,3 | -2,7 | -2,5 | -1,8 | -0,4 | 0,2 | 0,7 | *0,2* |

Source: Commission assessments of stability programme updates December 2005 - February 2006.

In terms of the assessment of good or bad times, it is notable that there is a prevalence of negative output gaps in all countries except Greece. For countries that do not have excessive deficits, this could provide a rationale under the new rules to plan less than the 0.5% annual adjustment even though, as output gaps are gradually closing, there is an assumption of above-trend growth. At present, this escape clause has not been explicitly invoked, which should be viewed positively given the uncertainties surrounding output gap estimates and the tendency for negative output gaps to predominate in the ex ante assessment of budgetary positions (see Box 5). At the same time, the lack of fiscal consolidation planned for 2006 in several countries represents a deviation from the 0.5% annual adjustment benchmark without any explicit justification.

### POLICY COORDINATION AND REFORM

As far as the intention of the SGP reform to "enrich the framework with a stronger emphasis on the economic rationale" is concerned, there is so far only limited evidence of increased attention being played to macro-fiscal linkages, such as divergence caused by external imbalances, demand pressures and losses in competitiveness. While it may be that such issues are increasingly taken into account in policy discussions, they have not so far found their way into the recommendations to Member States.

The discussion of the long-term costs of population ageing and fiscal sustainability has received more attention in the Council opinions, and for some countries, recommendations have been rather explicit in this regard. There have been no explicit attempts by Member States to trade-off fiscal consolidation and structural reform efforts, which the literature does not find convincing in any case (see EU Commission 2005; Annett, 2006; or Hauptmeier, Heipertz and Schuknecht, 2006). At the same time, there is no evidence of countries effectively pursuing ambitious and comprehensive consolidation and reform strategies.

With regard to governance, more attention is being paid to national budgetary rules and institutions. Especially in countries with a history of deficit and expenditure overruns, the Commission and Council are assessing the prevailing institutions and reforms, and in a number of cases, including all countries in excessive deficit, Council opinions contain recommendations regarding the need to strengthen such institutions, especially with a view to preventing expenditure overruns (see Table 4).

### FISCAL PLANS UNDER THE NEW PREVENTIVE ARM

One way of assessing the impact of the SGP reform on fiscal plans under the preventive arm is to compare the implications for the euro area of the fiscal plans presented in the stability programmes prior to and after the reform. Chart 5 compares how euro area real GDP growth and the main euro area fiscal aggregates are assumed to evolve in the latest round of stability programme updates compared to the previous programme updates, as well as vis-à-vis actual developments and the European Commission's spring 2006 forecasts.

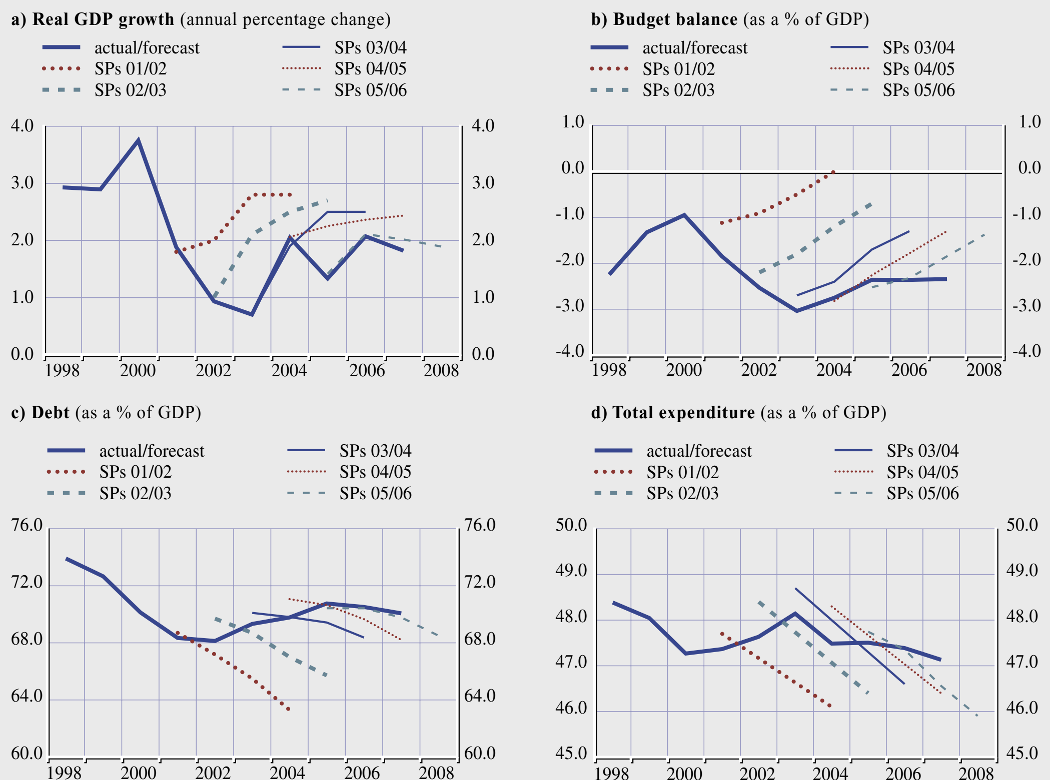
According to the latest round of programmes, real GDP growth is assumed to pick up to around its potential rate and then remain close to that level in the coming years (see Panel a of Chart 5). This is broadly in line with the Commission's forecast (as well as those of the ECB and other international institutions), although the stability programmes assume a somewhat quicker return to trend. These growth assumptions are similar to those presented in previous programmes, although they have become slightly more moderate and more realistic in the latest round of updates, at least with respect to the later years of the programme horizon. According to the assessments of this year's programmes prepared by the Commission, most Member States have based their fiscal plans on realistic or plausible macroeconomic assumptions. In Greece and Portugal, however, assumptions were still considered to be on the optimistic side.

