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1. The debate on the EU fiscal framework

1.1 Introduction

On 22 March 2005, the EU Heads of State and Government endorsed the report of the ECOFIN Council entitled 'Improving the implementation of the Stability and Growth Pact'.[24] Two days before, at their extraordinary meeting of Sunday 20 March, Ministers of Finance had reached consensus on the reform of the Pact after several months of intense discussion.

The new set of rules introduces more economic rationale and flexibility in the application of the EU fiscal framework and encourages Member States to achieve the necessary budgetary consolidation when economic conditions are favourable. In conjunction with a renewed commitment from all Member States to stability-oriented budgetary policies and the surveillance procedures, the new agreement puts an end to the uncertainty that has surrounded the interpretation of the existing budgetary rules since November 2003 and can reinforce the credibility of the EU fiscal framework.

The 2005 Ecofin report updates and complements the Stability and Growth Pact. It recommends furthermore complementary measures for improving fiscal and statistical governance both at the national and the EU level.

The agreement on the revision of the rules of the Pact is the result of a comprehensive review of the Stability and Growth Pact. It was launched by the Commission with its September 2004 Communication against the background of past and prospective budgetary developments and challenges as well as in light of the experience with the implementation of the budgetary rules in the EU Member States.

Overall, the agreement reached by the Council reflects a broadly balanced compromise. On the one hand, more economic judgement will be introduced in the application of the rules in order to better reflect the economic realities in the enlarged EU. This will help fostering the acceptability and ownership of the budgetary rules in Member States. On the other hand, renewed commitment of Member States to sound budgetary policy throughout the economic cycle provides a solid basis for improved and economically sensible implementation of the Pact.

The fundamental rules remain unchanged. In particular, the ECOFIN report reconfirms the agreement that the Treaty's reference values for government deficit and debt will remain the anchor of the system. This is underpinned by the commitment of the Commission to make a report under Article 104(3), the initial step of the excessive deficit procedure, always if a deficit exceeds 3%. Any excess of the deficit that will not be small and temporary will be considered excessive, whatever the influence of 'other relevant factors'. An excessive deficit will still need to be corrected promptly, despite the new extension of the deadlines in the excessive deficit procedure. A new annual minimum budgetary effort has been introduced for countries in EDP.

The Commission will ensure a forceful implementation of the agreement and continue the impartial and equal application of the rules to all Member States. Following the agreement by the Council, the Commission has swiftly move on and presented to the Council for adoption the necessary legislative proposals for implementing the agreed changes.[25]

This section of the report describes and explains the main elements of the 2005 reform package. It provides furthermore a first and tentative assessment of the changes against a set of established criteria for optimal fiscal rules and informs the reader about the main stages of the debate. In order to put the changes into

[24] See Presidency conclusions of the Brussels European Council of 22 and 23 March 2005 (7619/05) and the (Ecofin) Council report to the European Council of 21 March 2004 (7423/05).

[25] The legislative procedure was still ongoing by the time the 2005 Public Finance Report went to press.

perspective, the chapter starts by briefly recapitulating the key features of the existing EU fiscal framework.

1.2 The architecture of the existing EU fiscal framework

When the project of the European Economic and Monetary Union (EMU) was launched there was widespread recognition that enhanced economic co-ordination mechanisms were needed among the countries sharing the single currency.

In order to ensure the benefits of union-wide financial stability, Member States in the 1990s reached consensus on the design of a supranational fiscal policy framework at the level of the EU. The rules were adapted to the institutional characteristics of EMU and designed with a view to encouraging Member States to pursue sound budgetary policies while allowing sufficient margins for national budgetary flexibility.

The EU fiscal framework provides a combination of numerical and procedural rules enshrined in the Treaty and the Stability and Growth Pact.[26]

The Maastricht Treaty of 1992 established the requirement for Member States to keep their public deficit below 3% of GDP and the general government debt level below 60% of GDP (or diminishing at a satisfactory pace towards this reference value) as well as disciplinary rules to be followed in case a Member State fails to meet these criteria. According to Art. 104(3), when assessing a Member States' compliance with these criteria, the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors. The Stability and Growth Pact, adopted in 1997, further complemented and specified the rules of the Treaty with a view to reinforcing the preventive elements of the framework and inducing Member States to correct excessive deficit positions speedily if they occur.

The 1997 SGP consists of two Council Regulations, which are politically underpinned by the Resolution of the 1997 Amsterdam European Council. The first regulation, No. 1966/97, 'on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies', constitutes the preventive arm of the Pact. The regulation lays down a monitoring and early warning system with a view to prevent government deficits from becoming excessive. It requires Member States to achieve and maintain budgetary positions of 'close to balance or in surplus'. This is meant to ensure that fiscal policy contributes to an environment in which monetary policy can effectively maintain price stability whilst being growth supportive. Moreover, by maintaining a budget position of 'close to balance or in surplus', Member States would have the necessary room for manoeuvre for cyclical stabilisation through the working of the automatic stabilisers without the 3% of GDP reference value for deficits being breached (see e.g. Buti and Sapir (2002)). In addition, it would lead to a rapid reduction of the government debt to GDP ratio, implying a lower interest burden and creating further scope for governments to pursue growth enhancing reforms.

In order to allow for a consistent monitoring of the budgetary developments, the Regulation requests Member States to submit Stability or Convergence Programmes.[27] They include the medium-term objective for their budgetary position and describe the adjustment path towards it. In addition, since 2001, the annual up-dates of the Stability and Convergence Programmes contain complementary information on the long-term sustainability of public finances.

The Council is at the core of the peer review mechanism established by the Treaty and specified by the Pact. Based on the assessment of the Commission, the Council examines the programmes and formulates an opinion for each Member State. If the Council identifies significant divergence of the budgetary position from the medium-term budgetary objective or the adjustment path towards it, it can decide to address a recommendation to the Member State concerned to take the necessary action.

The dissuasive dimension of the Pact is laid down in the Council Regulation No. 1467/97 on "speeding up and clarifying the implementation of the excessive deficit procedure."[28] The main purpose of the regulation is to speed up and clarify the excessive deficit procedure as defined in the Treaty Article 104. It introduces a rigorous timetable for the procedure designed to strengthening the dissuasive nature of the Treaty requirements and providing incentives to ensure a sufficient safety margin from the reference value of 3% of GDP for the government deficit.

[26] For a more detailed description of the EU fiscal rules see Buti and Sapir (1998) and Cabral (2001). On the optimal design of fiscal policy rules see Kopits and Symanski (1998).

[27] Member States having adopted the euro submit Stability Programmes, the other Member States Convergence Programmes. The main difference between the Stability and Convergence Programmes concerns the quality of the monitoring of implementation. In terms of content, Convergence Programmes have to provide additional information on the medium-term monetary policy objectives, price and exchange rate stability. [See European Commission, (2000)]

[28] Council Regulation 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure.

Box II.1. Why fiscal rules?

Unsustainable budgetary positions are a major threat to macroeconomic stability. The experience of lax fiscal policies in several European countries up to the early 1990s had given evidence of the adverse effects of high public deficits and rising debt levels on economic growth and stability. The existence of large deficits and debt levels tends to push up prices and interest rates, distorts the allocation of resources and constrains the economy's capacity to respond counter-cyclically in case of an economic downturn. Effective multilateral fiscal rules can play an important role in countering the frequent deficit bias of fiscal policies by providing an external anchor to domestic budgetary reforms.

The formation of the European Economic and Monetary Union created additional arguments for fiscal rules at the supranational level. The combination of a single currency and decentralised fiscal policies carried out by sovereign countries call for enhanced coordination of macroeconomic policies within EMU. With the adoption of a single currency the potential for economic spillover between the participating Member States, including through the conduct of budgetary policy, increases considerably. At the same time market discipline tends to diminish as the risk of exchange rate changes and the ability of national central banks to influence the national interest rate of a specific country disappears. Such constellations open the possibility for free riding and give rise to the risk of moral hazard behaviour. In the absence of fiscal rules, governments in Member States may have an incentive to run overly expansionary policies because the costs in form of higher interest rates is spread across all members and can be expected to remain muted for the (ir-)responsible country. As a result of such behaviour the aggregate deficit and debt in the eurozone could rise to levels well beyond what is sustainable and socially acceptable. There is also a risk of impairing the functional independence of the European Central Bank, if Member States were allowed to accumulate unsustainable levels of public debt. High-debt countries, in order to avoid a default with negative repercussion on the euro area wide financial market, could *de facto* force the ECB to either accept a higher level of inflation than warranted (inflationary bail-out) or to bail out the indebted country at the cost of the whole union, despite the no-bail rule enshrined in the Maastricht Treaty. (See for example Eichengreen and Wyplosz 1998)

Main elements of Regulation 1467/97 include:

- The definition of the existence of an excessive deficit, including the concepts of 'exceptional and temporary' excess over the reference value and 'severe economic downturn'. According to the regulation the excess of a deficit can be considered exceptional if it results (a) from an unusual event outside the control of the Member State or (b) from a severe economic downturn. In either case, and provided that the deficit remains close to the reference value, no excessive deficit would be identified.
- The deadlines for the correction of the excessive deficit. The regulation stipulates that within four months the Member State has to take effective action for the correction of an excessive deficit and that the correction of the excessive deficits should be completed in the year following its identification by the Council, unless there are 'special circumstances'.[29] The latter concept is not specified and leaves discretionary room for decision making in the Council.
- Rules for the monitoring and assessment of the results of corrective actions taken,
- Deadlines for the subsequent steps in the procedure, including the application of sanctions.

