The Stability and Growth Pact: A Discussion Paper

March 2004

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I INTRODUCTION

I.1 This discussion paper looks at the Stability and Growth Pact (SGP). It sets out the rationale for an SGP and considers the principles that should guide its future development.

I.2 Issues surrounding the SGP and fiscal frameworks have been discussed recently: the global slowdown has tested the effectiveness of fiscal frameworks in supporting both stability and growth; interest in the SGP's operation and design has been heightened by the implementation of the Excessive Deficit Procedure for a number of countries; and there are a number of proposals for reform, including proposals from the European Commission.[1]

I.3 The UK supports the principle of a strong SGP founded on sensible fiscal policy co-ordination, recognising that fiscal sustainability is a prerequisite for macroeconomic stability, and that collective fiscal discipline and co-ordination are essential for a successful monetary union.

Effective macro frameworks

I.4 The starting point for the paper is the recognition that effective macroeconomic policy frameworks can contribute to supporting high and stable levels of growth and employment. Chapter 2 discusses the basis for effective policy frameworks, which are characterised by credibility, flexibility and legitimacy. It notes that experience has pointed countries towards 'constrained discretion' as the means for achieving these objectives. In establishing effective macroeconomic frameworks, policymakers have recognised the importance of three key principles: clear long-term goals; a pre-commitment to sound institutional arrangements; and maximum transparency.

Rationale and performance of SGP

I.5 Chapter 3 sets out the rationale for the Stability and Growth Pact. It considers why the SGP is necessary, and looks at experience with its operation. It highlights a number of issues. The SGP represents an important step forward in recognising the importance of long-term budgetary discipline and making more information available on fiscal policies. However, in order to strengthen its credibility and effectiveness there is a case for placing greater emphasis on debt levels and longer-term fiscal challenges, giving greater attention to cyclical factors and the quality of public spending, and addressing issues about its economic rationale, consistency and evidence base.

A prudent interpretation of SGP

I.6 Chapter 4 sets out the UK Government's support for a prudent interpretation of the SGP, which builds on the Code of Conduct agreed by Member States in June 2001 and the report agreed by EU Finance Ministers on strengthening budgetary co-ordination in June 2003. A prudent interpretation would take account of the economic cycle, the sustainability of public finances and the importance of low levels of debt, and recognise the importance of public investment. This would lock in long-term fiscal discipline and sustainability, enhance credibility across the economic cycle, while allowing the automatic stabilisers to operate fully and symmetrically to smooth fluctuations in output, and allow appropriate increases in investment in public services.

Guiding principles

I.7 Chapter 4 also considers the evolution of the Pact and its future development. The issue here is not fundamental overhaul or Treaty change, but evolution. There will need to be extensive discussion before specific proposals can be developed. The paper therefore sets out principles to shape future discussion and assess future proposals for reform.

[1] See Box 4.3 in Chapter 4 of this paper.

2 Effective policy frameworks

A strong macroeconomic framework is essential to maintaining high and stable levels of growth and employment. Effective macroeconomic frameworks are those which are characterised by:

- **credibility, so that policymakers have public trust;**
- **flexibility, allowing a prompt and timely response to economic developments; and**
- **legitimacy, meaning there is widespread support for the framework.**

Experience of macroeconomic frameworks has pointed countries towards the principle of 'constrained discretion' as the basis for achieving these objectives. 'Constrained discretion' commits macroeconomic policy to achieve long-term goals, while giving discretion to respond flexibly to shocks in a forward-looking manner. The principle has been operationalised by putting in place clear long-term goals; a pre-commitment to sound institutional arrangements; and maximum transparency.

2.1 This chapter outlines the basis for an effective policy framework, focusing in particular on fiscal frameworks. It discusses key objectives that a robust framework should strive to achieve and the principles through which such a framework can be operationalised.

Policy frameworks supporting growth

2.2 A strong macroeconomic framework is essential to maintaining high and stable levels of growth and employment. In particular, it can help maintain long-term economic stability. Stability allows businesses, individuals and the government to plan more effectively for the long term, improving the quality and quantity of investment in physical and human capital and helping to raise productivity. Robust macroeconomic frameworks can also mitigate uncertainty in an integrated global economy, where shocks can be transmitted more rapidly.

2.3 An effective macroeconomic policy framework also provides a stable basis on which policies that promote flexibility and fairness can be pursued. At the Lisbon European Council of March 2000, EU leaders committed themselves to a ten-year strategy for reform of Europe's product, capital and labour markets. These policies, in turn, can help to compensate for the impact of shocks.

2.4 A robust macroeconomic policy framework must be both comprehensive and coherent, encompassing monetary policy and fiscal policy, to help achieve the goals of high and stable levels of growth and employment. In establishing new macroeconomic frameworks, policymakers in the UK, Europe, and more widely have recognised: the need to avoid a purely discretionary reliance upon government fine-tuning of the macro-economy, the need for a credible framework that solved the problem of "time-inconsistency"[1] and the need to learn from the failure of rigid rules-based frameworks when the relationships that these rules are based on break down.

[1] The problem that policy-makers find it hard to commit to long-term goals if short-term pressures point in another direction.

POLICY FRAMEWORKS

2.5 Effective macroeconomic frameworks are those which are characterised by: credibility, flexibility and legitimacy.

Credibility

2.6 A credible framework is one in which the policymaker's commitment to long-term stability commands trust from the public, business and markets. This means that agents will not expect policymakers to sacrifice their long-term goals in response to short-term pressures.

2.7 Credibility will be enhanced where policy objectives are clear and where the way in which those objectives are to be pursued is transparent, for example through well-defined policy rules. Governments therefore need to set realistic and appropriate objectives and rules for macroeconomic policy which are clearly defined, consistent with achieving stability, and against which performance can be judged.

2.8 Objectives by themselves are, however, insufficient to ensure credibility; governments must also demonstrate their commitment to achieving their objectives. This commitment can be demonstrated by a track record of delivering an objective consistently over time. However, building up a track record takes time, and credibility can also be established more quickly by institutional arrangements, and through greater transparency, openness and clear accountability.

Flexibility

2.9 A robust framework will also provide appropriate short-term flexibility to allow policymakers to respond to shocks. This flexibility must, however, be delivered while maintaining the credibility of the government's commitment to its long-term objectives.

2.10 Where there is a credible commitment to long-term stability, policymakers will be able to exercise discretion in response to shocks without affecting long-term expectations. Without a commitment to long-term goals, credibility could suffer in the face of short-term discretionary action that agents could perceive as opportunistic. Flexibility can also help enhance credibility – a framework may lose credibility if it does not respond effectively or adapt to country-specific or changing circumstances.

Legitimacy

2.11 Macroeconomic frameworks must also demonstrate legitimacy, which means that they must have widespread support. This can be achieved through building a consensus about the appropriate goals and about the institutional arrangements through which they can be delivered. Legitimacy therefore allows policymakers to take difficult decisions in the public interest without paying a heavy cost in terms of public support. Transparency and accountability are key to ensuring legitimacy.

2.12 These three objectives are closely related. Policymakers that respond flexibly and decisively to economic developments and national circumstances will be able to build a track record for delivering long-term stability. Insufficient flexibility could lead to large fluctuations in output and unemployment, which can quickly undermine legitimacy as well as credibility.

Box 2.1: Designing effective fiscal frameworks

The OECD[a] recognises that fiscal rules, the practical tools of the fiscal framework, alongside structural reform, are crucial in order to maintain and deliver fiscal sustainability. The aim of the rules would be to bind the government to sustainable fiscal polices while at the same time communicating fiscal policy to the public.

The design of credible rules requires the government to decide on a number issues, including what to target, what to exclude and the relevant horizon over which performance relative to the target be evaluated. These three factors are inter-related and can be structured to heighten credibility and to reflect country-specific conditions. For instance, targeting the current budget can counteract the bias against investment observed in some countries. However, at the same time it means that there are trade-offs between economic efficiency and more practical considerations.

Alongside the importance of the rules being credible, the OECD highlights that rules should not be overly rigid. Acknowledging the need for flexibility, means that fiscal policy can deal with unforeseen events and fulfil its stabilising role.

Given the simultaneous need for credibility and flexibility, there could be a potential for a trade-off. However, this can be alleviated to some degree by increased transparency such as through a clear budgetary process. Transparency and accountability help to foster legitimacy, constraining governments to abide by their fiscal rules.

[a] Adapted from OECD Economic Outlook, No.74 December 2003.

The importance of co-ordination

2.13 Co-ordination between policy is important, especially where responsibility for monetary and fiscal policies rests with different organisations. The monetary and fiscal authorities need to understand each other's policy objective and reaction function. If they do not, there may be considerable welfare losses, particularly if their initial guesses are some way from the true outcome. This highlights the need for transparency, clear objectives and responsibilities, and the appropriate mechanisms to ensure effective policy co-ordination takes place.

Box 2.2: The co-ordination between fiscal and monetary policy in the UK

The UK's macroeconomic framework includes procedures to ensure that there is appropriate co-ordination between fiscal and monetary policy. This is achieved in three main ways:

- **the Government sets the objectives for both monetary and fiscal policy. Indeed, both arms of policy have the same fundamental objective of helping to achieve economic stability. Monetary policy does this by aiming to deliver price stability, while fiscal policy aims to deliver sound public finances;**
- **because the objectives and operating rules of both arms of policy are clear, and the procedures transparent, both sets of policy makers are aware of what the other is trying to achieve and how the other will react to news including their policy decisions; and**
- **this process is aided by the presence at Monetary Policy Committee meetings of a (non-voting) representative from HM Treasury who is able, in particular, to provide information on fiscal policy. This includes detailed presentations on the Budget and the Pre-Budget Report.**

Enhanced transparency built into the Bank of England Act 1998 and the Code for Fiscal Stability requires the MPC and the Treasury to put greater emphasis on communicating the policy stance not only to expert commentators but also to the general public. Greater clarity in macroeconomic policy enhances public debate and scrutiny of monetary and fiscal policies and has helped to establish credibility and legitimacy.