As for the euro area budget balance (Panel b), the envisaged adjustment in the latest stability programme updates is smaller than in previous stability programme updates, amounting to around 1% of GDP over three years (2006-2008), compared to around 1.5% of GDP in previous programmes. Moreover, the Chart illustrates the above-mentioned very limited planned improvement in the budget balance in 2006 and an increase in the degree of back-loading of consolidation efforts. The slower decline in the planned deficit is also reflected in a more gradual decline in the debt-to-GDP ratio, which is expected to fall by only around 1% of GDP between 2005 and 2008 (Panel c).[28] Meanwhile, in terms of the composition of planned fiscal consolidation, there is little change compared with previous years, with most Member States focusing on expenditure restraint, as can be seen from the projected reduction in the expenditure-to-GDP ratio (Panel d).

One way of interpreting these numbers is that, having missed targets in previous years, Member States are now using the additional flexibility provided by the reformed SGP to present more realistic (i.e. achievable) deficit and debt targets. If such targets were actually achieved, this would be indicative of a strengthening of the preventive arm. However, the reduced ambition of the programmes also implies that

28 The comparison of previous stability programme targets and actual fiscal outcomes in Chart 5 is affected by recent changes to national accounts. The latter have resulted in upward revisions of GDP and corresponding downward revisions in government revenue, expenditure and debt when expressed as a percentage of GDP. This explains why debt-to-GDP ratios and expenditure-to-GDP ratios were initially observed to be at higher levels in the 01/02 to 04/05 programme vintages than currently recorded by actual data.

**Chart 5 Euro area fiscal outlook: new versus old stability programmes**




Sources: Member States' updated stability programmes 2001-2006 and own calculations, European Commission AMECO database.

unless compliance with fiscal plans genuinely improves, actual fiscal outcomes may develop less favourably (or at least not better) than before the SGP reform. This would imply that the preventive arm has been adjusted to accommodate existing policies rather than the other way around. This will only become clearer when the first batch of fiscal outcomes fully reflecting the impact of the SGP reform on fiscal policy measures and their implementation becomes available. Moreover, the planned progress towards sound budgetary positions reflected in the updated stability programmes has to be seen in conjunction with the implementation of the corrective arm of the Pact and the incentives to avoid excessive deficits.