The regulation focuses on the budget deficit and does not explicitly specify the application of the debt criterion of the Treaty, as compliance with the deficit criterion was deemed sufficient to ensure a satisfactory rate of debt reduction.

The rules of the Pact are embedded in a wider framework of economic governance and coordination in the EU and complemented by a more comprehensive set of policy instruments and rules, both at the EU level (e.g. the Broad Economic Policy Guidelines) as well as at the national level. Moreover, statistical governance, both at the level of the EU and the Member States, including rules concerning the timely provision of correct and comparable budgetary data is another key element of the EU fiscal framework.

1.3 Improving the implementation of the SGP – the 2005 reform package

The Review of the Pact provisions took place against the background of deteriorating budgetary performance of many EU Member States as well as in light of the changes in economic circumstances of the enlarged EU. By and large in line with the ideas presented by the Commission in its Communication of 3 September 2004,[30] the 2005 Ecofin report identifies five areas where improvement is warranted, notably to:

(i) enhance the economic rationale of the budgetary rules to improve their credibility and ownership;

[29] See Council Regulation No. 1467/97, Art. 3(4).

[30] Communication of the Commission 'Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact' of 3 September 2004, COM(2004)581 final. See also Deroose and Langedijk (2005) for a concise presentation of the reasons for reform. An alternative view focussing on effective and full application of original SGP is presented by Annett, Decressin, and Deppler (2005).

(ii) improve "ownership" by national policy makers;

(iii) use more effectively periods when economies are growing above trend for budgetary consolidation in order to avoid pro-cyclical policies;

(iv) take better account in Council recommendations of periods when economies are growing below trend;

(v) give sufficient attention in the surveillance of budgetary positions to debt and sustainability.

While some of these objectives could only be achieved by reducing the degree of automaticity of the existing rules and allowing for more economic judgement, the achievement of others is facilitated by adequately strengthening the incentives for compliance and enforcement. Moreover, the Commission, being the guardian of the Treaty and responsible for equal treatment in the application of EU rules, was concerned to ensure that by improving the economic underpinning of the Pact its rules-based character would not be jeopardised. Overall, the agreement reached by the Council reflects a balanced compromise.

The 2005 Ecofin report, endorsed by the European Council, up-dates and complements the existing SGP. For the implementations of some of the agreed changes it is necessary to formally amend the Council Regulations which underpin the SGP. Beyond these legal changes, the Ecofin report provides guidance for the Member States, the Council and the Commission in the application and interpretation of the Pact provisions. In line with the commitment of the Council to limit legislative changes to a minimum, the Report actually suggests only minimal changes to the Regulations, [including in the preventive arm of the Pact (Regulation 1466/97), notably on how to take structural reforms into account in the context of budgetary surveillance, and in the corrective arm of the Pact (Regulation 1467/97), notably the new definition of a 'severe economic downturn'; the nature of 'other relevant factors' and the steps of the EDP in which they should be considered; and the extension of the deadlines for taking effective action and measures in the course of the excessive deficit procedure.]

Elements designed to improve the economic underpinning and to increase the ownership of the Pact provisions are introduced both in the preventive arm of the Pact as well as in the application of the rules of the excessive deficit procedure. Moreover, the agreed measures to improve economic, fiscal and statistical governance are cross-cutting by nature. Their main aim is it to strengthen the legitimacy and ownership of the Pact and thereby foster its preventive power.

In order to facilitate the comparability with both the existing Pact, the following three sub-sections review the major modifications of the Pact provisions, by looking in turn at the changes to the preventive and the corrective arm and the measures related to the dimension of fiscal and statistical governance.

1.3.1 Changes in the preventive arm

Both the Commission and the Council considered enhancing the preventive dimension of the Pact a central objective of the reform.[31] Experience in the run-up to the recent protracted economic slowdown had highlighted the importance of prudent and symmetric-over-the-cycle fiscal policies and in particular the need to achieve surpluses in economically good times. Moreover, in light of the increased economic diversification in the EU of 25 Member States there is a need to better differentiate the medium-term budgetary policy objective according to relevant country-specific features. For lack of economic rationale, uniform budgetary objectives for all countries appeared no longer appropriate.

In response these challenges, the new agreement includes four major innovations in the preventive arm: (i) the definition of country-specific medium-term objectives within a given range and the procedure to set and revise them; (ii) agreement on a minimum annual budgetary effort for countries that have not yet reached the medium-term objectives; (iii) policy advice by the Commission to encourage Member States to stick to their adjustment path and (iv) the treatment of structural reforms.

These reform elements are designed with a view to enhancing the economic underpinning of the EU's medium-term fiscal policies, by providing more room for country-specific considerations. They are intended to raise Member States' compliance with their MTO and strengthen the incentives for prudent fiscal policies over the cycle and the implementation of structural reforms. The main modifications in the preventive arm are described below.

i) Country-specific medium-term objectives

The new definition of the medium-terms budgetary objective (MTO) is designed to better take into account the diversity of economic and budgetary positions and risks across Member States. In future, the medium-term objective of a country will be defined on the basis of its current debt ratio and potential growth, while the overall objective of achieving over the medium-term budgetary position of close to balance or in surplus remains. For Member States having adopted the euro area and for those participating in the European Exchange Rate Mechanism (ERM II), the agreed range of MTOs is between -1% of GDP for countries with a combination of low debt and high potential growth and balance or in

[31] See Council Declaration on the Stability and Growth Pact of 18 June 2004 and the Commission Communication of 3 September 2004.

surplus for countries with a combination of high debt and low potential growth.

The aim of the new country-specific MTO is threefold. It is designed to provide a safety margin with respect to the 3% deficit limit, to ensure fiscal sustainability in the long-run, and to improve the scope for productive public investment.

By taking into account relevant economic fundamentals, the new provision on the MTO allows for a better differentiation among countries while preserving the simplicity and transparency of the rule. Sustainability risks associated with implicit liabilities are indirectly addressed by ensuring that debt converges towards and remains at prudent values. Member States are thus offered the choice of combining different degrees of structural reform and debt reduction according to national preferences. Incentives for structural reform are not compromised.

The Report invites the Commission to continue methodological work on measuring and assessing implicit liabilities and to provide a progress report by the end of 2006. Once criteria and modalities for the assessment of implicit liabilities are established and agreed by the Council, the definition of the MTO will be reviewed with a view to reflecting such implicit liabilities more explicitly in the medium-term objective. Like in the past, the MTO is defined in cyclically-adjusted terms, net of one-off and temporary measures. The MTO for every Member State will be reviewed every four years and revised in light of the respective developments in government debt, potential growth and fiscal sustainability.

ii) Minimum annual budgetary effort for countries that have not yet reached the medium-term objectives

Member States of the euro area and of the ERM-II that have not yet reached their MTO have agreed to achieve, as a benchmark, an annual adjustment of 0.5% of GDP.[32] All Member States that have not yet reached their MTO are expected to achieve it over the cycle, by implementing more ambitious fiscal adjustment during good times. The new agreement on a minimum budgetary effort underpins the medium-term orientation of the European fiscal rules. The 1997 Pact provisions contain no explicit reference to the appropriate adjustment path.

The 2005 Ecofin report contains furthermore a commitment of Member States for the conduct of more symmetric fiscal policies over the cycle. Governments agreed to pursue active consolidation of the budget when the economic conditions are favourable, i.e. in 'good times', and to use windfall revenues, as a rule, for the reduction of government deficit and debt. The Report defines 'good times' as periods during which actual GDP growth is above potential growth, 'taking into account tax elasticities'. This implies that the magnitude of consolidation in good times will depend on the actual impact of growth on public revenues. The latter is largely determined by the composition of the sources of growth.

iii) Early warning system

With a view to strengthening the preventive character of the Pact, the 2005 Ecofin Report clarifies and expands the existing early warning mechanism. The Report expects the Commission to issue direct, i.e. without prior Council involvement, policy advice to encourage Member States to realise the agreed adjustment path. Accordingly, the Commission will address the Council in future not only if there is an acute risk of breaching the 3%-of-GDP reference value, but can do so also in cases of unjustified deviations from the adjustment path towards the MTO or the MTO itself, including in good times. The agreement pertains to the transition period until the new Constitution becomes effective. Once it is in force, the instrument of the 'policy advice' will be replaced by a Commission 'opinion' in line with the new Article III-184(5), directly addressed to the Member State concerned.

iv) Structural reforms

With a view to eliminating possible disincentives for structural reforms, the Council agreed that under certain conditions, certain structural reforms can justify a temporary deviation form the MTO and, for Member States that have not yet reached their MTO, temporary deviations from the adjustment path towards the MTO.

Provided that the respect of the 3%-of-GDP reference value is not jeopardised and the budgetary position is expected to return to the MTO within the four-year programme period, the Council, when assessing the MTO or the adjustment path towards it, shall take into account major structural reforms. Only major structural reforms that have direct long-term cost-saving effects and verifiably improve fiscal sustainability over the long-term will be considered. This rule pertains in particular to systemic reforms of the pension scheme of a Member State. Such reforms typically imply budgetary costs in the short-run to the benefit of lower ageing-related implicit liabilities in the long-run. Significant other supply side reforms that raise potential growth can also be considered. These modifications should be seen in the context of increasing the consistency of the various policy objectives and instruments at the EU level, in particular with the objectives of the Lisbon Strategy.