In addition, fiscal policy is constrained by the inflation target because the Treasury must take into account the likely response of the MPC to different fiscal policy settings. Thus when deciding on the fiscal stance, the Treasury is effectively setting the policy mix. The clarity of objectives for both monetary and fiscal policy, based on a symmetric inflation target and clear fiscal rules, has therefore enhanced the co-ordination of monetary and fiscal policy.

2.14 Co-ordination between levels of government is also an important factor to consider when evaluating policy frameworks, especially where sub-national governments have considerable fiscal autonomy.[2]

THE PRINCIPLE OF CONSTRAINED DISCRETION

2.15 Experience of the problems with fine-tuning and complete discretion, and with overly rigid rules that do not allow the flexibility to respond to shocks, has pointed countries towards the principle of constrained discretion as the basis for delivering credibility, flexibility and legitimacy. This approach combines the discretion necessary for effective economic policy with a credible institutional framework and constraints on policy makers to deliver clearly defined long-term policy objectives. It rejects the idea of frameworks based solely on complete discretion or fixed rules.

[2] OECD Economic Outlook No. 74 December 2003.

2.16 Under conditions which afford complete discretion, policymakers have found it hard to commit to resisting short-term pressures or to shape expectations without a clear framework to guide them. This is partly an effect of the 'time-inconsistency' problem; long-term goals may be sacrificed if short-term pressures suggest a different course of action. On the other hand, frameworks that are based on fixed mechanistic rules – and therefore do not permit any discretion – also have limitations. While such frameworks force a government to commit to its long-term policy goals, rigid rules do not allow any flexibility to respond to economic shocks and can lead to substantial adjustment costs.

Making 'constrained discretion' operational

2.17 The principle of 'constrained discretion' recognises that long-term stability requires an overall principled framework which constrains macroeconomic policy to achieve clear long-term and sustainable goals, but which gives discretion to respond flexibly to shocks in a forward-looking manner.[3] In terms of fiscal policy, governments should not use discretionary fiscal policy to support growth in a downturn if they already have unsustainable levels of debt. Short-term flexibility and discretion is only possible where policy is credibly constrained to deliver long-term stability.

Box 2.3: Making the fiscal framework operational

Using France, Germany, Italy and Spain as case studies, Dában et al.[a] examine how national fiscal frameworks have evolved over time, and how well-placed these frameworks are to deal with new challenges, such as population ageing, increasingly heavy tax burdens, relatively large stocks of debt and infrastructure needs.

The paper argues that in a monetary union, fiscal policy has a useful stabilising role, which is particularly marked in Europe given relatively inflexible labour markets. Carefully designed rules can impose fiscal discipline, eliminate pro-cyclical fiscal policies and stabilise aggregate demand shocks. The key features necessary in effective fiscal frameworks mirror the key principles of constrained discretion outlined above. The paper states that for the framework to work effectively, compliance both *ex ante* and *ex post* is essential. This requires clear political or legal commitment, precise definition of a multi-year rule and maximum transparency through clear accounting and reporting standards. Institutional change in order to strengthen the implementation of the framework may be necessary to achieve maximum transparency. Degrees of flexibility to deal with unforeseen events are also viewed as useful to guarantee compliance.

The paper also highlights the importance of a successful fiscal framework applying to all levels of government. This is especially important when sub-national governments have sizeable fiscal autonomy, in which case there may have to be intergovernmental agreement.

[a] Adapted from Dában *et al*. (2003)

2.18 This principle of 'constrained discretion' has been operationalised by putting in place:

- clear and well-defined long-term policy objectives;
- pre-commitment to sound institutional arrangements which could allow credible and flexible policy responses in the face of shocks; and
- maximum transparency.

[3] Speech by the Chief Economic Adviser to the Treasury, Ed Balls at the inaugural Ken Dixon lecture, to the Department of Economics, University of York, 23 January 2004. Available at http://www.hmtreasury.gov.uk/newsroom_and_speeches/speeches/speech_index.cfm

Long-term policy objectives

2.19 Shifting the policy focus towards sustainable long-term goals requires governments to set realistic and appropriate objectives for macroeconomic policy that are clearly defined, and against which performance can be judged. To ensure credibility, long-term policy objectives need to be supported by the other two principles – credibility through institutional arrangements and procedural rules, and greater transparency and accountability.

Strong institutional arrangements and clear procedural rules

2.20 Credibility can be enhanced by designing procedures and institutions to ensure support for the objective of long-term stability. If the government faces a reputational 'cost' should it fail to achieve a goal or change its aims, it is likely that agents in the economy will believe that decisions are consistent with sound long-term objectives. In terms of fiscal policy, governments have a range of options to build credibility. They could, for example, establish explicit fiscal rules, legal requirements that commit governments to set long-term objectives and account for their performance, and public expenditure management procedures to ensure that spending plans are consistent with the fiscal objectives of the government as a whole. Several EU member states and accession countries have fiscal frameworks and fiscal rules at the national level (see Box 2.4). Box 2.5 describes the approach taken in the UK.

Box 2.4: Examples of national fiscal frameworks and rules in EU member states and accession countries

A variety of fiscal frameworks and rules operate within the EU and accession countries, reflecting different needs at the national level.

Denmark. The Danish government focuses on ensuring sustainable public finances in the medium and long term by maintaining general government surpluses of the order of 1½-2½ per cent of GDP on average towards 2010.

Estonia. The coalition agreement states that the Government will maintain a balanced central government budget. The only possible exception to this general rule are costs incurred in financing pension reform.

Poland. The Polish approach is based on solvency rules with the Polish constitution capping public debt at 60 per cent of GDP. It states that the Government may not contract any additional loans or guarantees if this would involve breaching that level.

Spain. In 2002, the Government finalised a multi-annual framework which obliges all levels of government to show a surplus or balanced budget, with deficits only permitted in exceptional situations. Whenever any government forecasts a deficit, it must immediately present a correction plan.

Sweden. The Swedish Government sets a target of a surplus in general government net lending equivalent to 2 per cent of GDP on average over a business cycle. The target surplus is designed to provide for the fiscal challenges resulting from the sharp increase in the percentage of older people in the population in the future. It is also targeted to provide a safety margin in public finances, making it possible to counter a recession with a counter-cyclical fiscal policy.

United Kingdom. The UK has two fiscal rules: the golden rule, that over the economic cycle the Government will borrow only to invest and not to fund current spending; and the sustainable investment rule that public sector net debt as a proportion of GDP will be held over the economic cycle at a sustainable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

Importance of transparency

2.21 Greater transparency means it is easier to hold policymakers to account for their performance. The public are able to examine the arguments and issues that lie behind policy decisions and are given a thorough explanation of those decisions. It also helps governments to respond to shocks through discretionary policy actions without damaging long-term credibility, as they can clearly explain why they are undertaking such actions and how the expected outcome is consistent with long-term goals and policy frameworks.

Box 2.5: Achieving the objectives of macroeconomic frameworks in the UK

In 1997, the new Government embarked on a radical overhaul of the frameworks which guide monetary and fiscal policy, against a legacy of a poor track record in macroeconomic policymaking.[a] The design of the UK fiscal framework reflects the three reinforcing principles set out above. These principles are not only features of the fiscal policy framework but are evident in the monetary policy framework and public spending framework, strengthening the UK's overall macroeconomic framework through a principled approach.

Clear and well defined long-term policy objectives

The Government has set two objectives for fiscal policy:

- over the medium term, to ensure sound public finances and that spending and taxation impact fairly within and between generations; and
- over the short term, to support monetary policy and, in particular, to allow the automatic stabilisers to help smooth the path of the economy.

These objectives are implemented through two fiscal rules, against which the performance of fiscal policy can be judged. The fiscal rules are:

- the golden rule – over the economic cycle, the Government will borrow only to invest and not to fund current spending; and
- the sustainable investment rule – public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

Pre-commitment to sound institutional arrangements

The Code for Fiscal Stability, which was given legal backing in the 1998 Finance Act, underpins the fiscal framework and demonstrates the Government's commitment to improve the conduct of fiscal policy, ensuring that fiscal policy is conducted in an open and transparent manner.

Maximum transparency

The principle of transparency is a central feature of the Code for Fiscal Stability and the Government has taken a number of steps designed to increase transparency. These include:

- having the key assumptions used in the public finances independently audited by the National Audit Office to assess whether they are reasonable and cautious; and
- regular publication of data on the public finances in the Budget and Pre-Budget Report combined with more detailed publications such as the *End of year fiscal report*, and the *Long-term public finance report*.

[a] See Balls and O'Donnell (eds.) (2002).

3 THE STABILITY AND GROWTH PACT

The Stability and Growth Pact (SGP), is designed to ensure sound public finances, as a pre-requisite to achieving stable long-term economic growth. Fiscal sustainability is essential for macroeconomic stability. The UK supports the principle of a strong Stability and Growth Pact founded on sensible policy co-ordination.

The Stability and Growth Pact represents a significant step forward in recognising the importance of long-term budgetary discipline. However, experience with the operation of the SGP highlights a number of issues:

- **While the SGP has played an important role in enhancing the credibility of governments' commitment to fiscal discipline in the EU, implementation of the SGP has tended to focus on short-term deficits with rather less consideration being given to debt levels and longer-term fiscal challenges, for example those relating to an ageing population.**
- **The effectiveness of the SGP may have been adversely affected by the lack of attention paid to cyclical factors, especially when economies have been in the upswing phase of the cycle.**
- **More generally, while the operation of the SGP has made more information available on countries' fiscal positions, questions have been raised about its economic rationale, the consistency of treatment of countries, and the evidence base which could undermine levels of support for the Pact.**

Overview

3.1 This chapter discusses the rationale for the Stability and Growth Pact (SGP). It explores the reasons why collective fiscal discipline and co-ordination are essential for a successful monetary union. It discusses the role of the SGP in ensuring long-term sustainability, promoting fiscal co-ordination, and providing the flexibility to respond to shocks. It then explores how effective the SGP has been in recent years, looking at the credibility; flexibility; legitimacy and transparency of the framework.