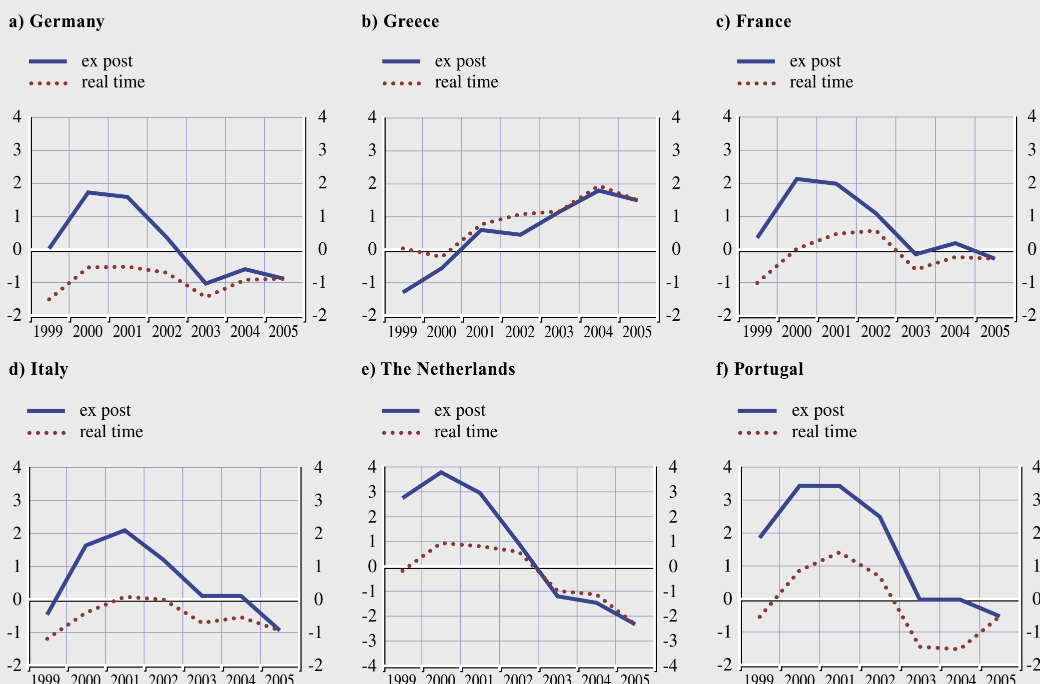
Box 5

## GOOD TIMES OR BAD TIMES?: REAL TIME AND EX POST ESTIMATES OF THE OUTPUT GAP IN EDP COUNTRIES

A major challenge for the effective implementation of the new provisions regarding the adjustment path towards the MTOs is the identification of so-called good times and bad times. In this regard, the decision to qualify times as good or bad primarily in relation to the level – rather than changes – in the output gap is particularly significant. The current round of stability programme updates suggests, as does past experience, that there is a tendency for negative output gaps (i.e. a perception of bad times) to predominate in the ex ante assessment of budgetary positions, particularly in countries suffering from budgetary imbalances. This can primarily be

**Chart 6 Real-time and ex post estimates of the output gap, 1999-2005**

(as a % of GDP)




Source: European Commission, AMECO database.

attributed to the limitations of the methodologies used for calculating output gaps. It implies that in most cases, countries would have an argument for undertaking less fiscal adjustment, even in cases where growth is above potential and the output gap is closing. However, bad times often come to be seen ex post as "not so bad" or even relatively good, and only then it becomes clear that consolidation has been unduly delayed.

To illustrate this point, Chart 6 compares real-time and ex post estimates of the output gap contained in the Commission's spring forecasts for the period 1998-2005 for the six euro area Member States that have experienced excessive deficits during this period. The real-time estimate refers to the estimate contained in the Commission's spring forecast immediately after the year in question (e.g. the estimate of the output gap in 1999 contained in the spring 2000 forecast). The ex post estimate is the estimate contained in the Commission's spring 2006 forecast.[1] (It should be noted that by definition, the real-time and ex post figures for 2005 are identical, but may diverge as new forecast vintages are published in the future.)

With hindsight, the period 1999-2001, and to a lesser extent 2002 as well, should have been viewed as good times, which would have called for additional consolidation efforts. In real time, however, the perception was that output gaps were either still negative or close to zero, which would have justified less consolidation efforts. There is hence a risk that the new rules concerning the adjustment path exacerbate rather than help correct the past mistakes of failing to undertake sufficient consolidation during good times.

1 For reasons of data availability and consistency, the estimates shown here are those calculated according to the Commission's previous method (using a Hodrick-Prescott filter) as opposed to the production function approach currently used by the Commission. However, the estimation method chosen does not affect the fundamental nature of the results.

## 5.2 THE IMPLEMENTATION OF THE REFORMED CORRECTIVE ARM

One year after the SGP reform, experience with the implementation of the revised corrective arm is limited, in particular since most of the revised provisions and escape clauses remain untested. Nonetheless, EDPs have been launched against Italy and Portugal, and decisions have also been taken in the context of the EDP against Germany, so it is possible to make some initial inferences about the application of the new rules. On the whole, the implementation of procedures appears to be smoother and more consistent. However, this may have come at the cost of leniency in the setting of deadlines for the correction of excessive deficits, while the compliance with these deadlines and underlying targets remains subject to considerable implementation risks. Overall, targets are broadly consistent with the revised Pact, but projected progress seems too slow to ensure that deficits and debt ratios are brought down to safe levels before the budgetary costs of population ageing become more acute.

### ONGOING EXCESSIVE DEFICIT PROCEDURES

At the time of writing, five euro area countries (Germany, Greece, France, Italy and Portugal) are the subject of ongoing EDPs. Among these, Germany and France first exceeded the 3% of GDP reference value in 2002 and, in the following year, received recommendations from the Council to correct the situation by 2004 at the latest. Following the procedural deadlock of November 2003, this deadline was de facto extended to 2005.[29]

29 Following the annulment by the ECJ of the Council conclusions of 25 November 2003, the Commission issued a Communication in December 2004 setting out its approach in the context of the EDPs against Germany and France. In its Communication the Commission concluded that the Council's initial recommendation under Article 104(7) remained in force. However, in the light of subsequent events, it argued that the 2004 deadline should be extended to 2005. The Council endorsed this approach at its meeting on 18 January 2005.