[32] Measured in cyclically adjusted terms, net of one-off and other temporary measures.

Table II.1. Main changes to the Stability and Growth Pact following the Council agreement of 20 March 2005

	original	revised
1. Changes in the preventive arm		
Medium-term objective (MTO)	All Member States (MS) have a medium-term budgetary objective (MTO) of 'close-to-balance-or-in-surplus'.	• Country-specific differentiation of MTOs according to stock of public debt and potential growth. • MTOs for euro area and ERM II MS are set between -1% of GDP and balance or surplus (in cyclically-adjusted terms and net of one-offs). • Implicit liabilities to be taken into account at a later stage, when modalities for doing so are agreed by the Council.
Adjustment path towards the MTO	No specific provisions.	• MS to take active steps to achieve the MTO. • Annual minimum adjustment for MS of the euro zone or of ERM-II of 0.5% of GDP. • The effort should be higher in '*good times*'. • '*Good times*' are identified as periods where output exceeds its potential level, 'taking into account tax elasticities'
Early policy advice	Early Warnings are adopted / addressed by the Council, upon recommendation of the Commission.	In addition, the Commission can issue direct '*early policy advice*' to encourage MS to stick to their adjustment path. To be replaced by '*early warnings*' in accordance with the Constitution once applicable.
Structural reforms	No specific provision.	Reforms will be taken into account when defining the adjustment path to the MTO and may allow a deviation from it under the following conditions: • Only major reforms (direct / indirect impact on sustainability); • safety margin to the 3% reference value is guaranteed; • the deficit returns to the MTO within the programme period; • detailed information is provided in the Stability/Convergence Programmes. Special attention to systemic pension reforms.
2. Difference s in the corrective arm		
Preparing a report under Article 104(3)	No obligation for the Commission to prepare a report if a deficit exceeds 3%.	• The Commission will always prepare a report in case there is a deficit above 3%. • The report will examine whether the exceptions in Article 104(2) apply. • It will take into account whether the deficit exceeds government investment expenditure and all '*other relevant factors*'.
Severe economic downturn	'*Severe economic downturn'* if there is an annual fall of real GDP of at least 2% for the preparation of report under Art. 104(3) by the Commission, and in decisions under 104(6) by the Council, if observations by the Member State concerned show that the downturn is exceptional in light of evidence of the abruptness of the downturn and the accumulated loss of output with respect to past trends. The Member States commit not to invoke the severe economic downturn when growth is above -0.75%.	An economic downturn may be considered '*severe*' in case of a negative growth rate or accumulated loss of output during a protracted period of very low growth relative to potential growth
'Other relevant factors' (ORF)	No specific definition of '*ORF*' and their role in the excessive deficit procedure.	• The Commission report under Art. 104(3) will take into account: – Developments in the medium-term economic position (potential growth, cyclical conditions, implementation of policies); – Developments in the medium-term budgetary position (public investment, quality of public finances, as well as fiscal consolidation in '*good times'*, debt sustainability); – Any other factors, which in the opinion of the MS, are relevant in order to assess the

		excess over the reference value. • '*ORF*' will be considered in the steps from Article 104 (4) to (6)) only if the excess over the reference value is temporary and the deficit remains close to the reference value. Any deficit above 3% that is neither close to the reference value nor temporary will be considered excessive. • If the Council has decided that an excessive deficit exists, the ORF will also be considered in the subsequent procedural steps of Article 104 (except in Article 104(12), i.e. abrogation, and when deciding to repeat steps in the EDP).
Systemic pension reforms	No specific provision.	• These are treated like an 'ORF', but under strict conditions also with a role in abrogation. • Consideration to the net cost of the reform will be given regressively for the initial five years after a MS has introduced the reform (or five years after 2004).
Increasing the focus on debt and sustainability	No specific provision.	• The debt criterion, and in particular the concept of a debt ratio 'sufficiently diminishing and approaching the reference value at a satisfactory pace' will be applied in qualitative terms. • The Council will formulate recommendations on the debt dynamics in its opinions on the stability and convergence programmes.
Extending deadlines for taking effective action and measures		Deadlines are extended: • for a decision under 104(6) – from 3 to 4 months after notification; • for taking effective action following 104(7) - from 4 to 6 months; • for moving to 104(9) – from 1 to 2 months; • for taking action following a notice under 104(9) – from 2 to 4 months.
Minimum fiscal effort	No specific provision.	Countries in excessive deficit are required to achieve a minimum fiscal effort of at least 0.5 % of GDP as a benchmark.
Initial deadline for correcting the excessive deficit	The excessive deficit has to be corrected in the year following its identification, unless there are '*special circumstances*'.	The rule remains; possible extension by one year based on '*ORF*' and on the condition that minimum fiscal efforts have been taken.
Repetition of steps in the EDP	Not foreseen.	Deadlines for correcting the ED can be extended if: • effective action has been taken by the MS concerned in compliance with the initial recommendation or notice, and • unexpected adverse economic events with major unfavourable budgetary effects occur during the correction phase.

Source: Commission services.

In order to allow the Commission and the Council to scrutinise the envisaged structural reforms and assess their impact on the MTO and the adjustment path towards it, Member States will be requested to provide detailed documentation of the expected cost-benefit effects of the envisaged reforms in the context of the annual up-dates of stability and convergence programmes. It is furthermore envisaged to give the Council three, instead of two, months for the examination of the programmes following their submission.

1.3.2 Changes in the corrective arm

The main modifications in the corrective arm of Pact concern (i) the definition of 'excessive deficits', including the revision of the concept of 'severe economic downturn' and the role of 'other relevant factors', (ii) the possible extension of the existing one-year deadline for the correction of an excessive deficit following its identification by one year and the introduction of repeatability of steps in the EDP; (iii) considerations related to the assessment of systemic pension reforms in the EDP and (iv) focus on debt and fiscal sustainability.

Many commentators have criticised the revisions in the excessive deficit procedure as a significant weakening of the dissuasive dimension of the Pact. It is argued that in particular the agreement on the application of other relevant factors *de facto* erodes the 3%-of-GDP reference value, and that the lack of constraint would give rise to growing deficits in the future.[33] However,

[33] See e.g. Feldstein (2005) and Deutsche Bundesbank, press release of 21 March 2005.

such an assessment overlooks key elements of the new 2005 reform.

In practice, the room for discretionary judgement in the excessive deficit procedure to better capture economic reality, including the consideration of the agreed wider set of 'other relevant factors' or the possibility to incur a repetition of procedural steps, is effectively constrained by complementary provisions of the new agreement, preserving the character of the rules-based system. First of all, both the Commission, when considering whether an excessive deficit exists or may occur, and the Council, when deciding on the existence of an excessive deficit, will take into account any relevant factors only if the general government deficit remains close to the reference value and its excess over the reference value is temporary.

Secondly, there will be no simple discounting of certain categories of public expenditure from the deficit calculations. Other relevant factors are always considered in an overall assessment, in which a large number of factors, including those that may call for a stricter interpretation of the deficit figures, are examined symmetrically to assess compliance with budgetary discipline.

Thirdly, Member States in excessive deficit are requested to achieve a minimum annual budgetary effort of 0.5% of GDP[34] irrespective of relevant factors.

Fourthly, the Commission will always issue a report under Art. 104(3), if the deficit of a Member State exceeds 3%, or if it sees a risk of an excessive deficit.

And finally, the obligation of the Council to impose sanctions in case a Member State in excessive deficit repeatedly fails to act in compliance with the successive decisions of the Council remains unchanged as the ultimate threat against non-compliance. The various modifications in the corrective arm are presented in more detail below.

i) Definition of 'excessive deficits'

The identification of an excessive deficit is the cornerstone of the SGP's dissuasive arm. According to Article 104 (2a) of the Treaty (and the Protocol on the Excessive Deficit Procedure) a government deficit above 3% of GDP is considered to be excessive unless the excess over the 3% is only exceptional and temporary and the government deficit ratio remains close to the reference value.[35] The existing Council Regulation 1467/97 specifies in Art. 2 that the excess over 3% can be considered exceptional if it results (a) from an unusual event outside the control of the Member State (e.g. a natural disaster) or (b) from a severe economic downturn, which is defined as an annual fall of real GDP of at least 2% (Article 2(2)). In order for the excess to be considered temporary, the Commission's forecast must indicate that the deficit will fall back below the reference value following the end of the unusual event or the severe economic downturn. The Commission's usual forecasting period is two years.

'Severe economic downturn' redefined

In order to reformulate the exceptionality clause more in line with economic reality in the EU Member States, the Council agreed to make the condition of 'severe economic downturn' less demanding and suggested adapting paragraphs Article 2 (2) and (3). Accordingly, both the Commission and the Council, when assessing and deciding on the existence of an excessive deficit according to Treaty Article 104 (3-6) may consider as exceptional in the sense of Art. 104(2a) an excess over the reference value 'which results from a negative growth rate or from the output loss accumulated during a protracted period of very low growth relative to potential growth'. However, the overarching conditions of 'close to the reference value' and 'temporariness' continue to apply.