RATIONALE FOR THE STABILITY AND GROWTH PACT

Ensuring sustainability

Sustainable policies are key

3.2 The SGP is important for ensuring sustainable public finances and to prevent high-debt countries from continuing to run high deficits and debts that could adversely affect all members in the monetary union. If the costs of unsustainable policies fall entirely within the country that carries them out, they need not be the concern of area-wide rules. However, they can have adverse spillovers in a monetary union and become a concern for other countries.[1] A country within a monetary union that became unable to finance its expenditure would face three options: it could default on its debts; it could receive direct transfers from other members of the monetary union or another international organisation to finance its expenditure; or it could put pressure on the central bank to relax monetary policy. All three options would be harmful, for both the country involved and for other member countries.

[1] See, for example, Thygesen (2002).

Sustainability and the markets

3.3 In the euro area, the Treaty explicitly rules out 'bail outs' of one member state by another or by the European Central Bank (ECB). However, to secure credibility in a monetary union, additional safeguards are needed to bolster sustainability and minimise the risk of adverse spillovers occurring. It is sometimes argued that financial markets will discipline fiscally profligate countries by increasing their borrowing costs. However, markets may not provide sufficient incentives for restraint. Also, the market response to unsustainable policies can be highly non-linear, with interest rate spreads widening substantially only when debt levels are already very high, while the market response may not discriminate properly between individual countries in the currency area. Market perceptions of the euro area and euro area long-term interest rates could therefore be affected adversely by the actions of one member country.

Policy Co-ordination

3.4 In principle, policy co-ordination can bring substantial gains, helping to produce a better policy mix and supporting overall economic stabilisation. However in the euro area framework, characterised by a single monetary authority with a number of decentralised fiscal authorities (currently 12), policy co-ordination is intrinsically more complex because of the need for co-ordination and information sharing among the various fiscal authorities ('fiscal-fiscal' co-ordination) as well as effective co-ordination between the fiscal and monetary authorities ('fiscal-monetary' co-ordination).

Fiscal-fiscal co-ordination and information sharing

3.5 Information sharing and co-ordination between the euro area's fiscal authorities is important. Individually each fiscal authority will have only a limited impact on the European Central Bank's decision making, but collectively they can have a large effect. The Stability and Growth Pact is the key mechanism for fiscal policy co-ordination in the euro area. The surveillance processes set up under the SGP are important in enabling euro area countries to share information with each other about their fiscal policy plans, and thereby aid policy co-ordination.

Monetary-fiscal co-ordination

3.6 Information sharing and co-ordination between the fiscal authorities and monetary authorities is also important in order to achieve an appropriate policy mix across the euro area as a whole. There are no formal mechanisms for fiscal-monetary co-ordination in the euro area (for example, to agree an appropriate interest rate and fiscal stance).

3.7 There are, however, several mechanisms for information sharing to help the fiscal and monetary authorities to enhance understanding of each other's reaction functions: the ECB is party to all Economic and Financial Committee and Eurogroup discussions of fiscal policy; the Commission and the chair of Eurogroup have the opportunity to attend ECB Governing Council meetings; while the publication of a range of documents on monetary and fiscal policy also facilitates information exchange. There is some suggestion that these mechanisms for information sharing are not used to their full potential, and there is scope for further work on monetary-fiscal co-ordination issues.[2]

Flexibility to respond to shocks within a credible long-term framework

3.8 Within EMU, the loss of an independent monetary policy strengthens the case for preserving fiscal flexibility to respond to country-specific shocks, or common shocks which impact asymmetrically.[3] An area where the SGP might have an important role to play is in allowing individual member states with low debt sufficient room to use either the automatic stabilisers fully or, where necessary, discretionary fiscal policy in responding to shocks, while ensuring the credibility of long-term fiscal objectives.

[2] See Bini Smaghi and Casini (2000).

[3] See *Policy Frameworks in the UK and EMU*, HM Treasury, June 2003 for a fuller discussion.

3.9 Yet one criticism that has been identified in the SGP is that some countries could find themselves unable to allow the automatic stabilisers to operate fully within the constraint of the 3 per cent deficit reference value.[4] Greater transparency over the long-term objectives of fiscal policy, and the national fiscal operating rules and policies that would implement them, could bolster credibility by building confidence that short-term responses to economic shocks did not jeopardise longer-term commitments.

THE SGP FRAMEWORK

Common goals of growth and employment

3.10 In Economic and Monetary Union (EMU), policy co-ordination and economic governance more generally[5] is founded on the principle of an intergovernmental approach; that is member states act together to make decisions. The UK Government is strongly supportive of this intergovernmental approach.

3.11 The EU fiscal framework, which applies to euro area countries as well as other EU members including the UK, has two arms: the Excessive Deficit Procedure and multilateral surveillance (see Annex A).

Excessive Deficit Procedure arm of SGP

3.12 The Treaty and SGP set out an Excessive Deficit Procedure (EDP). This may be initiated under one of two scenarios: a government deficit exceeds 3 per cent of GDP; or government gross debt exceeds 60 per cent of GDP, unless the level of debt is "sufficiently diminishing and approaching the reference value at a satisfactory pace" (Treaty Article 104.2).

3.13 A government deficit is not excessive if the excess over 3 per cent is exceptional and temporary and the deficit remains close to the reference value. Furthermore, any assessment of whether or not an excessive deficit exists must take account of government investment and all other relevant factors, including the medium-term budgetary position (Treaty Article 104.3). Since the launch of the single currency on 1 January 1999, member states other than the UK are obliged to avoid excessive deficits and, in the last resort, euro area countries are subject to sanctions and fines. The UK is obliged only to endeavour to avoid excessive deficits and is exempt from sanctions and fines (see Annex A for details).

Surveillance arm of the SGP

3.14 The surveillance arm is designed to give early warning if risks exist of a member state having an excessive deficit. The Stability and Growth Pact sets out a medium-term objective of "close-to-balance or in surplus". The 2001 Code of Conduct states that close-to-balance should be measured in cyclically-adjusted terms.

National autonomy retained

3.15 As part of the fiscal policy process, the European Commission and the ECOFIN Council monitor national fiscal policies and plans of all EU member states. However, within this process, the national fiscal authorities of each member state have autonomy over fiscal policy: they set the specific objectives of policy and make policy decisions about the overall stance of fiscal policy and tax and spending policies.

[4] See Eichengreen and Wyplosz (1998).

[5] Economic governance is different from economic government, as Jacquet and Pisani-Ferry (2001) explain. Economic governance suggests a number of actors working together to agree and adopt best practice in economic policy; economic government, on the other hand, suggests that a supranational body exists to set economic policy.

PERFORMANCE OF THE STABILITY AND GROWTH PACT

3.16 The previous sections considered the rationale for the Stability and Growth Pact and discussed the elements that are codified in the current EU framework. This section assesses the effectiveness and performance of the SGP in providing a macroeconomic framework for the euro area.

3.17 Progress has been made in recent years in the implementation of the Stability Pact, and the SGP has evolved to meet new challenges. One question is whether the SGP has so far proved the best possible vehicle for delivering the fiscal discipline and co-ordination that is necessary in a monetary union.

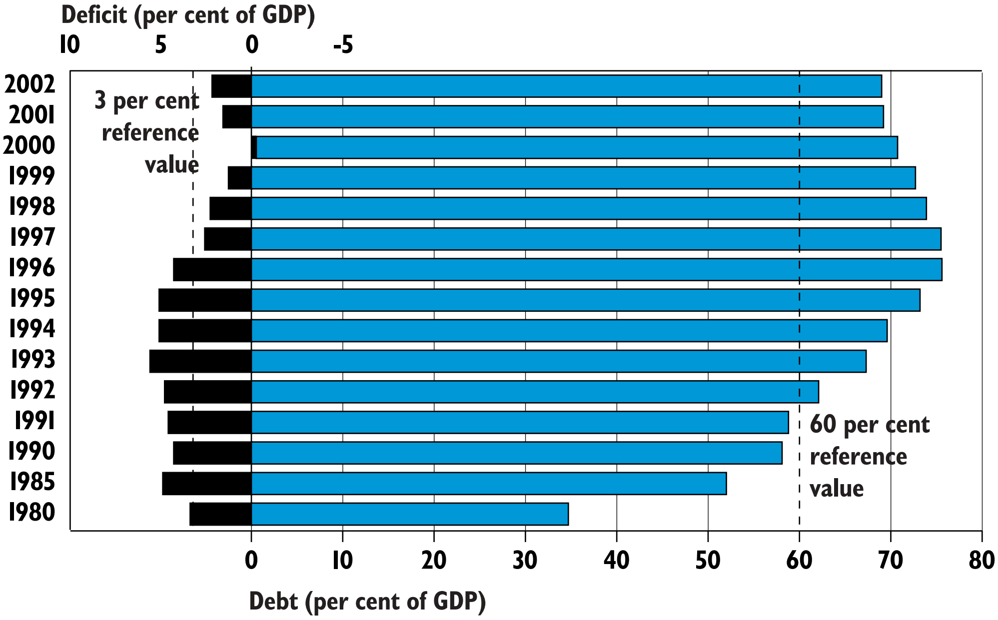
Credibility

3.18 Experience has shown that macroeconomic frameworks must command credibility, and building a strong track record is central to achieving credibility. This section considers the performance of the SGP in promoting sound fiscal policies and fiscal sustainability.

SGP has enhanced credibility

3.19 The historical problems of fiscal policy in the EU member states are well-known. During the 1980s and early 1990s high and persistent budget deficits fed an ever-growing stock of public debt. Against this backdrop, the objectives and rules in the Maastricht Treaty and the SGP have played an important role in enhancing the credibility of EU governments' commitment to fiscal discipline. Chart 3.1 shows the average deficits and debts in the euro area were both steadily reduced over the second half of the 1990s. Indeed by the start of EMU all participating countries had deficits within 3 per cent.

Chart 3.1: Debt and deficits in the euro area



Source: European Commission – Public Finances in EMU 2003 and Autumn Forecasts 2003.

... but debt remains high

3.20 However, the objective that debt levels should not exceed 60 per cent of GDP still remains to be achieved. While debt fell slightly in the lead up to EMU, the average level for the euro area countries is around 70 per cent of GDP and is expected to rise in coming years. Some countries still have debt levels over 100 per cent of GDP, substantially above the 60 per cent Treaty reference value. That debt consolidation now appears to have stalled and gone into reverse suggests there may be insufficient incentives in the SGP to reduce to more credible levels[6]

3.21 Assessing the credibility of the framework in delivering long-term sustainability requires analysis not just of explicit liabilities measured by debt ratios, but also of any implicit liabilities, such as those arising from the costs of an ageing population.