While the latest data have confirmed a deficit marginally below 3% of GDP in the case of France, Germany's deficit remained above 3% of GDP in 2005. Towards the end of 2005, the German government announced a package of fiscal measures which effectively postponed the correction of its excessive deficit to 2007. In the light of the continued breach of the reference value, the Council decided to move to the next step of the EDP by issuing a notice to Germany under Article 104(9) of the Treaty.[30] Flexibility was shown, however, by granting an extension until 2007 to correct the excessive deficit, in line with the German government's announced fiscal plans. The reasons stated for this extension included the fact that Germany's budgetary adjustment was embedded in a comprehensive strategy, that measures were well advanced in the legislative process and that some measures already implemented would only produce results with a lag. It was also deemed sufficient that Germany would comply with the 0.5% annual adjustment path on average in 2006 and 2007 rather than in each individual year.

The EDP against Greece was launched in 2004 (following an initial breach of the reference value in 2003), and the Greek government was given until 2005 to correct the excessive deficit. By early 2005 it became clear that Greece was not going to comply with this deadline, in particular given that statistical revisions had pushed Greece's deficit well above the 3% threshold (and also confirmed breaches of the reference value in earlier years). The Council therefore issued a notice to Greece to take measures to correct its excessive deficit by 2006. In autumn 2005, the Council considered that Greece had taken effective action in response to the Council notice, and this assessment was confirmed in the Council's March 2006 opinion on Greece's updated stability programme. Nonetheless, the fiscal situation in Greece continues to be blurred by large discrepancies between the headline Maastricht deficit and the government's much higher net borrowing requirement.

EDPs against Italy and Portugal were launched shortly after the SGP reform. In the case of Italy, this was due to a breach of the 3% deficit limit being confirmed for 2004. Moreover, due to low growth and a phasing-out of temporary measures, the government announced that it planned an even higher deficit of around 4% of GDP in 2005. Portugal, meanwhile, announced that it would no longer take temporary measures to keep its deficit below 3% of GDP as it had done in the previous three years and that, as a result, its deficit in 2005 would rise to around 6% of GDP.

In July and September 2005 respectively, the Council decided that Italy and Portugal had excessive deficits and issued recommendations for their correction.[31] Since neither Italy nor Portugal could be considered to have deficits that were close to and only temporarily above 3% of GDP, the revised exceptional circumstances clause was not invoked, and the Commission's assessment of the other relevant factors was not taken into account when deciding whether or not the deficits were excessive.

When setting the deadlines for the correction of the excessive deficits, however, in both cases "special circumstances" were found to warrant extensions. In the case of Italy, the cyclical weakness of the economy and the size of the required adjustment were deemed sufficient grounds to grant a one-year extension of the deadline to 2007. In the case of Portugal, the same reasons as well as the intention to no longer rely on temporary measures were considered as warranting an extension by two years to 2008. In both cases, the Council recommendations accepted the 2005 budget plans, but called for significant budgetary adjustment towards the 3% reference value in

30 Council Decision of 14 March 2006 giving notice to Germany to take measures to correct its excessive deficit.

31 Council Recommendation of 28 July 2005 with a view to bringing to an end the situation of an excessive deficit in Italy; Council Recommendation of 20 September 2005 with a view to bringing to an end the situation of an excessive deficit in Portugal.

2006. Based largely on its assessment of 2005 budget outcomes and 2006 budget plans, the Council has so far deemed the action taken by Italy and Portugal to be consistent with its recommendations, but has also pointed to implementation risks in both countries, calling for a rigorous implementation of budget plans and implementation of additional measures as necessary.

### ASSESSMENT OF THE IMPLEMENTATION OF THE NEW CORRECTIVE ARM

The initial experience outlined above suggests that the changes introduced by the SGP reform have facilitated decision-making under the corrective arm. Procedural deadlocks such as the one that occurred in the context of the EDPs for Germany and France in November 2003 have been avoided. All deficits above 3% of GDP have been considered excessive (i.e. the "close to and temporary" condition of the revised Pact has been properly applied). In the case of Germany, a decision to issue a Council notice under Article 104(9) of the Treaty (which was the main stumbling block in November 2003) has since been taken without any controversy. Fiscal targets in the affected countries are in line with (but do not go beyond) minimum requirements under the respective EDPs. Moreover, with the exception of Greece recourse to temporary measures appears to be significantly reduced, which is encouraging given that the extended use of one-off measures and creative accounting was a factor that undermined the implementation of the original SGP.