The role of 'other relevant factors' clarified

Moreover, with a view to ensure a balanced and comprehensive assessment of the budgetary developments in the context of the economic and fiscal conditions prevailing in a country, the 2005 Ecofin Report clarifies a set of 'other relevant factors' that the Commission and the Council will take into account when deciding on the existence of an excessive deficit and when determining the deadline for its correction.[36] In particular, the Commission when preparing the report under Article 104(3), which initialises the Excessive Deficit Procedure, 'should appropriately reflect developments in the medium-term economic position, (in particular, potential growth, prevailing cyclical conditions, the implementation of policies in the context of the Lisbon agenda and policies to foster research and development and innovation) and developments in the medium-term budgetary position (in particular, fiscal consolidation efforts in 'good times', debt sustainability, public investment and the overall quality of public finances)'.

Furthermore, the Commission shall give 'due consideration' 'to any other factor, which in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value'. Such factors may include 'budgetary efforts towards increasing, or maintaining at a high level, financial contributions to fostering international solidarity and to achieving European policy goals, notably the unification of Europe'.

[34] In cyclically-adjusted terms net of one-off and temporary measures.

[35] See Cabral (2001) for details.

[36] The Treaty provisions on the excessive deficit procedure (Article 104) include the concept of other relevant factors. However, in practice it did not play a significant role in the excessive deficit procedures in the past.

Once the Council has taken the decision that an excessive deficit exists, 'the other relevant factors will also be considered in the subsequent steps' of the procedure, including in the decision on the appropriate deadline for the correction of the excessive deficit and the assessment of effective action, but not 'in the decision of the Council whether a Member State has corrected its excessive deficit'.

The 2005 Ecofin Report stresses that other relevant factors are taken into account only under the condition that 'the excess over the reference value is temporary and the deficit remains close to the reference value'. In other words, if a deficit above 3% exceeds what is considered 'close to the reference value' or if there is no indication in the budgetary forecast provided by the Commission that the deficit will fall below the reference value, the presumption prevails that an excessive deficit exists despite all 'other relevant factors', and the Council shall decide accordingly.

ii) Deadlines and repeatability of steps in the excessive deficit procedure

The 1997 Pact provisions are characterised by a high degree of automatism both with respect to the timing and the sequence of the respective steps in the EDP. The 2005 Ecofin Report, while up-holding the principle that an excessive deficit should be corrected promptly, introduces more flexibility to respond to changes in economic circumstances. The new agreement sticks to the provision that, as a rule, an excessive deficit should be corrected the year after it is identified by the Council, i.e. usually the second year after it occurs. However, in cases where a correction in the consecutive year would be unwarranted for economic reasons, the Council may decide to set the deadline for the correction of the excessive deficit in the second year after its identification. When deciding on the appropriate deadline for the correction of the excessive deficit, the other relevant factors analysed by the Commission in its report under Art. 104(3) will be taken into account.

The increased flexibility with respect to setting the initial deadline for correction is counterbalanced by the Council agreement that, as a benchmark, countries in excessive deficit have to implement a minimum fiscal adjustment of at least 0.5 % of GDP[37] irrespective of the existence of other relevant factors. The Council, on the basis of a recommendation by the Commission, can intervene at any time, if it finds that the action implemented by the country concerned is inadequate to bring the excessive deficit to an end as recommended, and move to the next step in the procedure.

With a view to allowing both the Commission and the Council for an appropriate assessment of all aspects, the delay for adoption of a decision under Article 104(6) establishing the existence of an excessive deficit should be extended from three to four months after the notification deadline. By the same token, to facilitate the effective adoption of more comprehensive consolidation packages in the context of national budgetary processes, the delay for taking effective action will be extended from currently four to six months. For the same reasons, the one-month deadline for the Council to take a decision to move from Article 104(8) to Article 104(9) will be extended to two months, and the two-month deadline under Article 104(9) to 4 months. As a result, the overall maximum period of 10 months within which the Council is obliged to take a decision to impose sanctions in case a Member States participating to the eurozone fails to comply with the successive decisions of the Council[38] is effectively expanded to 16 months.

The 2005 Ecofin Report introduces also the possibility of repeating steps in the excessive deficit procedure, thereby correcting what has been seen as one of the main sources of rigidity of the current Pact.

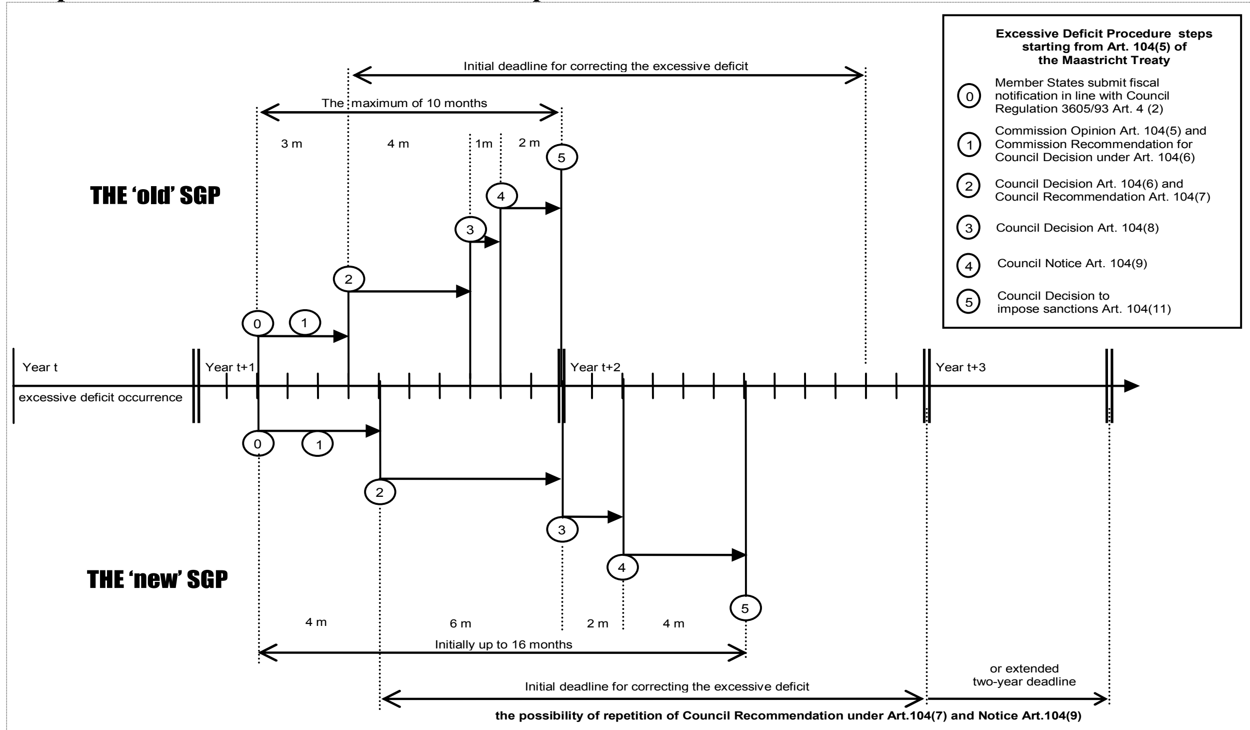
In case an unexpected adverse economic event with a considerable negative impact on the budget hits a country in the course of correcting its excessive deficit, the deadlines initially agreed by the Council following Art. 104(7) or Art. 107(9) can be revised and expanded.

However, a repetition of these steps can only be invoked under the provision that effective action has been taken by the country concerned in compliance with the initial recommendation or notice. This implies that as a minimum, measures in the magnitude of 0.5% of GDP in cyclically-adjusted terms, net of one-off and other temporary measures, must be in place.

[37] In cyclically-adjusted terms, and net of one-off and other temporary measures.

[38] Council Regulation 1467/99, Art. 7.

Graph II.1. Extended deadlines for the steps in the EDP



Source: Commission services.

iii) Taking into account systemic pension reforms

In line with the provisions concerning the treatment of so-called second-pillar pension reforms in the definition of the MTO, the 2005 Ecofin Report commits the Council and the Commission to 'consider carefully' in the context of the EDP an excess close to the reference value caused by the introduction of a multi-pillar pension system that includes a mandatory, fully funded pillar.

In particular, when assessing whether the excessive deficit has been corrected, the Commission and the Council will compare the developments of the nominal deficit figures under the EDP with the net costs related to the implementation of the second pillar.

Over the first five years after the implementation of such a reform, and following a regressive mode, the deficit figures can be corrected for the net costs of the pension reforms. The correction will be for 100% of the net costs in the first year, for 80% in the second year, and for 60%, 40%, and 20% in the third, fourth and fifth year. For Member States that have already implemented such reforms, the same five-year mechanism would apply, starting in 2005.