Greater attention to sustainability and ageing populations

3.22 A framework that focuses on maintaining prudent levels of debt should help to ensure that EU member states address the long-term challenge to public finances posed by population ageing. Moreover, issues concerning long-run sustainability are increasingly recognised amongst EU member states and within the SGP framework. For example, Stability and Convergence Programmes are now required under the Code of Conduct to include information on longer-term sustainability. This facilitates assessment of long-term sustainability in member states.

... but sustainability needs further work

3.23 However, joint work at the EU level suggests that, if current policies remain unchanged, several EU countries face substantial increases in public pension expenditures in the coming decades.[7] At the same time health and long-term care spending are also likely to rise as populations age. Enhancing credibility further requires more work to ensure comprehensive and reliable assessments of long run sustainability in the future and the commitment to policy reforms to underpin it.

Flexibility and the SGP

3.24 Experience has also shown that credible macroeconomic frameworks must encompass sufficient flexibility. It is important to have a framework within which policymakers can take early and forward-looking monetary and fiscal policy action in the face of upturns and downturns of the economic cycle without jeopardizing the credibility of the government's long-term goals.

Counter - cyclical policy important...

3.25 In the short term, provided that rules are adhered to and sustainability is not in doubt, fiscal policy should be flexible enough to be able to support monetary policy in smoothing economic fluctuations and stabilising output. To this end, fiscal policy should be counter-cyclical – fiscal policy should be more relaxed when the economy is below trend and tightened when above trend.[8]

3.26 As discussed in Chapter 2 in the UK this is achieved by setting the fiscal rules over the economic cycle. This provides room for the automatic stabilisers to operate and also allows for discretionary changes in the fiscal stance to restrain or stimulate demand, provided that any change is symmetrical: a fiscal stimulus in a downturn is matched by a restraining measure in the upturn.

...but SGP encourages procyclical behaviour

3.27 In a single currency area, with monetary policy no longer able to react to country specific shocks, there could be a greater need for fiscal stabilisation at a national level. Despite this, there is less emphasis on the role of the economic cycle and the importance of policy symmetry in the SGP framework. Without adequate focus on the cycle there is a risk that economies will not tighten fiscal policy sufficiently when the economy is growing strongly. Moreover, the 3 per cent Treaty deficit limit is defined in nominal rather than cyclically-adjusted terms. This could reduce the degree of fiscal stabilisation in a downturn, as a country with a deficit close to 3 per cent of GDP might not allow the automatic stabilisers to operate

[6] In theory, the deficit, debt and close to balance rules in the SGP should support debt reduction. Indeed, strict adherence to the SGP might be expected to reduce debt levels to close to zero in the long term, although this might not be desirable in practice.

[7] The Economic Policy Committee (EPC), one of ECOFIN's supporting committees, published a comprehensive report on the impact of population ageing on the public finances in October 2003 (EPC, 2003).

[8] Counter-cyclical fiscal policy may also be justified by tax-smoothing considerations - see Barro (1979).

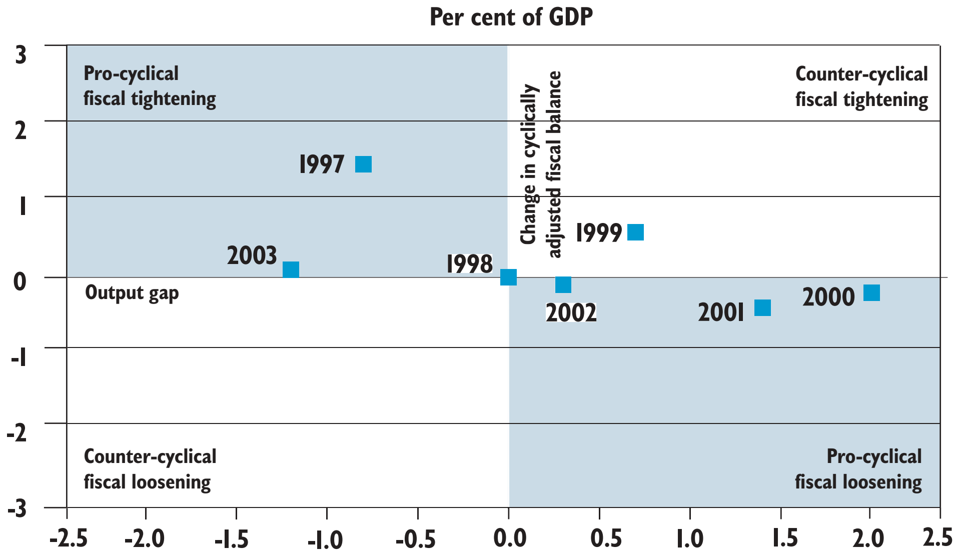
freely. Procyclical policy is therefore encouraged by forcing countries to tighten policy in a downturn, while providing no disincentive to loosen policy during an upturn.

3.28 It could be argued that the SGP permits as much short-run stabilisation as a country wants, so long as the country has achieved a high enough surplus in normal times to permit it.[9] However, structural surpluses (or balanced budgets) in countries with low and sustainable debt positions could be undesirable for two reasons:

- they could harm intergenerational equity, if the current generation pays for measures from which the next generation will benefit.
- they could squeeze public investment.[10] This has been an issue in the UK and it may be particularly important for many EU accession countries in the future, given their often higher nominal GDP growth potential and high public investment needs[11] (see Box 3.2).

3.29 It is worth considering the extent to which fiscal policy has helped to support monetary policy during the recent period of global economic uncertainty, and the period immediately preceding when most EU economies were above trend. In practice, the Stability and Growth Pact does not appear to have supported counter-cyclical policy in recent years. Chart 3.2 below shows that on average fiscal policies in the euro area have not been strongly counter-cyclical in recent years. However, these charts are adjusted for the automatic effects of the cycle; the automatic stabilisers have generally been able to operate at least partially in euro area countries.

Chart 3.2: Cyclicality of fiscal policy in euro area



Source: European Commission forecasts, Autumn 2003, Public Finances and EMU 2003

[9] For this reason, the Swedish Government Commission on Stabilisation Policy recommended that the Swedish government run surpluses of over 2 per cent of GDP in normal times. See Government of Sweden (2002).

[10] Easterly (1999) claims that the Maastricht deficit rules harmed many public investment projects.

[11] See Buiter and Grafe (2002). They could also damage financial market efficiency. Government securities are an important benchmark asset in financial markets. Were they to be reduced to zero, as structural surpluses could eventually imply, this could have a detrimental impact on efficiency.

3.30 While the implementation of the SGP has evolved, it was perhaps understandable at the outset that, dealing with so many countries, the Pact would resort to mechanistic rules, rather than guiding principles that could afford some constrained discretion. While precise dates by which countries should balance their cyclically adjusted budgets have been dropped, they have been replaced for euro area countries by a target annual reduction in the cyclically adjusted deficit of 0.5 per cent of GDP. This does not take account of debt levels or public investment needs.

3.31 So without a clear pre-commitment to flexible operating rules, and as a consequence of the initial failure to take explicit account of the cycle, the result has been an asymmetric application. In particular, the SGP does not have a mechanism to promote a tightening of fiscal policy in the above trend phase of the cycle, even for high debt countries. Perversely countries can end up cutting spending or raising taxes at the wrong stage of the cycle, at the expense of stability and growth, in an attempt to make up the lost ground that should have been made up when the economy was stronger.

Flexibility to invest . . .

3.32 For countries with sound public finances and economic stability, the fiscal framework should provide maximum capacity to adopt measures to implement structural reforms and improve the quality of public finances. In particular, there should be room for policies that help deliver structural reform and long-term economic benefits but require significant investment in the short run. The principle of intergenerational equity suggests that governments should be able to borrow to finance such public investment, meaning that the generations that benefit contribute to the cost.

. . . is recognised in Treaty . . .

3.33 The SGP framework recognises, to some extent, the importance of public investment. Article 104(3) of the EC Treaty states that assessment of whether a country's deficit is excessive should take into account *"whether the government deficit exceeds government investment expenditure."* Indeed, initial proposals for a fiscal stability pact explicitly called for *"priority in government spending for public investment."*[12]

. . . but more focus on investment needed

3.34 In practice, the SGP could benefit from greater recognition of the importance of measures that will have long-term gains, even if they require significant investment in the short run. Enlargement will also bring countries into the EU whose fiscal positions are rather different from most existing members. In particular, as shown in Box 3.2 accession countries will have higher investment needs, starting from a position of lower debt and higher deficits.[13]

Legitimacy and the SGP

3.35 Legitimacy means that the policy framework engenders lasting public and parliamentary support. For the policy framework to promote legitimacy it must be seen to be based on a sound economic rationale and to be applied consistently over time. Accountability and transparency are key contributors to legitimacy. But legitimacy can also be measured by whether the policy framework gives policymakers the democratic mandate to take action on behalf of the public.

3.36 The multilateral surveillance provided for under the SGP should enhance its legitimacy. For example, the annual publication of Stability and Convergence Programmes increases the transparency of member states' fiscal positions. Assessment of these programmes undertaken by the ECOFIN Council introduces an element of peer review. This is supported by ongoing work undertaken at the EU level on fiscal issues, such as the programme of work devoted to assessing long-run sustainability.

[12] Waigel (1995), page 3.

[13] See Buiter and Grafe (2002 and 2004).

3.37 In recent years the SGP has faced a number of challenges that suggest further steps could be undertaken to enhance the transparency, accountability and legitimacy of the current framework. Particular criticisms of the SGP which have been raised include:

- rules without a clear economic rationale;
- mechanistic targets; and
- a lack of transparency and consistency.

3.38 These issues have prompted considerable debate and reflection amongst all 15 EU member states, particularly following proposals made by the European Commission in January 2004[14] to strengthen economic governance in the EU.