With regard to the use of the additional flexibility and broader escape clauses, it may be premature to draw any firm conclusions, particularly since initial experiences may reflect a transition from the old to a new steady state. However, in all three countries for which important decisions have been taken, the invoking of special circumstances (in the cases of Portugal and Italy) and ad hoc justifications (in the case of Germany) to extend deadlines could be viewed as a lenient implementation of the new rules.

While the SGP reform aimed at improving the consistency between requirements under the EDP and the broader economic requirements of affected countries, there are only limited signs of this in practice. For example, Council recommendations and notices point to the need for debt reduction but do not explicitly tie this in with consolidation plans. Similarly, divergence in terms of demand pressures, asset price developments and/or competitiveness does not explicitly feed into recommendations regarding stricter adjustment needs or into advice concerning structural reforms designed to enhance the quality of public finances. Moreover, when broader considerations are cited in the context of determining the required consolidation path, this tends, as in the case of Germany, to go in the direction of extending deadlines and allowing consolidation delays.

Another conclusion that can be drawn from the experience so far is that the new rules introduced by the reform are themselves malleable. For example, while the reformed Pact refers to the possibility of extending deadlines "by one year", deadlines have been extended by two years in the cases of Portugal and Germany. In the case of Germany, the "annual" 0.5% of GDP adjustment benchmark was applied in cumulative terms over a two-year period (hence becoming a "biennial" benchmark) in order to accommodate a longer deadline. Hence, even if one rationale behind the SGP reform was to clarify and codify the flexibility or judgement that had previously been exercised under the EDP, room for (additional) discretion remains.

From the perspective of governance, it is notable that all recommendations issued so far under the reformed corrective arm have effectively endorsed the budget plans of the Member States concerned, although in some cases the latter may already have reflected the interests and concerns of the Commission and the other Member States. The emphasis has thus been on peer support for previously announced policies (with the Member State in question acting as leader, and the Council as a follower). Moreover, the call for "closer co-operation between the

Member States, the Commission and the Council" seems to be implemented by the Commission in trying to strike a balance between issuing recommendations that boost consolidation in line with the revised Pact while also achieving qualified majority support in the Council. In this way the Commission acts as a "consensus builder", which has the advantage of facilitating a smooth implementation of the EDP, but also limits the Commission's ability to act as an independent arbiter.

The implementation of EDPs (and the reformed SGP more generally) has also been facilitated by 2005 fiscal outcomes in most countries staying broadly in line with or even exceeding expectations. However, a number of challenges remain on the horizon that could potentially place considerable strain on the new rules and procedures.

An immediate concern is the question of how to proceed in the context of the EDP against France. While France's deficit was brought marginally below the 3% of GDP reference value in 2005, the Commission's spring 2006 economic forecasts point to the likelihood of a renewed breach of the reference value in 2006 or 2007, indicating that France's excessive deficit is yet to be corrected in a sustainable manner. The circumstances under which the Council decides to bring the EDP against France to a close is likely to be an important indicator of whether the supposedly enhanced economic rationale of the reformed SGP, and the increased focus on sustainability, is reflected in actual decisions.

Another issue is that Greece, Italy and Portugal have so far been deemed to be complying with their respective Council recommendations at least partly on the basis of their budgetary targets, rather than through concrete and credible adjustment measures that form part of a comprehensive strategy. The Commission's spring 2006 forecasts confirm that there is a significant risk of non-compliance in these countries. In the event that one or another of these countries fails to meet its obligations, an important test of the new rules will be whether or not the ex ante flexibility granted in the initial deadlines will be matched by a greater willingness to enforce compliance ex post.

### IMPLICATIONS OF EXCESSIVE DEFICIT PROCEDURES FOR THE PUBLIC FINANCE OUTLOOK

A slow correction of excessive deficits can result in deficits remaining close to or above 3% of GDP on average over extended periods of time. Even if the targets set in the most recent recommendations and notices were all met, in the decade since the SGP came into force, deficits will have been above 3% of GDP for five years in Germany and Italy, six years in Portugal and seven years in Greece (see