While these provisions are generally designed to provide further incentives for increasing the long-term sustainability of pension systems, they pertain particularly to a number of new Member States, which have recently started with the build-up of a fully funded second pillar. While most of these countries are currently in EDP, a certain proportion of the excessive deficit is attributable to the pension reform. Thus, the agreement reached by the Council on the treatment of second-pillar pension reforms in the EDP may have implications for the assessment of fiscal convergence in line with the deficit criteria laid down in the Treaty for deciding on membership in the euro zone.

iv) Focus on debt and fiscal sustainability

The Commission intends to apply in full the provisions of the Treaty. Under the current legal provisions, according to Article 104(2) of the Treaty, the Commission monitors whether the debt ratio exceeds the reference value and, if so, whether it is sufficiently diminishing and approaching the reference value at a satisfactory pace. The Commission has the possibility, where it is of the opinion that there is an excessive deficit for non-compliance with the debt criterion, to recommend to the Council to take a decision on the existence of an excessive deficit according to Article 104(6) of the Treaty.

The 2005 Ecofin Report recalls the Commission's obligation to examine compliance with budgetary discipline on the basis of both the deficit and the debt criterion and reaffirms the need to reduce government debt to below 60 % of GDP at a satisfactory pace. The Council calls in particular for a strengthening of the debt surveillance framework by applying the Treaty's concept of 'sufficiently diminishing and approaching the reference value at a satisfactory pace' for the debt ratio in qualitative terms. This implies that macroeconomic conditions, in particular the level of potential growth and the cyclical position, and debt dynamics should be taken into account, including the pursuit of appropriate levels of primary surpluses as well as other measures to

reduce gross debt, including the one-off and other temporary measures, and debt management strategies. Following such an approach avoids a mechanistic interpretation of gross debt figures.

In case the Council identifies a situation of non-compliance with the debt criterion, it will formulate a recommendation in the context of the Council opinions on the stability programme.

1.3.3 Improving governance

The 2005 Ecofin report recognises that modifications to the provisions of the Pact are not sufficient to ensure a meaningful improvement of their implementation. In order to solidly re-establish the credibility of the Pact and to strengthen the enforcement of budgetary discipline, it is important that complementary measures are taken to enhance the institutional conditions for fiscal and statistical governance. The report contains a number of elements designed to increase the ownership of the Pact provision, clarify the respective roles and responsibilities of the various actors involved as well as measures to improve the quality and timeliness of statistical data, both at the national and the EU level.

i) Fiscal governance

The 2005 Ecofin Report stresses that increasing the effectiveness of peer support and pressure is an integral part of a reformed Stability and Growth Pact. With a view to strengthening the central peer support functions of the Pact, the Council and the Commission commit to explain publicly their positions and decisions at all appropriate stages of the fiscal surveillance procedure established by the Treaty and the Pact.

The Report highlights furthermore the importance of national budgetary rules complementing Member States' commitments under the Stability and Growth Pact at the EU level. It suggests that national institutions could play a more prominent role in domestic budgetary surveillance, thereby underpinning and complementing the monitoring and surveillance procedures at EU level. A more effective mobilisation of the national public opinion is seen as a useful measure to strengthen national ownership and enhance enforcement.

Following the same rationale, it is foreseen that a new government taking office shows continuity with respect to the budgetary targets endorsed by the Council on the basis of the Member States' previous update of the stability/convergence programme. When the new government prepares its first up-date of the programmes, it is expected to present its budgetary strategy, outlining the means and instruments which it intends to emply to achieve the agreed targets.

With due respect to the subsidiarity principle, the Report suggests a greater involvement of national parliaments in the EU fiscal surveillance process. It invites Member State governments in particular to present to their national Parliaments their stability or convergence programme and the respective Council opinions thereupon, and to discuss with the national parliaments the follow-up to recommendations in the context of the early warning and the excessive deficit procedures.

In order to facilitate a better differentiation between forecasting and policy errors, Member States are requested in future to include more comprehensive sensitivity analysis and/or developing alternative scenarios in their respective stability and convergence programmes. This will enable the Commission and the Council to consider a wider range of possible fiscal outcomes.

In this context, the report points to the important contribution that Commission forecasts can provide for the coordination of economic and fiscal policies. It calls in particular on the Member States of the euro area and ERM II to use the 'common external assumptions' provided by the Commission in its forecasts. More generally, Member States are called upon to explain divergences between the national and the Commission forecasts in their stability or convergence programmes and their respective up-dates, also to assess possible forecast errors.

ii) Statistical governance

The 2005 Ecofin Report recognises that the credibility and implementation of the fiscal framework rely crucially on the availability of correct and reliable fiscal data. Transparent budgetary statistics are also seen as instrumental to enable financial markets to better assess and distinguish the creditworthiness of the different Member States, thus providing an important signalling function for policy errors.

The Report recalls in particular the need to have in place adequate practices, resources and capabilities to produce high quality statistics at the national and European level and to ensure the independence, integrity and accountability of both national statistical offices and Eurostat. With respect to Eurostat, the Report emphasises the importance of further developing its operational capacity, monitoring power, independence and accountability.

Given the crucial importance of reliable data for the functioning of the EDP and in order to avoid moral hazard behaviour, the report makes reference to the possibility of invoking sanctions, to be considered in case of an infringement of the obligations to duly report government data.

The Commission and the Council pursue the objective of improving the governance of the European statistical system in parallel with the reform of the SGP. In December 2004, the Commission presented three main lines of action towards a European governance strategy

for fiscal statistics.[39] They include the further elaboration of the legal framework related to the reporting of fiscal data; the development of European standards for the institutional set-up of statistical authorities; and finally the provision of additional resources to enable the relevant Commission services to enhance their activity level with respect to budgetary surveillance and the verification of the quality of budgetary statistics (See box on 'Strengthening the governance of budgetary statistics').

1.4 An assessment of the 2005 SGP Reform according to criteria for an optimal fiscal policy rule

Buti, Eijffinger and Franco (2003) assess the design and compliance mechanisms of the Stability and Growth Pact rules against the set of eight criteria for an ideal fiscal rule established by Kopits and Symanski (1998). They conclude that EU fiscal rules appeared to fare relatively well against the Kopits-Symanski criteria. The SGPs strongest point was its simplicity while its weakest aspects concerned enforceability and support of structural reforms. Buti et al. highlight the existing trade-offs between the various criteria, namely between simplicity and flexibility, between simplicity and adequacy, and between flexibility and enforceability. These trade-offs are influenced by the multinational setting in which the rules are applied. In particular, Buti et al. argued that a multiplicity of countries increases heterogeneity and dispersion of preferences with the consequence that a one-size-fits-all fiscal rule is likely to be sub-optimal.

Against this background, the 2005 reform of the SGP, as reflected in the Ecofin report, can be tentatively assessed. Overall, the analysis suggests that the changes result in a broadly balanced set of new rules. Table II.2 shows that the Kopits-Symanski (KS) score deteriorated on the criteria on which the SGP scored high in the assessment of Buti et al. In particular, it appears that in comparison to the original Pact, the new provisions are less well-defined, contain a higher risk of interpretative ambiguity, and are less transparent and more complex. On the other five criteria, where the ratings had been less positive, its score improved.

KS-1 - A ***well-defined*** fiscal rule, in terms of the indicator to be constrained, institutional coverage and escape clauses, is paramount for effective enforcement. Whereas the Treaty criteria remain well-defined as to the policy variables subject to constraints (i.e. budget balance and gross public debt) and the institutional coverage (i.e. general government), the escape clauses specified by the SGP are widened and subject to some more ambiguity. The concept of closeness and temporariness are activated, but not fully specified; overall judgement of 'other relevant factors', as well as of 'cumulative loss of output' to identify a severe economic downturn, is introduced in the decision on the existence of an excessive deficit; room for judgment is introduced in setting the deadline for correction of the excessive deficit. On the other hand, the SGP medium-term objectives, which remained vague under the 1997 SGP, are specified. Moreover, the required fiscal adjustment both in the excessive deficit procedure and towards the medium-term objective is specified, while additional judgement is introduced by allowing for considering structural reforms. The SGP remains silent on how to apply the Excessive Deficit Procedure in the case of violation of the public debt criterion of the Treaty which requires the debt ratio to be on a declining trend as long as it is above the 60% of GDP reference value. Overall, the adjustments of the SGP which introduced more room for judgement have resulted in a deterioration against the KS criteria of a well-defined system.

KS-2 - Transparency has several dimensions. For fiscal rules to score high on transparency, they need to include provisions on accounting conventions, forecasting exercises, reporting practices, and interpretation of data. The Treaty and the SGP continue to be based on ESA-95 accounting. The Commission forecasts are the reference point for assessing the risk of an excessive deficit or for detecting a "significant divergence" from the set of budgetary targets. The respective roles of Commission and national forecasts in the assessment of Stability and Convergence Programmes and in the EDP (repetition of steps) have been partly clarified. However, increased use of non-measurable indicators in the assessment in order to allow for a richer judgement of the economic and budgetary circumstances, reduce transparency. The 2005 reform of the SGP formalises the practice of the previous years to increasingly use cyclically-adjusted measures, indicators of implicit and contingent liabilities and estimates of potential growth which are all subject to uncertainty. In addition the assessment of structural reforms for which no conventions or reporting practices exists reduces transparency of the fiscal rules. The reform of the statistical governance, on the other hand, addresses moral hazard problems and incentives for creative accounting by enhancing statistical surveillance. Overall, the more complex and richer framework with increasing importance of non-measurable and uncertain indicators, in addition to the data based on ESA-95 accounting, will reduce transparency.