Lack of clear economic rationale

3.39 Of the criticisms raised over the SGP, one of the most damaging is the accusation of a lack of clear economic rationale for some of its provisions.[15] This could be harmful to the achievement of the SGP's goals, since a lack of transparency and makes enforcement of the rules difficult. The lack of economic justification could also cause difficulties in distinguishing between a breach of the rules by a state with fundamentally sound policies and finances and one by a state without. The current SGP leaves little scope to differentiate between countries on the basis of their individual economic circumstances, beyond deficit levels.

Mechanistic targets

3.40 Concern that such a country-by-country approach might be perceived as a weakening of the SGP has led to a move to the other end of the spectrum: the imposition of mechanistic targets. For example, in October 2002 , Eurogroup (with the exception of France), together with the Commission and ECB, agreed that those countries which had not yet reached the objective of close-to-balance or in surplus, needed to pursue continuous adjustment in their cyclically adjusted balances of at least 0.5 per cent of GDP per year. As Chapter 4 discusses, the Government believes that the SGP rules could do more to take account of the economic circumstances of individual countries, including the effects of the economic cycle, sustainability, and the role of public investment.

Transparency and consistency

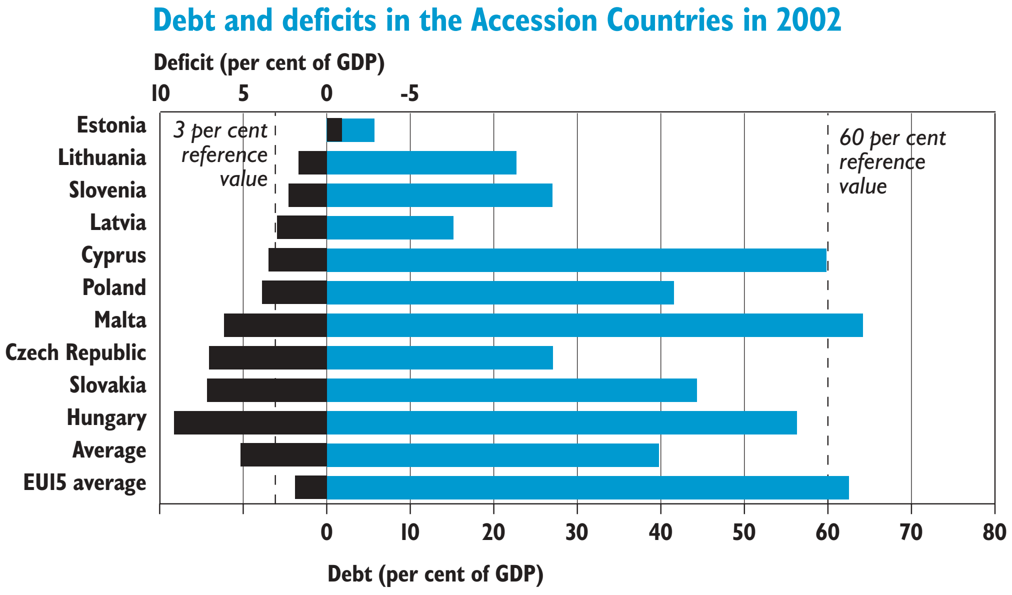
3.41 Transparency is important for legitimacy, it can also bolster credibility while countries are building up a track record. Some commentators (for example, Berglöf *et al.* 2003) have expressed concerns about the degree of transparency in the SGP framework. The Council does publish its Opinions on individual member states' Stability and Convergence Programmes, as well as any decisions that an excessive deficit exists in a member state.

[14] The Commission's statement of 13 January 2004 is available at
http://www.europa.eu.int/rapid/cgi/guesten.ksh?p_action.gettxt=gt&doc=IP/04/35101RAPID&lg=EN&display=

[15] Buiter and Grafe (2003) state that the SGP's rules are not credible because they "are arbitrary and rigid in design." Mèlitz (2002) argues that "The means of enforcing the ceiling are too weak, and this is true in no small extent because of the limp justification for the ceiling". See also Pisani-Ferry (2002), page 7: "It is a fact of life that a law that has lost justification is not considered legitimate anymore and cannot be credibly enforced for long".

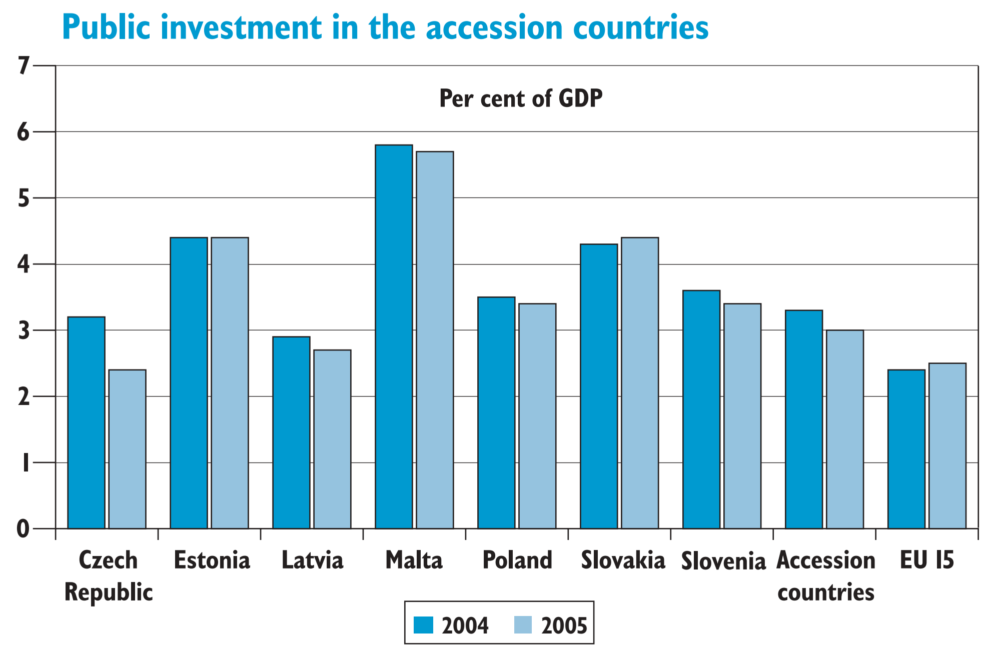
Box 3.2 The accession countries

The budgetary position of the accession countries is, on average, quite different from that of existing EU member states. While there is considerable variation between countries, on average the accession countries have higher deficits than existing EU member states, but lower levels of debt. In most of the accession countries, the population is ageing, and either stable or declining in terms of numbers.



Source: European Commission Autumn 2003 forecasts

Many of the accession countries also have high investment needs. The chart below shows forecasts for public investment this year and next. In general the accession countries are planning higher levels of investment than the current EU member states. The chart shows gross investment, but on a net investment basis[a] the difference is likely to be more marked as the accession countries are likely to have a smaller public capital stock.



Source: European Commission Autumn 2003 forecasts

[a] Net investment is gross investment less depreciation of the current capital stock.

3.42 However, statistical difficulties have been highlighted. The existence of an excessive deficit in Portugal for 2001 was only identified by ECOFIN in November 2002, following the release of substantially revised statistics. The frequent use of one-off measures to reduce the reported deficit in a given year has also been a factor.[16] However, recently there have been useful moves to improve the reliability of statistics, including ECOFIN's adoption of a Code of Best Practice on compiling and reporting data in the context of the EDP on 18 February 2003.

Accountability

3.43 There are fewer formal parliamentary mechanisms for ensuring accountability at an EU level than at national level, though the Treaty does require that the President of the Commission and the Council report to the European Parliament on the results of multilateral surveillance and the Parliament can call the President of the Council to appear. And there is also a role for national parliaments.[17]

3.44 In considering whether the processes for fiscal policy co-ordination at an EU level are legitimate, it is important to examine the division of responsibilities. With fiscal policy decisions remaining firmly within national competence, legitimacy is achieved through the usual democratic mandate; i.e., decisions made by elected politicians (Hodson and Maher, 2000). Although the European Commission has the right of initiative on, for example, recommending that a member state has an excessive deficit, the Council has the ultimate right of decision and can choose whether to accept or reject Commission recommendations. The Council represents member states and therefore, together with the fact that the Council makes the final decisions, the system ensures legitimacy. As Hodson and Maher state, "the case of the EDP shows that even when economic policy is defined in terms of regulations (the most rigorous form of legal rule within the EU legal order) it remains fundamentally intergovernmental" (page 13).

3.45 A number of proposals have been made to increase the role of the Commission in EU fiscal policy at the expense of the Council and, therefore, member states. This could have implications for the legitimacy of the EU fiscal framework, by shifting the institutional balance away from the Council and towards the European commission. The UK Government strongly supports an intergovernmental approach, which is the foundation of policy coordination and the basis for economic governance in EMU.

Summary

3.46 The Stability and Growth Pact is designed to ensure sound public finances as a prerequisite to achieving stable long-term economic growth. Fiscal sustainability is essential for macroeconomic stability in the EU. The UK supports the principle of a strong Stability and Growth Pact founded on sensible fiscal policy co-ordination. It recognises that collective fiscal discipline and co-ordination are essential for a successful monetary union.

3.47 The Stability and Growth Pact represents an important step forward in recognising the importance of long-term budgetary discipline. However, experience with the operation of the SGP highlights a number of issues:

- While the SGP has played an important role in enhancing the credibility of governments' commitment to fiscal discipline in the EU, implementation of the SGP has tended to focus on short-term deficits with rather less consideration being given to debt levels and longer-term fiscal challenges, for example those relating to an ageing population.

[16] See Easterly (1999).

[17] The Treasury Select Committee and the EU Committee of the House of Lords have both considered recent developments in the SGP.

- The effectiveness of the SGP may have been adversely affected by the lack of attention paid to cyclical factors, especially when economies were in the upswing phase of the cycle.
- More generally, while the operation of SGP has made more information available on countries' fiscal positions, questions have been raised about its economic rationale, the consistency of treatment of countries, and the evidence base which could undermine levels of support for the Pact.