**Table 6 Overview of excessive deficit procedures and implications for deficit and debt developments**

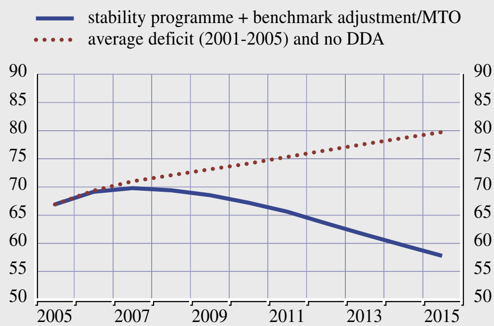
| | Germany | Greece | France | Italy | Netherlands | Portugal |
|---|---|---|---|---|---|---|
| Year in which deficit first exceeded 3% of GDP | 2002 | 1999 | 2002 | 2001 | 2003 | (1) 2000<br>(2) 2005 |
| Year in which deficit was declared excessive | 2003 | 2004 | 2003 | 2005 | 2004 | (1) 2002<br>(2) 2005 |
| Deadline (Article 104.7) | 2004/5 | 2005 | 2004/5 | 2007 | 2004 | (1) 2003<br>(2) 2008 |
| Deadline (Article 104.9) | 2007 | 2006 | - | - | - | -<br>- |
| Years above 3% if current targets are met [1] | 5 | 7 | 3 | 5 | 1 | 6 |
| Average deficit 1999-2005 (% of GDP) | 2.9 | 5.1 | 2.7 | 2.9 | 0.8 | 3.5 |
| Change in the debt-to-GDP ratio 1999-2005 | 6.5 | -4.8 | 8.2 | -9.2 | -8.6 | 11.9 |

Note: In 2004 Greece reported deficit and debt figures for the period 1997-2003 which were considerably higher than the previously released figures, and which showed deficits in excess of 3% of GDP over the whole period.
1) Number of years during the period 1999-2009 that the country will have had a deficit above 3% of GDP assuming that, for the period 2006-2009, the fiscal targets currently laid down in its stability programme are met.

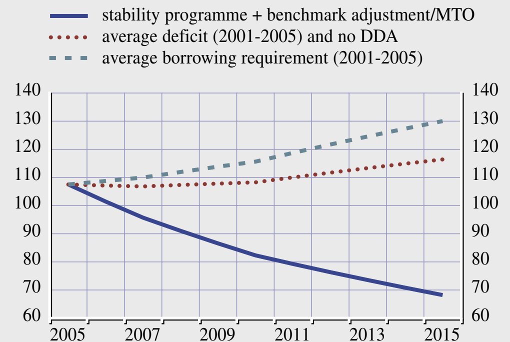
## Chart 7 Debt outlook for EDP countries and the euro area under different scenarios

(as a % of GDP)

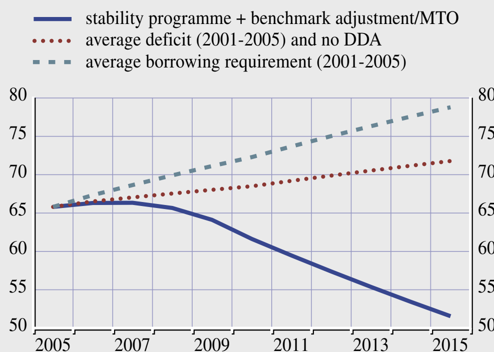
**a) Germany**



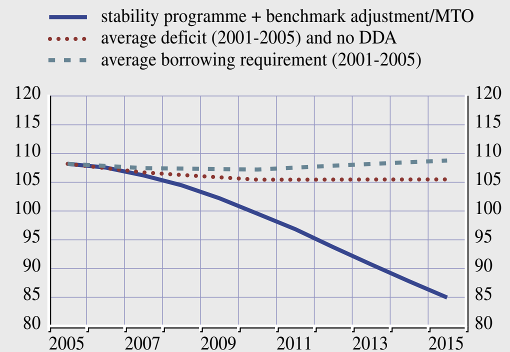

**b) Greece**



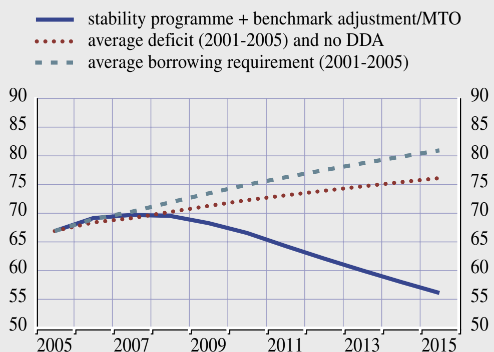

**c) France**



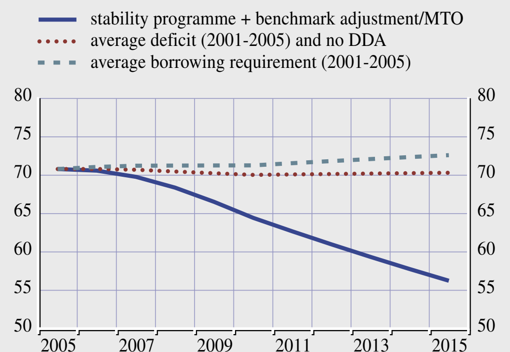

**d) Italy**




**e) Portugal**




**f) Euro area**




Sources: European Commission AMECO database, ECB.
Note: DDA = deficit-debt adjustment. Assumptions: (i) potential real GDP growth in line with the Economic Policy Committee report on ageing populations (i.e. for 2006-2010 and 2011-2015 Germany will record 1.7% and 1.4% growth respectively; then Greece 2.9% and 1.6%, France 2.2% and 1.8%, Italy 1.9% and 1.5%, Portugal 1.9% and 2.1%, and the euro area 2.1% and 1.9%); (ii) GDP deflator (annual change): Commission spring 2006 forecast up to 2007, thereafter 1.8% for Germany, France and Italy, 2.2% for Greece and Portugal, and 1.9% for the euro area.