[39] See Commission Communication 'Towards a European governance strategy for fiscal statistics' of 22 December 2004, COM(2004)832.

Box II.2. Strengthening the governance of budgetary statistics

Main elements of the governance of budgetary statistics. The main elements of the governance of budgetary statistics in the EU were described in Chapter II-4 of the 2003 edition of the report *Public Finance in EMU*. They consist in (i) a consistent set of accounting rules; (ii) the Commission authority in providing the data for budgetary surveillance, though statistics are compiled from basic sources by the national authorities in compliance with the principle of subsidiarity; (iii) well-defined deadlines for the transmission of the main government figures – i.e. deficit and debt – as well as for the transmission of the complete underlying accounts, (iv) the role of Eurostat in the assessment of the quality of data reported by Member States, and (v) multilateral discussion of methodological issues within the Committee on Monetary, Financial and Balance of Payment Statistics (CMFB). The 2003 report also described developments such as the adoption by the ECOFIN Council, on 18 February 2003, of a Code of Best Practice and a number of steps towards the compilation of government accounts with quarterly frequency.

Some progress… In the meantime, there has been progress notably concerning the timeliness, completeness and consistency of government accounts. There were also important decisions concerning the accounting of innovative and complex transactions – e.g. private-public partnerships – and the government delimitation, for example in relation to the reform of pension systems. A major achievement was the remarkably smooth integration of new Member States in the transmission and validation of fiscal statistics. As regards the compilation of quarterly accounts and their use in budgetary surveillance – which was characterised in the 2003 report as a medium-term project and a major challenge for the future – there has also been some steps forward. Quarterly government revenue and expenditure accounts are already available for the euro-area, ([1]) though data per country are under embargo until the end of 2005; the quarterly government debt is available for most countries.

… but evidence of data quality problems. However, evidence of substandard quality in the budgetary statistics of some Member States – which materialised notably in the exceptionally large revision in the Greek government accounts in 2004 ([2]) –, the discrepancies in the accounts of some Member States ([3]) and the ensuing suspicions about the quality of budgetary data has led the Council and the Commission to propose strengthening the governance of these statistics.

The Council calls for action. On 2 June 2004, the ECOFIN Council noted that "*reliable fiscal statistics are essential for the credibility of the excessive deficit procedure (EDP). The EDP notification of March 2004 showed rather good compliance with the Code of Best Practice as regards the reporting deadlines. There was also a considerable improvement in the availability of detailed data on the government sub-sectors* (…)." However, "*on several occasions, fiscal statistics have been revised after a new government took office. The Council considers that the compilation and reporting of statistics for the EDP must not be vulnerable to political and electoral cycles.*" Therefore, "*the Council invites the Commission to strengthen the monitoring of the quality of reported fiscal data and report back to the Council before the end of the year 2004*".

From a more general perspective, the Council also concluded that "*high-quality statistics are fundamental for European policies. The Council considers that integrity, independence and accountability of data compilers, and the transparency of the compilation methods, underpinned by the appropriate institutional arrangements, are crucial to ensure such high-quality statistics. It would therefore be recommendable to develop minimum European standards for the institutional set-up of statistical authorities. The Council invites the Commission to make, by June 2005, a proposal for such standards, which reinforce the independence, integrity and accountability of Member States' national statistical institutes. These standards should also help to address the specific concerns on the quality of fiscal statistics*". The importance given by policymakers to the quality of budgetary statistics is illustrated by the fact that this topic was also in the agendas of the 10 September, 7 December 2004 and 17 February 2005 ECOFIN Council meetings.

The Commission proposes three lines of action. The Commission response to the ECOFIN Council conclusions was outlined in the Communication "*Towards a European governance strategy for fiscal statistics*" ([4]) adopted on 22 December 2004. The Commission strategy involves three lines of action: (i) building-up the legislative framework; (ii) the development of the operational capacity of the Commission; (iii) the preparation of European standards on the independence of statistical institutes. The rest of this box elaborates on the first and third items of this strategy. The second line of action consists mainly in increasing the resources devoted to budgetary surveillance and to checking the quality of budgetary statistics in the relevant Commission services (Eurostat and DG ECFIN).

Completing the legal framework. On 2 March 2005, the Commission adopted a proposal for a Council Regulation which is intended to strengthen the quality of the statistical data for the excessive deficit procedure.([5]) The proposal consists in amending Council Regulation (EC) N° 3605/93, which is the legal act governing the reporting of fiscal data for EDP. The amended regulation will enter into force after formal adoption, by qualified majority, by the ECOFIN Council. The European Parliament and the ECB also participate in the adoption of this regulation as they are required to prepare non-binding opinions.

Regulation (EC) N° 3605/93 currently has two sections on (1) definitions and (2) rules and coverage of reporting. According to the Commission proposal, these two sections will be kept basically unchanged. However, section 2 will be completed with two new articles establishing the Member States' obligation to report and properly documenting revisions in data, and clarifying that the tables transmitted by Member States are public.

The Commission proposes to add three new sections (3, 4 and 5) to the regulation. Section 3 establishes a number of processes to check that data compiled and reported by national authorities comply with the accounting rules and are reliable, complete and consistent. In a number of respects, the proposal enshrines existing practices, such as the preparation and publication by the national authorities of statistical inventories for government accounts, ([6]) the regular dialogue between Eurostat and the Member States' statistical authorities, and a procedure involving the CMFB when there is a need to complete and clarify the accounting rules. However, the proposal goes farther than existing practice by establishing further visits, during which Eurostat will look at the detailed economic data which justify the reported figures. The association of experts from other Member States to these visits

will broaden the expertise. Moreover, transparency will be ensured by making public the conclusion of the quality assessment. ([7])

Section 4 clarifies the provision in the Treaty Protocol, according to which the statistical data for EDP are provided by the Commission. The provision of data is done by Eurostat, by publishing the data three weeks after the deadlines for the transmission of data by the Member States. The new section makes clear that the Eurostat task is not simply to reiterate Member States' figures; it can publicly raise reservations to the data transmitted by Member States in case there is enough evidence that data compiled by the national authorities are of substandard quality, or even unilaterally amend these data in case reported figures do not comply with the rules and there is sufficient information to provide alternative estimates.

Section 5 answers specifically to concerns on the vulnerability of fiscal statistics to political cycles. It establishes that the compilation of fiscal statistics data is done in accordance with a number of principles, most notably impartiality ([8]) and that the officials responsible for the compilation of government accounts should abide by these principles.

European standards for the statistical institutes. The third line of action – which covers all economic statistics and not simply fiscal data – concerns the development of European standards for the institutional set-up of statistical authorities. Such standards should reinforce the independence, integrity and accountability of statistical institutes, which should improve trust and confidence in statistical authorities and the credibility and quality of their statistics. On 24 February 2005, the Statistics Programme Committee (SPC), which gathers the director generals of the national statistical institutes and of Eurostat, unanimously adopted a European Statistics Code of Practice. This code of practice includes fifteen principles ranging from professional independence of data compilers, statistical confidentiality, impartiality and objectivity, accuracy, reliability and timeliness of data to adequacy of resources of statistical institutes. On 25 May 2005, the Commission endorsed this code, recommending that Member States recognise it as a common set of standards at the European level for statistical authorities and intends to set up a reporting system to monitor adherence within the European Statistical System.([9])

([1]) See Table 6.4 of the ECB Monthly Bulletins (Euro area statistics).
([2]) See Box I.1 on the revisions of the Greek accounts.
([3]) See Part 2 Section 2.2 of this report for a detailed discussion on the stock-flow adjustments in the EU Member States.
([4]) COM (2004) 832.
([5]) COM (2005) 71.
([6]) Statistical inventories are documents prepared by the national statistical authorities, describing the methods, procedures and sources for the compilation of statistics. Rather than a description of the accounting rules, the inventories should detail how Member States apply the rules, which services provide which data, the estimation procedures to deal with missing data, etc.
([7]) In the Communication of 1 December 2004 (COM (2004) 784), the Commission acknowledged that discussions on the quality of fiscal statistics often took place within a restricted circle of statisticians and were not effectively communicated to the political level and to the public.
([8]) According to Council Regulation (EC) N°322/97 on Community Statistics, statistics shall be compiled according to the principles of impartiality, reliability, relevance, cost-effectiveness, statistical confidentiality and transparency. Specifically, impartiality means that data are compiled "*in an objective and independent manner, free from any pressure from political or other interest groups*".
([9]) Communication from the Commission to the European Parliament and to the Council and Recommendation on the independence, integrity and accountability of the national and Community statistical authorities (COM (2005) 217).

KS-3 - The EU fiscal rules were ***simple*** and easily understandable. Some of the simplicity has been lost by introducing room for judgement in the decision on the existence of an excessive deficit and in the adjustment path. The large range of possible relevant factors which need to be assessed renders the system more sophisticated and complex. In addition, the factors mentioned under KS1 and KS2, affecting transparency and the concept of a well-defined framework also affect simplicity. On the other hand, the agreement that the Commission shall always prepare a report under article 104(3) if the EDP deficit exceeds the 3% of GDP reference value is straightforward. It enhances simplicity and clarifies accountability in the decision making. Overall, the increased room for judgement and the wider range – and more uncertain nature - of indicators that are assessed implies increased complexity of the rules.