4 A PRUDENT INTERPRETATION OF THE STABILITY AND GROWTH PACT

The Government supports a prudent interpretation of the Stability and Growth Pact, which takes account of the economic cycle, the sustainability of public finances with low levels of debt, and recognises the importance of public investment. This would lock in long-term fiscal discipline and sustainability, enhance credibility across the economic cycle, while allowing the automatic stabilisers to operate fully and symmetrically to smooth fluctuations in output, and allow appropriate increases in investment in public services.

Supported by the principles of clear long-term objectives, pre-commitment to sound institutional arrangements and maximum transparency, a prudent interpretation of the Pact would help achieve the three objectives of credibility, flexibility and legitimacy.

4.1 This chapter examines how a prudent interpretation of the Stability and Growth Pact (SGP) would help achieve the objectives of macroeconomic frameworks identified in Chapter 2 of credibility, flexibility and legitimacy and addresses the issues of how the SGP performs raised in Chapter 3.

4.2 The Government has consistently stated that, to meet the objectives of credibility, flexibility and legitimacy, a prudent interpretation of the Stability and Growth Pact that takes account of the economic cycle, sustainability and the importance of public investment is required. Focusing on clear objectives, with over-arching fiscal principles in this way and supported by reforms to enhance co-ordination, transparency and accountability, provides a sound basis for strengthening the Pact.

A PRUDENT INTERPRETATION OF THE STABILITY AND GROWTH PACT

4.3 The Government supports a prudent interpretation of the Pact that builds on the Code of Conduct, agreed by Member States in June 2001 and the report agreed by EU Finance Ministers on strengthening budgetary co-ordination in March 2003. A prudent interpretation would lock in long-term fiscal discipline and sustainability and enhance credibility across the economic cycle, while allowing the automatic stabilisers to smooth fluctuations in output, and allow appropriate increases in investment in public services. Specifically, in assessing a country's compliance with the Stability and Growth Pact, it would take into account the economic cycle, sustainability and public investment.

The economic cycle

Importance of automatic stabilisers

4.4 As set out in Chapter 3, fiscal policy can play an important role in supporting monetary policy to help smooth the path of the economy by allowing the automatic stabilisers to operate fully and symmetrically over the cycle. The importance of automatic stabilisers in dampening economic volatility has been shown both theoretically and empirically.[1] A prudent interpretation of the Pact would recognise this, and help avoid the situation where fiscal policy is pro-cyclical, or where the operation of the automatic stabilisers is partially offset by discretionary changes in fiscal policy. It is therefore important to focus on cyclically-adjusted fiscal aggregates when assessing the public finances.

[1] For example, Christiano (1984) and van den Noord (2000). See also Chapter 5 of *Fiscal Stabilisation and EMU*, HM Treasury (2003).

4.5 There is also a case for allowing appropriate discretionary fiscal policy in cases where countries have low debt and sustainable public finances. In particular, the discussion paper *Fiscal Stabilisation and EMU*[2] sets out the case for a greater role for UK fiscal policy in helping to stabilise the economy should the UK join EMU. This is discussed in more detail in Box 4.1.

Recognition of the cycle

4.6 There is increasing recognition of the importance of taking account of the economic cycle in the Stability and Growth Pact. For example, the 2001 Code of Conduct makes clear that the assessment of the appropriateness of member states' medium-term objectives and the extent to which those objectives have been achieved must take explicit account of the cyclical position of the economy and its effect on the budget.[3] The idea of taking more account of the cycle was also recognised in the ECOFIN conclusions of March 2003 following proposals made by the European Commission in November 2002. The European Commission, working with the EU member states, has also made significant progress on agreeing a methodology for estimating countries' cyclically-adjusted balances.[4]

...but more focus on cycle needed

4.7 An important issue for the future development of the Pact is the need to ensure that the automatic stabilisers operate symmetrically; i.e. in both upturns and downturns over the cycle. The automatic stabilisers should be allowed to support demand in the below-trend phase of the cycle. Pro-cyclical fiscal policy at times when economies are above trend should also be avoided as such policies will exacerbate economic instability. In addition, a failure to consolidate the public finances by reducing debt during an economic upswing may mean that countries are unable to allow the automatic stabilisers to support economic growth and stability during periods when the economy is below trend while maintaining fiscal sustainability.

Box 4.1: Fiscal stabilisation, EMU and the Stability and Growth Pact

The discussion paper *Fiscal stabilisation and EMU*[a] examined the case for a greater role for fiscal policy to help stabilise the economy if the UK were to join EMU. Within EMU, interest rates are set by the European Central Bank according to conditions across the entire euro area. To the extent that the UK were subject to asymmetric shocks (or to an asymmetric reaction to a common shock), there could therefore be a case for an enhanced stabilisation role for fiscal policy as European-wide monetary policy would not adjust fully to address these shocks.

The paper set out a number of options for using fiscal policy to help maintain economic stability if the UK were to join EMU. One option on which the Government is consulting is for a fiscal stabilisation rule. Under such a rule, if the actual or forecast output gap exceeded a trigger value, for example plus or minus 1½ per cent of GDP, the Government would send an 'open letter' to Parliament. Alternatively, a rule could be defined in terms of inflation. The open letter would set out whether the Government was going to use fiscal policy, and if so how it was going to be used, to meet its stabilisation or other fiscal objectives.

If there were greater use of discretionary fiscal policy, it would be vital that policy was operated symmetrically to prevent deterioration in the public finances over the cycle. A key issue would be to promote a high degree of transparency, including through well-defined objectives and operating rules, regular reporting and accountability arrangements. These could also be supported by increased transparency and improved surveillance discussed later in this chapter.

[a] *Fiscal Stabilisation and EMU*, HM Treasury, June 2003

[2] *Fiscal Stabilisation and EMU*, HM Treasury, June 2003.

[3] The 2001 Code of Conduct on the content and format of Stability and Convergence Programmes states that "The time frame for interpreting the medium term would be the length of the business cycle" and is available at http://ue.eu.int/newsroom.

[4] See the minutes of the ECOFIN Council meeting of 12 July 2002, available at http://ue.eu.int/newsroom.

Sustainability and Debt

4.8 Over the long term, fiscal policy should support the government's goals by ensuring that the public finances are sustainable, thereby contributing to a stable economic environment that promotes growth. Sustainable public finances are also a prerequisite for flexibility. Countries will only be able to respond flexibly to economic shocks or increase the level of public investment without threatening credibility if public finances are sustainable in the long term.

Low debt is important

4.9 Low levels of debt enhance the sustainability of the public finances. A low level of debt provides a sufficient margin to allow the automatic stabilisers to work in full without endangering sustainability. In addition, countries with low debt stocks will be well-placed to undertake investment in public services.

4.10 Government borrowing can help stabilise the economy by smoothing incomes over the economic cycle, and promote inter-generational fairness by spreading the cost of investment across current and future generations. However, as discussed in chapter 3, high debt levels can have adverse economic effects through higher real interest rates and 'crowding out' of private sector investment, high debt servicing requirements and reduced credibility.

Progress in focusing on debt

4.11 Recently, both ECOFIN and the European Commission have reaffirmed the importance of debt in fiscal surveillance. The 2001 Code of Conduct notes that assessment of countries' public finances must take account of the need for a rapid decline in debt among those countries which have high debt levels. In addition, the March 2003 ECOFIN conclusions stated that greater weight must be attached to debt over future years.

4.12 A prudent interpretation of the Pact would take into account debt levels in assessing the sustainability of the public finances. One idea that has been raised is that countries with low debt levels would be subject to less restrictive conditions on their level of borrowing. Pisani-Ferry[5] suggested that countries with gross debt below 50 per cent of GDP, which publish comprehensive and forward-looking balance sheet information and set a debt target, should be exempt from the Pact. Wyplosz[6] suggests that countries with a low debt ratio should have a higher deficit ceiling.

4.13 A related proposal from Wren-Lewis[7] suggests that countries which adopt national fiscal rules that are sufficient to ensure long-term sustainability should be exempted from the Pact. European surveillance would then be focused on compliance with those national rules. There are analogies here with the UK's *Code for fiscal stability*, which does not set down fiscal rules but requires that the Government states its objectives and operating rules and how they are consistent with a set of fiscal principles. The Code also provides for high levels of transparency to facilitate the monitoring of progress against the rules.

[5] Pisani-Ferry, "Fiscal Discipline and Policy Coordination in the Eurozone: Assessment and Proposals", in *Budgetary Policy in E(M)U: Design and Challenges*, Ministerie van Financien, 2002

[6] Wyplosz,, "Fiscal Policy and Macroeconomic Stabilisation in the Euro Area: Possible Reforms of the Stability and Growth Pact and National Decision-Making Processes", in European *Economic Advisory Group Report on the European Economy,* 2003

[7] Wren-Lewis (2003), "Changing the rules", *New Economy*, vol. 10.

Public finances in the long term

4.14 Assessment of the sustainability of the public finances should also take into account the long-term budgetary impact of ageing populations. Indeed, sustainability is one of the key areas being considered by ECOFIN and the member states following proposals made by the European Commission in November 2002 to strengthen the co-ordination of budgetary policies in the EU. In January 2004, the Commission reiterated the importance of these proposals as part of an approach to strengthen economic governance (see Box 4.3 for further details of the Commission's proposals). This emphasis on sustainability has been supported by analysis undertaken by the EU Economic Policy Committee on the impact of ageing populations on the public finances.[8]

Progress in emphasising the long term

4.15 The UK Government's 2003 *Long-term public finance report*, published alongside the 2003 Pre-Budget Report, provides a comprehensive analysis of long-term economic and demographic developments in the UK, and their likely impact on the public finances. This report shows a number of indicators of fiscal sustainability, alongside an analysis of spending and revenue projections, and concludes that on the basis of current policies and a range of reasonable assumptions, the UK's public finances are sustainable in the longer term.

4.16 Other member states have also acknowledged the challenges of an ageing population in their fiscal frameworks. Sweden, for example, has set an objective of maintaining a budget surplus equivalent to 2 per cent of GDP on average over a business cycle to prepare for the economic effects of an ageing population, while Denmark has put in place a programme of debt reduction. Finland is implementing reforms to contain future spending increases associated with ageing populations. Many countries have undertaken structural reforms, often related to the pension system, to improve the long-term sustainability of their public finances. The Code of Conduct on the Content and Format of Stability and Convergence Programmes also requires member states to include information on long-run sustainability in their programmes.