Table 6). One implication of this is that, with the exception of the Netherlands, the countries that have been subject to EDPs have, on average, had deficits close to or above 3% of GDP since the start of monetary union. In the cases of Germany, France and Portugal, this has led to notable increases in their debt-to-GDP ratios, while in Greece and Italy debt-to-GDP ratios remain at very high levels, with little decline observed in recent years.

As far as developments since the SGP reform are concerned, it remains to be seen whether current consolidation strategies and their implementation under the revised Pact will be sufficient to bring debt ratios down at a satisfactory pace, if at all, before the fiscal impact of ageing places additional strains on public finances.

To illustrate what is at stake, Chart 7 simulates the evolution of the debt ratio over the next decade for the countries currently in an excessive deficit situation as well as for the euro area under three different scenarios. In the first scenario, current stability programme targets and compliance with SGP requirements are fully respected. In the second scenario, the average deficit of the past five years (i.e. the period 2001-2005) is maintained for the coming decade (and there are no deficit-debt adjustments, so that changes in the debt-to-GDP ratio are driven solely by the deficit ratio and nominal GDP growth). Finally, taking into account the fact that for some countries, debt developments have been negatively affected in recent years by deficit-debt adjustments, a third scenario is presented in which the debt ratio is driven by the borrowing requirement rather than the deficit (again assuming that the average of the past five years is maintained).[32] For all countries it is assumed that GDP grows in line with potential as estimated in the recent Commission/Economic Policy Committee report on the budgetary impact of ageing populations. (Regarding the link between steady state deficit and debt ratios and GDP growth, see Box 6)

These three different scenarios imply a very wide range of possible paths for the debt ratio. For Germany, France and Portugal, compliance with current targets would imply debt ratios below 60% of GDP by 2015, compared to ratios of close to or above 80% in the alternative scenario(s). For Italy, the difference is between a debt ratio that declines slowly but steadily towards 80% of GDP and a debt ratio that remains at around 100% of GDP. For Greece, the contrast is most stark, with a debt ratio falling to around 70% of GDP at one extreme, and a debt ratio climbing to above 130% of GDP by 2015 at the other extreme.

32 The borrowing requirement refers to transactions in debt and is equal to the change in the debt ratio minus certain valuation effects.

Box 6

### DEFICITS AND THE DEBT CRITERION: SOME SIMPLE ARITHMETIC

In the steady state, a country's debt-to GDP ratio should converge to a level that is equal to the deficit ratio divided by the nominal growth rate of GDP:

$$b = \frac{d}{y}$$

where $b$ is the debt-to-GDP ratio, $d$ is the deficit-to-GDP ratio and $y$ is the nominal growth rate of GDP. At the time the Maastricht Treaty was signed, a nominal growth rate of GDP of 5% per annum, consisting of a real GDP growth rate of around 3% and an inflation rate of around 2% (broadly in line with price stability), was assumed to be a reasonable estimate of the long-term

growth potential of the European economy. This assumption linked the deficit and debt criteria of the Treaty in the sense that, in the steady state, a deficit ratio of below 3% of GDP should be sufficient to ensure a debt-to-GDP ratio below the 60% reference value, since, arithmetically:

$$0.6 = \frac{0.03}{0.05}$$

Since the early 1990s, however, trend growth in the euro area has declined and most estimates now point to potential real GDP growth in the order of 2% per annum, implying trend nominal GDP growth of around or slightly below 4%. A consequence of this is that the deficit ratio needed to stabilise the debt-to-GDP ratio at a level safely below the 60% reference value is now closer to 2% of GDP rather than the 3% initially assumed in the Treaty. Or in other words, a deficit ratio of 3% of GDP would stabilise the debt ratio at levels somewhat above 60% of GDP (85% of GDP in case of nominal GDP growth of 3.5% per annum). While the EU's Lisbon agenda of structural reforms aims at raising potential growth rates above present levels, other factors, notably the ageing of populations, continue to work in the opposite direction so that potential growth rates may decline further in the years to come. This would make the deficit requirements for stabilising the debt ratio even more stringent than in the past.

## 6 SUMMARY AND CONCLUSIONS

Both theory and evidence suggest that, in the absence of adequate countervailing mechanisms, governments are prone to spend beyond their means, thereby incurring high deficits and causing public debt to increase, with adverse economic consequences in the long run.