KS-4 A number of factors have been adjusted allowing more ***flexibility*** in different stages and parts of the fiscal framework. The tight specification of the escape clauses of the 'severe economic downturn' has been widened, allowing judgement by the Commission and Council. Also the consideration of other relevant factors in the decision on the existence of an excessive deficit increases flexibility, though within the margins of 'temporariness' and 'closeness to the reference value'. The Council also has the flexibility to grant at the start an additional year for the correction of an excessive deficit if 'special circumstances' occur. As to deviation from the medium-term objective and the adjustment path to it, certain structural reforms may be considered. Overall, the flexibility is clearly enhanced - though within constraints - to better capture economic reality and allow sound policy advice.

KS-5 - Adequacy of the rules has to be assessed in relation to their final goal. Rules should be neither too broad nor too narrow. The goal of the EU fiscal rules is ensuring budgetary prudence. The concept of budgetary prudence has widened over the years (see sub-section II.3 on increased focus on sustainability and growth). The deficit limit guaranteed fiscal discipline on a yearly basis, but was no longer adequate for long-term sustainability. Increased focus on debt and future debt developments as well as catering for structural reforms enhances the adequacy to this long-term objective.

Table II.2. Trade-offs according to good fiscal policy rule criteria

Kopits and Symanski criteria.	Buti et al. (2003) assessment of the SGP	Impact of the 2005 reform on fulfilment of the criteria
Well-defined: no ambiguous definitions, competence divisions or escape clauses	+ +	(-)
Transparent: data reporting and data analysis according to the same rules / procedures; no interpretation problems	+ +	(-)
Simple: rules being easily understandable and observable	+ + +	(-)
Flexible: allow for capturing of the impact of important influences not captured in the framework, making its application less mechanistic	+ +	(+)
Adequate to goal: rules should be not too broad nor too narrow; legal instruments should be capable of obtaining the goal	+ +	(+)
Enforceable / credible: rules should be credible; application impartial; susceptible to subjective pressures	+	(+)*
Consistent - internally and with other policy objectives	+ +	(+)
Supportive of structural reforms: rules should take due account of importance of structural reforms for the economy.	+	(+)

** The (+) assessment of the enforceability/credibility of the rules is compared to the situation existing after November 2003.*
Legend: - Buti, Eijffinger and Franco (2003) assessment: +++ very good, ++ good, + fair
- Assessment of the 2005 Reform of the SGP: (+) improvement, (-) deterioration

Moreover, differentiation of the medium-term objective according to risks to sustainable debt developments (initially on the basis of debt levels and potential growth; in the future possibly also on the basis of implicit liabilities) allows better catering for adequate policies in all countries, including in particular in peripheral countries that are characterised by large public investment needs, low debt level and high growth potential. While the goal remains budgetary prudence, a more sophisticated approach is taken to minimise short-term policies which are excessively pro-cyclical and inconsistent with budgetary stabilisation over the cycle. To this end, the economic situation and developments are considered in the deadlines for correcting excessive deficits and early warnings or early policy advice will be applied to avoid pro-cyclical policy in good times. Overall, the adequacy of the rules to their goal has improved.

KS-6 - The narrow specification in the SGP of the timetable of the Excessive Deficit Procedure and the application of sanctions were set to improve ***enforceability***. Experience has shown that the narrow specification did not contribute to the enforceability in the existing institutional setting. Instead, it led to raising tensions and a loss of credibility after the events of November 2003. Against this background, the renewed commitment and consensus among the 25 Member States as reflected in the 2005 Ecofin Report constitutes a solid fundament for restoring the dented credibility of the framework. Agreement to enhance fiscal governance, through development and increased involvement of national institutions and parliaments could also contribute to enhancing peer pressure and increasing reputational costs to discipline national authorities. As in the old system, subjective political pressure on the enforcement can be expected to remain, which proves that the renewed SGP continues to bite.

KS-7 Consistent - internally and with other policy objectives A good fiscal rule has to be internally *consistent* and consistent with other policies. The SGP implies that countries attain broadly balanced budgets in cyclically-adjusted terms and then let automatic stabilisers play freely. Empirical evidence shows that this would be consistent with attaining a relatively high cyclical smoothing while safeguarding the 3% deficit ceiling. Such behaviour would imply a neutral fiscal stance at the euro area level and be consistent with a monetary policy entrusted with maintaining price stability. This could be considered an internally consistent framework in its steady state, if all countries have achieved their medium-term objectives. However, as long as the medium-term objectives had not been achieved, excessively pro-cyclical policies were required in economic downturns, which could be considered inconsistent with the objectives of (automatic) fiscal stabilisation. Allowing for considering the economic situation and developments of a country in EDP addresses this inconsistency between policy objectives. It should be noted however, that this also reduces the possible deterrent effect of high economic (and political) costs of an EDP which provided Member States with an incentive to pursue ambitious consolidation towards the medium-term objective. In addition to the consideration to avoid excessively pro-cyclical policies in bad times, the 2005 reform allows taking into account structural reforms, thus addressing a

major criticism and potential external inconsistency between the policy objectives of the budgetary framework and structural reforms (see also KS-8).

KS-8 Fiscal rules should be ***supportive of structural reforms.*** The reformed framework explicitly takes better account of structural reforms, in particular those that enhance long- term sustainability, both in the preventive arm (deviation from the MTO or adjustment path) and the corrective arm (other relevant factors, special circumstances, possible early abrogation for specific second pillar pension reforms).

Overall, the comparative assessment of the new rules against the established set of criteria for ideal fiscal rules provides a useful indication of the quality and direction of the various changes. The interpretation of the results, however, must be taken with care. Some of the criteria partly overlap and some are highly interlinked. Moreover, it is important to keep in mind that the various qualitative scores in table II.1 cannot be summed up. While the results suggest a broadly balanced set of rules, it cannot be concluded that the new rules are 'better' or 'worse' than the existing rules.

After six years of accumulated experience with the existing rules of the Pact, the 2005 report reflects Member States' shifted preferences along the trade-offs towards greater flexibility, in order to better respond to the changing economic conditions, such as related to enlargement, demographic ageing and the low growth conditions. There are basically two distinct options to allow for greater flexibility in the application of fiscal rules. Either the sophistication of the provisions themselves is increased by adding more contingencies to the rules while their implementation is kept straightforward. Or the rules are kept simple, but a more flexible application is introduced, thus exerting more economic judgement of the individual case.[40]

Following the intention to preserve the rules-based character of the EU fiscal framework, the Commission initially favoured responding to the increased preference for flexibility with the development of a significantly more sophisticated set of rules. While this would have been at the expense of simplicity and transparency, it would have minimised the room for discretionary judgement and facilitated equal treatment. In light of these considerations, the agreement finally reached by the Council constitutes a compromise.

Whereas the legal content of the rules remains by and large unchanged, the new agreement introduces more room for economic judgement in their application. However, given the limits of enforcement power in a supranational setting, in order to contain deficits from becoming excessive, the new procedural flexibility is effectively restricted to relatively small fiscal slippages by holding on to simple and transparent conditions, including the deficit and debt reference values and the principles of closeness and temporariness, and by requesting an annul minimum fiscal effort.

[40] Beetsma and Debrun (2003) also make this point.

The increase scope for judgement raises furthermore the responsibility for both the Commission when assessing budgetary developments in Member States and the Council when deciding on the appropriate steps in the surveillance procedure. It also elevates the need to ensure transparency and accountability in the decision making by the various actors.

1.5 The road to the 2005 SGP reform

The agreement on the 2005 Reform marks the end of a longer drawn review and discussion process at the level of the EU about the further development of the EU fiscal rules. The interpretation and application of the rules have evolved over time and discussions about reinforcing the fiscal co-ordination has practically been ongoing since the start of EMU.[41]

1.5.1 Early stages of the reform debate

Following the conclusions of the 2002 Barcelona European Council on the need to reinforce existing fiscal policy co-ordination mechanisms, the Commission adopted on 27 November 2002 five proposals to improve the interpretation of the SGP.[42] Against the background of mixed budgetary performance since 1999 and emerging difficulties in the implementation of the rules, the Commission proposed (i) to establish medium-term budgetary objectives that take account of the economic cycle, i.e. measured in cyclically-adjusted terms and net of one-off measures; (ii) for countries that have not yet realised a budgetary position of 'close to balance or in surplus' to achieve an annual improvement of the underlying budget position of at least 0.5% of GDP; (iii) to avoid pro-cyclical policies in economically good times; (iv) to ensure the consistency between the Pact rules and the goals of the Lisbon strategy, by allowing for small and temporary deviations from the underlying budgetary position of 'close to balance or in surplus' or the adjustment path to it; and (v) to attach greater weight to the sustainability of public finances, including by making the Treaty's debt criterion operational. Moreover, the Commission pointed to need to take complementary measures in order to foster the overall fiscal and statistical governance, including through more transparent communication so a to enhance external incentives for Member States to run

[41] Previous editions of 'Public finances in EMU' provide ample evidence. See also Deroose and Langedijk (2005) for a concise overview of the experiences with the Stability and Growth Pact in the first 6 years and a description of the Commission's approach for improving the Stability and Growth Pact.

[42] See Commission Communication on 'Strenghtening the co-ordination of budgetary policies' of 27 November 2002, COM(2002)668 final and Public finances in EMU 2003.

sound fiscal policies and improvements concerning the quality and timeliness of government finance statistics.