4.17 A prudent interpretation of the Pact would be based on thorough analysis of the long-term sustainability of the public finances, which needs to take into account both the quantitative and qualitative indicators of sustainability. This is because sustainability is a complex issue, which is unlikely to be appropriately captured by a single indicator. Moreover, quantitative indicators are sensitive to the starting point for the projections, the underlying assumptions, such as the interest rate, and the time horizon. The European Commission's analysis reflects these conventions,[9] and the main conclusions from that analysis are shown in Box 4.2 below.

[8] See Economic Policy Committee (2003) *"The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme"*, available at http://europa.eu.int/comm/economy_finance/epc/documents/2003/pensionmaster_en.pdf

[9] *Public finances in EMU*, European Commission, 2003

Box 4.2: The sustainability of public finances within the European Union

The discussion of sustainability in Public Finances and EMU 2003[a] (the European Commission's annual publication on fiscal issues) was based on analysis of the 2002 updates of Stability and Convergence Programmes. It considered the quantitative indicators of sustainability, such as the evolution of debt levels and the Commission's own 'synthetic' indicators, alongside qualitative factors. The conclusions grouped countries in the following way:

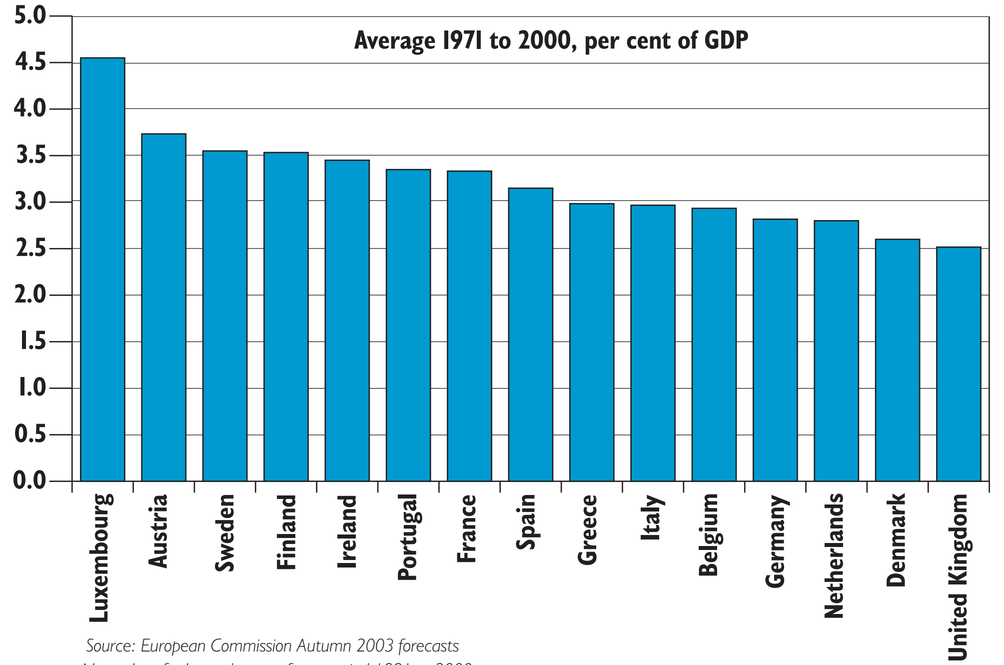
- **a large risk of budgetary imbalances** due to pension expenditures was identified in the case of Spain and Greece;
- **a risk of budgetary imbalances** from a variety of factors, including health and pension spending, slow debt reduction and poor labour market performance, was highlighted in Germany, France, Austria and Portugal;
- **a particular set of challenges** were faced by high-debt countries, such as Belgium, Greece and Italy, as they would need to run high primary surpluses for a prolonged period;
- **sustainable public finances** were suggested for a number of countries including Denmark, Luxembourg, the Netherlands, Finland, Sweden and the UK; and
- **policy challenges that need to be addressed**, despite a significant improvement in public finances in recent years, were identified in Ireland.

[a]*Public finances in EMU*, European Commission, 2003

Public Investment

4.18 Public investment contributes to the provision of high-quality public services and can help to underpin a flexible, high productivity economy. Historically, the UK has had low levels of public investment compared to other developed countries. As Chart 4.1 shows, public investment in the UK was the lowest of all EU Member States over the last 30 years, with an average over the period around 60 per cent of that for the EU as a whole.

Chart 4.1: Public investment in the EU



Source: European Commission Autumn 2003 forecasts
Note: data for Luxembourg refer to period 1991 to 2000

Country-specific investment needs

4.19 A prudent interpretation of the Pact recognises the importance of country-specific circumstances including investment requirements and structural reform. There are important differences between current and capital spending, which have implications for how such spending should be financed. In particular, "Investment implies future returns: its cost should thus be distributed over time as those returns accrue."[10] From the perspective of inter-generational fairness, this return could either be financial or non-financial, though from a perspective of ensuring sound and sustainable public finances financial returns are more important.

Progress in taking account of investment

4.20 The issue of taking public investment into account within the Stability and Growth Pact is increasingly discussed at a European level. In a speech to the European Parliament in October 2002, the President of the European Commission stated that the Pact needs to be compatible with a recognition that *"the Pact's rules apply to different countries in different situations as regards debt, financial burdens arising from the ageing of the population and public investment requirements"*.[11]

4.21 The Commission proposals of November 2002 also included a suggestion that government investment in public infrastructure should be taken into account when assessing compliance with the Pact. Recent Council opinions on member states' Stability and Convergence Programmes have recognised public investment, where country-specific circumstances mean member states are undertaking a significant programme of investment.[12] This will be an important issue for the accession countries (see Box 3.2 for further details).

4.22 In the UK's framework, the difference between capital and current expenditure is recognised through the golden rule, with the definition of capital expenditure based on internationally agreed accounting rules. In terms of the Stability and Growth Pact, one idea that has been suggested[13] is that, when assessing a country's compliance with the Pact, it would be the budget balance excluding net investment that would be taken into account, in effect the current budget surplus. Alternatively, countries with low debt and sustainable public finances could be given greater flexibility to undertake capital expenditure.

KEY PRINCIPLES FOR REFORM

4.23 There are important and encouraging signs that the SGP is steadily evolving towards a more prudent interpretation. Over the past two years the Council has approved: a greater focus on cyclical adjustment; a recognition publicly that the automatic stabilisers should be allowed to operate symmetrically over the cycle, and to this end that member states should avoid pro-cyclical policies; a greater focus on long-run sustainability, including the impact of ageing populations; a greater emphasis on debt reduction in highly indebted countries; and some more emphasis on the importance of the quality of public expenditure, public investment and structural reform.

4.24 The question is how best to consolidate progress. It is important to recognise that the issue here is not fundamental overhaul or Treaty change, but evolution. Indeed, any proposals will need to be carefully considered to ensure they are consistent with the Treaty (see Annex A). More generally, there will need to be extensive discussion before specific proposals can be developed (see Box 4.3 for a discussion of European Commission proposals for reform). At this stage, it is helpful to consider the principles that should guide further evolution of the SGP.

[10] *Improving the SGP through a proper accounting of public investment,* Blanchard and Giavazzi, February 2003 (available at http://www.igier.uni-bocconi.it/whos.php?vedi=404&tbn=albero&id_doc=177)

[11] http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.getfile=gf&doc=SPEECH/02/505|0|AGED&lg=EN&type=PDF

[12] The Opinions for Ireland, Greece and the UK note the investment programmes being undertaken in those countries.

[13] Ibid.

4.25 Chapter 2 identified the objectives for a robust macroeconomic framework of credibility, flexibility and legitimacy. It described how experience has pointed countries towards 'constrained discretion' as the best means for achieving this. It also discussed how countries have put this into operation on the basis of three key principles: clear long-term objectives; pre-commitment to sound institutional arrangements; and maximum transparency. This section sets out the relevance of these principles to the SGP.

Clear Objectives

Box 4.3: European Commission Proposals for Reform

In January 2004, Pedro Solbes, member of the European Commission responsible for Economic and Monetary Affairs, outlined proposals for reform of economic policy co-ordination and surveillance within the European Union.[a] The Commission identified three pillars around which its proposals would be built:

1. *"The need to better combine discipline with economic growth considerations by placing fiscal policy within the broader context of general economic policy surveillance."*

Under this pillar the Commission hopes, to find a new balance between the Broad Economic Policy Guidelines (BEPGs) and the SGP in a way that will underpin the euro area as a monetary union and bring the EU closer to achieving the Lisbon goals.

2. *"The need to focus on the sustainability of the member states' public finances"*

Building on its communication of November 2002, the Commission hopes to combine stricter discipline with flexibility in the conduct of national budgetary policies. It hopes to achieve this by putting more emphasis on public debt and sustainability, strengthening surveillance during upturns to ensure symmetry over the cycle, making more allowance for country-specific circumstances without compromising the principle of equal treatment and setting principles for prescribing the budgetary adjustment path and ensuring stronger enforcement.

3. *"The need to improve implementation by enhancing the common interest in the area of economic policy."*

Under this pillar, the Commission believes that it should continue to play a full and effective role in the conduct of economic surveillance, using all possibilities to make public opinions on economic and budgetary policies.

[a] The Commission's statement of 13 January 2004 is available at:
http://www.europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=IP/04/35|0|RAPID&lg=EN&display=

4.26 This first principle suggests that policy credibility will be enhanced, and therefore more effective, if the objectives of policy are clear and if the way in which those objectives are to be pursued is established *ex ante*.

4.27 While the SGP has evolved, the question is whether the principles of a prudent interpretation should be codified within the SGP. This would recognise that it is for governments, collectively and inter-governmentally, to take into account: the stage of the economic cycle in each country, borrowing for investment for low-debt countries, and differences in long-term sustainability including between high and low-debt countries.