Fiscal rules are supposed to correct the deficit and spending biases of governments and to provide an anchor or signal regarding the sustainable course of fiscal policies. The design of such rules needs, however, to take into account the transmission channels through which fiscal discipline is fostered, including the constraints and mechanisms that strengthen external monitoring and the scrutiny of fiscal policy. This means that a trade-off has to be made between adopting fiscal rules that are optimal in the sense of allowing a fine tuning of policy responses to all circumstances, and rules that are sufficiently clear and simple so that they can be fully understood and enforced.

In the run-up to monetary union, fiscal positions in euro area Member States improved significantly as the 3% deficit limit of the Maastricht Treaty for participation in the single currency set a clear benchmark against which fiscal policies could be assessed. The SGP, adopted shortly prior to the adoption of the euro, was intended to provide an additional means of maintaining fiscal discipline once the incentive of EMU membership had been achieved. The SGP's preventive arm, including the close to balance or in surplus requirement and the provisions for multilateral surveillance, sought to approximate an effective fiscal policy rule while remaining relatively simple, ensuring equal treatment, and respecting the principle of subsidiarity. Meanwhile, the corrective arm of the SGP, consisting of a hard 3% limit on deficits backed up by a sanctioning procedure, was intended to ensure a minimum of fiscal discipline and to provide an ultimate anchor for fiscal policy expectations.

Experience with the implementation of the SGP has been mixed, however. While some countries managed to achieve and maintain sound budgetary positions, half of the euro area

Member States (including the largest three, Germany, France and Italy) incurred excessive deficits, and all but one of these remain to be corrected in a sustainable manner. Moreover, as fiscal positions deteriorated, the implementation of the SGP procedures became beset with difficulties.

In 2005, the ECOFIN Council agreed on a reform of the SGP. The reform did not fundamentally change the Pact's original two armed (i.e. its preventive/corrective) structure. However, a number of adjustments have been, made. Under the preventive arm, Member States' medium-term objectives now more closely reflect country-specific situations in terms of debt and growth dynamics. Moreover, the corrective arm has been made more flexible.

While the changes to the preventive arm could essentially be considered as a shift in favour of sophisticated as opposed to simple rules, in the context of the corrective arm increased flexibility is associated with less stringent rules and procedures. Compared to the original framework, there are now more grounds for permitting deficits above 3% of GDP and extending deadlines for their correction. There is a risk that this will result in more frequent and more persistent deficits above 3% of GDP and less favourable debt developments, which could in turn have an adverse effect on expectations concerning fiscal discipline and macroeconomic stability.

Now that the SGP has been reformed, what matters is the effective and rigorous implementation of the new framework. Approximately one year after the reform, it is possible to draw some initial conclusions in this respect, albeit focused primarily on ex ante fiscal plans and decisions and not yet on ex post fiscal outcomes. On the whole, experiences have been mixed and further improvements are needed.

Member States have set themselves appropriate MTOs, plan the phasing out of one-off measures and make reasonable assumptions about the macroeconomic outlook. Nonetheless, in many cases planned progress towards achieving MTOs is very slow and planned budgetary consolidation is, on the whole, slightly less ambitious and more back-loaded than prior to the reform. This could be interpreted as a move towards greater realism in the setting of targets, but it could also be indicative of reduced incentives for Member States to achieve sound budgetary positions over the medium term. Moreover, while there has been some progress in focusing on issues related to long-term sustainability and budgetary institutions, there is so far only limited evidence that the "enhanced economic rationale" of the revised Pact is being used to more explicitly link considerations regarding high debt ratios, ageing costs, structural weaknesses, economic "good times" or broader macro-fiscal linkages with the specification of stricter adjustment and reform needs.

In the context of the corrective arm, most of the changes to the Pact have not yet been tested, although some important decisions have nevertheless been taken. Experience points to a smoother, relatively consistent implementation of the procedures, including moving to further procedural steps. At the same time, deadlines have been extended on the basis of special circumstances and ad hoc justifications (while in one case, the 0.5% annual adjustment requirement has been stretched to apply on average over a two year horizon). Some increased attention is being paid to sustainability concerns and to the need to improve national fiscal rules and institutions. Regarding the substance of fiscal plans in EDP countries, fiscal targets are broadly consistent with Council recommendations, but the latter are rather lenient and imply that progress with fiscal consolidation in the euro area would be rather slow. Moreover, compliance with recommendations continues to be subject to significant implementation risks.

In terms of the implications for public finances in the coming years, much depends on how Member States, the Council and the Commission

implement the revised rules and use the flexibility that they imply. If the rules are applied in a rigorous manner (i.e. sufficient structural adjustment is required and compliance improves), fiscal positions should converge to levels that are consistent with the sustainability of public finances. But if implementation is lax in the sense that requirements are lenient and compliance is weak, imbalances will remain large or even be exacerbated leading to debt ratios that follow an unsustainable path.

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