In March 2003, the Ecofin Council endorsed in its report to the Spring European Council[43] most of the Commission proposals to improve the effective application of the SGP, yet agreed that there was no need for legal chances to the current EU fiscal rules.[44]

In parallel, the debate on the coordination of budgetary policies in the framework of EMU continued in the Convention on the Future of Europe. The new Treaty establishing a Constitution for Europe, which was signed in Rome on 29 October 2004 and currently subject of the ratification procedures in the 25 Member States, strengthens the role of the Commission in the excessive deficit procedure. Notably it establishes the right for the Commission to address an early warning directly to the Member State if it considers that an excessive deficit in a Member State exists or may occur. Furthermore, the Council's decision on the existence of an excessive deficit will in future be based on a 'proposal' from the Commission, which is more difficult for the Council to overrule than a Commission 'recommendation', which is the current basis for the Council decision.

Tensions in the application of the SGP continued to accumulate, creating considerable institutional uncertainty. They culminated in the legal dispute between the Commission and the Council concerning the excessive procedure for France and Germany.[45] These tensions gave further evidence of diminished ownership of the rules in several Member States and undermined the credibility of the framework as a whole.

Even though the budgetary framework set by the Maastricht Treaty and the Stability and Growth Pact helped to deliver overall macroeconomic stability in the EU and to keep budgetary positions at prudent levels in most EU countries, it became clear that the fiscal rules need to be adapted in light of changing economic circumstances in order to remain relevant and acceptable to Member States. A further stretching of the Pact provisions by simply modifying their interpretation would have jeopardised the rules-based character of the system. Against this background, the Commission launched a major review of the Stability and Growth Pact, by examining both its performance in the past as well as its potential to adequately respond to the prospective challenges, notably those associated with the increased economic heterogeneity in the enlarged EU and the demographic changes ahead.

On 18 June 2004, when agreeing on the Draft Treaty Establishing a Constitution for Europe, the European Council adopted a Declaration on the Stability and Growth Pact (SGP). It stressed that raising growth potential and securing sound budgetary positions are the two pillars of the economic and fiscal policy of the Union and the Member States. The European Council also invited the Commission to come forward with proposals towards a further development of the SPG.

1.5.2 The launch of the review

The Commission with the adoption of its Communication on 'Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact' on 3 September 2004 launched a major review process of the SGP and provided further orientation for the future set-up of the SGP. Building on the Communication of November 2002, it proposed four main areas for reform, notably (i) to place more focus on debt and sustainability in the surveillance of budgetary positions; (ii) to introduce the concept of country-specific medium-term objectives; (iii) to increase the economic underpinning of the excessive deficit procedure; and (iv) to ensure earlier action to correct inadequate budgetary developments. In addition, the Communication contained a number of ideas to improve the fiscal governance, enforcement and ownership of the EU fiscal rules. Particular proposals included measures to improve the consistency between national and EU processes, including through more involvement of national institutions in budgetary surveillance, and to increase the transparency and accountability of the various actors in the surveillance process.

On 10 September 2004, the Council, in its Ecofin formation, stated that the Commission Communication provided a good basis for discussion. There was consensus not to envisage any changes to the Treaty provisions and to keep legal modifications of the regulations underlying the SGP to a minimum.

On the basis of the Communication, the Council's further guidance, and drawing from abundant input from academics and policy makers, the Commission services further analysed and developed the options for strengthening the Stability and Growth Pact, expanding the main ideas into a practical coherent framework. A set of technical issues papers addressing the key elements of the fiscal framework was prepared by the Commission services for discussion in the Economic and Finance Committee. Together with contributions from Member States, they provided the basis for in-depth discussions with the Member States from September 2004 through March 2005.

[43] Ecofin Council report on 'strengthening the coordination of budgetary policies', 7 March 2003, 6877/03 (Press 61).

[44] See Public Finances in EMU 2003, pp. 78/79.

[45] See Box II.3 on the decision of the European Court of Justice of 13 July 2004.

Box II.3. The European Court of Justice's decision on the EDP for France and Germany of 13 July 2004

On recommendation by the Commission, the Council decided in the first half of 2003 that an excessive deficit existed in Germany and France and adopted recommendations with a view to bringing this situation to an end by 2004. In autumn 2003 the Commission recommended that the Council should establish that the actions implemented by Germany and France were not adequate and should give them notice to take measures to remedy the situation. In light of the weaker than expected economic situation, the Commission recommended that the deadline for correcting the deficit should be extended to 2005. On 25 November 2003 the Council voted on the recommended decisions but did not achieve a majority. (See Public finances of EMU 2003, Box II.1). Instead, the Council adopted conclusions addressing recommendations to Germany and France for the correction of the excessive deficit by 2005 and stating that in light of the commitments by the two Member States the excessive deficit procedure was held in abeyance. The Commission challenged certain elements of the Council conclusions of 25 November before the Court of Justice.

In its judgement of 13 July 2004 (See Case C-27/04 Commission of the European Communities against the Council of the European Union), the Court annulled the Council conclusions in so far as they aimed at formally suspending the procedure and modifying the existing recommendations. The Court, recalling the Commission's right of initiative in the excessive deficit procedure, argued that the Council went beyond its competence by de facto modifying the recommendations decided by the Council under Article 104(7) EC. While it acknowledged the Council's right for discretion, the judgement clarified that '…the Council cannot break free from the rules laid down in Article 104 EC and those which it set for itself in Regulation 1467/97…'

The Court's judgement created unique circumstances in relation to the excessive deficit procedure concerning Germany and France. In substance, the annulled Council conclusions went along the same lines as the recommendations of the Commission for remedying the situation, notably that the deadline for the correction of the excessive deficit should be extended to 2005. Moreover, the actions of the Council in November 2003 had a factual effect on the path of fiscal adjustment in the countries concerned. In its Communication concerning 'the situation of Germany and France in relation to their obligations under the excessive deficit procedure following the judgement of the Court of Justice of 14 December 2004 (COM(2004)813) the Commission took the position that a satisfactory resolution of the budgetary problems of Germany and France within the framework of the Stability and Growth Pact demands the assessment of the actions taken to correct the excessive deficit should refer to 2005 as the relevant deadline.

On 16 November, Ecofin Ministers had an exchange of views on substance on a number of the issues at stake. The discussion followed by and large the proposals made by the Commission. Ministers agreed to explore a limited number of practical options, so as to be able to agree on concrete proposals to the Heads of State or Government at the Spring European Council in March 2005. The main focus of the debate was in particular on ways to better use periods of economic recovery to consolidate public finances, how to take into account sustainability of public finances in defining medium-term targets, how to increase the focus on debt and sustainability, how to take into account economic circumstances in the excessive deficit procedure, and about whether and, if so, how to take into account structural reforms and investment needs in the budgetary framework. The agenda was widened in the course of the subsequent meetings of Ministers notably to address aspects of fiscal and statistical governance.

The negotiations revealed differing views among Member States on how much judgement was deemed necessary to sufficiently capture economic reality and pursue economically sound policies. While mainly the larger countries tended to be in favour of ensuring more room for case-specific judgement, the Commission and most of the smaller countries expressed a high preference for the predictability of the Pact as a rules-based system.

At the Ministerial level, discussions in the Ecofin Council, including all 25 Member States, were usually preceded by an exchange of views within the Eurogroup. The capacity of the Luxembourg Presidency, starting in January 2004, to mediate a compromise was boosted by the unique triple function of Luxembourg's Prime Minister and Minister of Finance, Jean Claude Juncker, being simultaneously President of both the eurogroup and the Ecofin Council as well as presiding over the European Council.

1.5.3 The 2005 Council agreement on the reform of the SGP and follow-up

Following the failure of the Ecofin-meeting of 8 March to reach agreement on the reform package on the occasion of their meeting of 8 March, Jean-Claude Juncker convened an extraordinary meeting on Sunday 20 March, thus two days preceding the start of the 2005 Spring European Council. Ministers met first in the formation of the euro group, succeeded by the meeting of the Ecofin in the afternoon. Ministers were keen to conclude their review of the SGP in time for the Spring European Council in order to avoid a reopening of the debate by the Heads of States and Government. The specification of 'other relevant factors' and the treatment of second-pillar pension reforms in the excessive deficit procedure were the main issues of debate until the last moment. Agreement was finally reached later in the day. The Ecofin Council adopted the report to the European Council on 'Improving the implementation of the Stability and Growth Pact'.

The European Council endorsed the report on 22 March, stating that is up-dates and complements the Stability and Growth Pact. It furthermore invited the Commission

to adopt the necessary legislative proposals to adapt the existing regulations 1466/97 and 1467/97 in accordance with the new agreement.

On 20 April, the Commission adopted the draft proposals for amending Council Regulations 1466/97 and 1467/97, which were subsequently submitted to the Council.

The Council is the decisive body for the adoption of the Commission draft proposals. The two regulations are based on different legal bases, requiring distinct legislative procedures. Inter alia, they foresee a different degree of consultation of the European Parliament and the European Central Bank. By the time the 2005 report on Public finances in EMU went to press, the procedure for the adoption of the legislative package was still ongoing. On parallel track, work has started to amend and up-date the Code of Conduct in light of the 2005 Pact reform.