4.28 This would mean greater emphasis on the implementation of fiscal consolidation in higher-debt countries as set out in the 2001 Code of Conduct, particularly when the economy is above trend (see also the Commission's proposals for reform in Box 4.3) and to combine that with greater flexibility, not only by allowing the automatic stabilisers to operate fully over the economic cycle, including in the below trend phase, but also by allowing countries with low debt and sustainable public finances the room for manoeuvre, when necessary, to use discretionary fiscal policy to support stability and growth and to undertake public investment.

Flexibility for low-debt countries

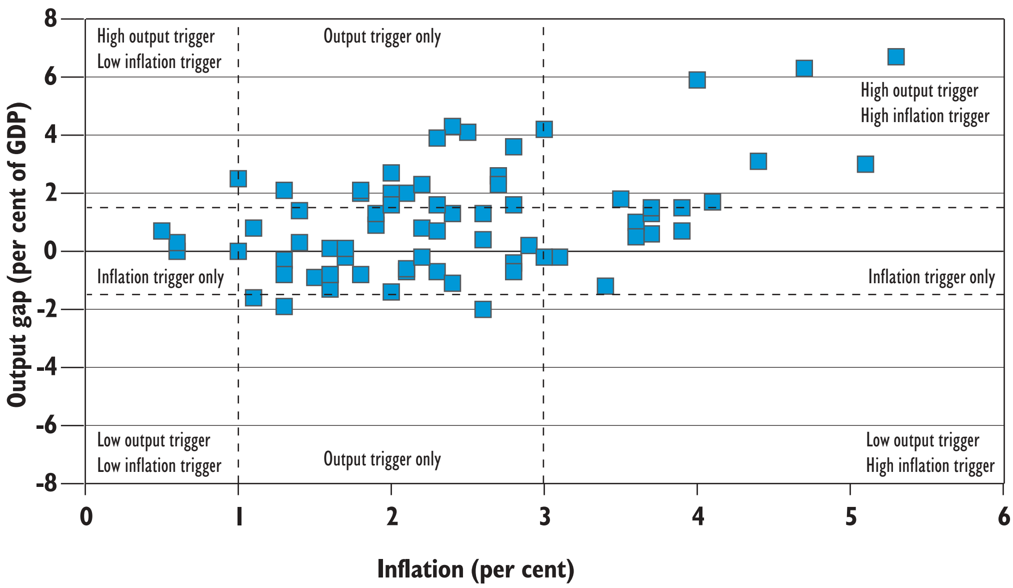
4.29 Some flexibility around the 3 per cent reference value is already allowed for under the Treaty if the excess is only exceptional and temporary and the deficit remains close to the reference value. A prudent interpretation would take account of debt levels and emphasise the free and full operation of the automatic stabilisers symmetrically over the cycle and make any need for discretionary fiscal policy, to support structural reform and to undertake public investment, more transparent at all stages of the cycle.

Box 4.4: The operation of the fiscal stabilisation rule

As described in Box 4.1, the Government is consulting on a fiscal stabilisation rule should the UK join EMU. Under such a rule, should the output gap, or possibly the rate of inflation, exceed a trigger value, the Government would be required to send an 'open letter' to Parliament. The open letter would set out whether the Government was going to use discretionary fiscal policy, and if so, how it was going to be used in order to meet its stabilisation and other fiscal objectives.

The chart below considers how a stabilisation rule such as this would have worked in the euro area over the recent past. It provides a broad illustration based on data from the European Commission's Autumn 2003 forecasts, with each point on the chart representing one of the euro area countries for one year. The chart shows a number of occasions where countries have had output gaps greater than 1½ per cent of GDP in absolute terms, suggesting a case for fiscal tightening. It also shows that were the rule defined in terms of inflation, there would also have been occasions where trigger values of 1 and 3 per cent were exceeded.

Output gap and inflation in euro area countries, 1999 to 2004



Sound institutional arrangements

4.30 The second key principle is that, in addition to clear long-term objectives, credibility can be enhanced through pre-commitment to sound institutional arrangements and clear procedural rules. Chapter 2 discussed the evolution of such procedural rules and institutional arrangements at national levels, and it is important to consider how these might be applied in the context of the SGP.

Trigger values

4.31 There are a number of options to help strengthen the institutional arrangements and Box 4.5 summarises some of the academic suggestions for reform. Some argue that the basis for an appropriate institutional framework already exists within the provisions of the Treaty. Von Hagen (2003) points out that in the Treaty procedure for assessing whether a Member State has an excessive deficit there already exists adequate provision for taking account of the economic cycle, sustainability and public investment (see also Annex A). If these provisions were fully implemented the 3 per cent and 60 per cent Treaty reference values would act as triggers for a further level of surveillance, whereby the Council, taking into account the views of the Economic and Financial Committee and the Commission, would examine more closely the circumstances of the country concerned.

4.32 Reference values that triggered more intensive intergovernmental surveillance could help to enhance the transparency, flexibility and credibility of the Pact by constraining discretion in a less mechanistic way than strict numerical targets. However, these values ought to be applied symmetrically, focusing both on the need for fiscal consolidation in the above-trend phase of the cycle as well as the need for flexibility in the below-trend phase.

Box 4.5: Academic ideas for reforming the Stability and Growth Pact

Fiscal-fiscal co-ordination: a new level of commitment: Pisani-Ferry (2002) argues that Eurogroup should agree on a set of broad non-binding policy principles outlining the operation of fiscal policy to assist fiscal-fiscal co-ordination.

Fiscal-monetary information-sharing: In order to increase information exchange between the ECB and national fiscal authorities, Bini Smaghi and Casini (2000) argue that the ECOFIN Presidency should attend meetings of the ECB Governing Council and report back to other members of the euro area more regularly (see Policy Co-ordination section in Chapter 3).

Fiscal policy committees: Wyplosz (2002) proposes the creation of new fiscal policy committees in each member state. These would have authority over the deficit in each country, but no say on the size and composition of expenditure or taxes. They would be given the long-term mandate of maintaining debt at a certain target, but would be able to vary the deficit in the short term to stabilise the economy.

New monitoring institutions: Several authors argue that independent bodies would be more credible in assessing whether discretionary fiscal policy compromised sustainability. For example, Begg *et al.* (2002) argue that the EU should delegate monitoring to an independent body. Fatás *et al.* (2003) and von Hagen (2003) argue for the creation of an independent European fiscal sustainability council to monitor the sustainability of member states' finances.

Allowance for public investment: Blanchard and Giavazzi (2003) argue that investment spending should be excluded from deficit calculations under the SGP. They argue that this would increase transparency, permit quality public investment, and prevent pro-cyclical tightening of fiscal policy in the short run.

A 'permanent balance' rule: Buiter and Grafe (2002 & 2004) favour a 'permanent balance' rule, whereby the net present value of total future government future revenues (adjusted for future growth and inflation) should be at least equal to the net present value of total future expenditure, including debt repayments. Although both sides of this equation would be hard to calculate accurately, the authors see the benefits of allowing for counter-cyclical policy and public investment outweighing any implementation costs.

More clarity of monetary reaction function: Allsopp (2002) argues that a key requirement for effective co-ordination is an *"appropriate and transparent monetary policy reaction function."* This would give national fiscal authorities a better understanding of how monetary policy would respond to economic fluctuations.

Tradeable deficit permits: Casella (2001) proposes the introduction of tradeable permits to run deficits. Countries that wanted to run higher deficits would have to buy such permits from others before they could do so.

A more pragmatic Pact: Buti *et al.* (2003) propose a collection of measures designed to deliver a more pragmatic interpretation of the Pact including: adjusting interpretation of the 'close-to-balance or in surplus' rule on a country-by-country basis to take better account of public debt and sustainability more generally; improving transparency by distinguishing between long-lasting and one-off measures; monitoring cash flows and reporting contingent liabilities; devising a sanction (perhaps wider use of early warnings) for member states not undertaking sufficient consolidation during economic upturns; and making implementation of the rules less partisan by strengthening the role of the Commission in assessing compliance with the rules and in the application of sanctions.

National fiscal rules set in an EU context

4.33 In strengthening the SGP, it is necessary to consider how detailed EU-level rules should be, and indeed whether legitimacy and accountability are enhanced by emphasising rules set at national level subject to ensuring that these are consistent with the SGP. However, there is a common interest in ensuring that the operating rules that are pursued at the national level are consistent with the broad, long-term objectives of the SGP.

Enhanced transparency and effective surveillance

Maximum transparency and accountability

4.34 The third key principle suggests that, in addition to clear long-term objectives and a commitment to sound institutional arrangements, credibility also depends on maximum transparency, openness and clear accountability.

Enhanced transparency at national level

4.35 Greater transparency about policy can make it easier for governments to respond to shocks through discretionary policy actions without damaging long-term credibility, if they clearly explain why they are undertaking such actions and how the expected outcome is consistent with long-term goals and policy frameworks. Greater transparency means it is easier to hold policy-makers to account for their performance. The public are able to examine the arguments and issues that lie behind policy decisions and are given a thorough explanation of those decisions. And so greater transparency helps build public and market confidence and can increase accountability.

4.36 Recognising the complexity of fiscal policy decisions and that they involve a significant element of judgement, there is a case at a national level for constraining Governments' discretion and enhancing the credibility of fiscal policy by introducing greater independent analysis of specific elements of fiscal policy, particularly the more technical aspects. In addition, there may be a greater role for independent audit, such as that undertaken in the UK, where the key assumptions underpinning the public finance projections are audited by the National Audit Office.

...combined with surveillance at EU level

4.37 Moreover, as part of a robust institutional framework, where the Council retains responsibility and accountability for enforcing fiscal discipline while exceptionally sanctioning fiscal stabilisation, there would also be a case at the EU level for strengthening the role of independent monitoring, surveillance and transparency. This could be achieved by strengthening the multilateral surveillance arm of the SGP (Annex A). Box 4.6 summarises the operation of multilateral surveillance under the SGP and Broad Economic and Policy Guidelines, and discusses the potential for further independent surveillance at the EU level.

Box 4.6: Independent surveillance in the EU

For the purpose of multilateral surveillance under the Treaty, the European Council discusses the broad guidelines of the economic policies of the member states. Multilateral surveillance is also provided under the Stability and Growth Pact, with member states submitting annual Stability and Convergence Programmes (SCPs) ignore to the Council and Commission. The content and format of SCPs is clarified in the ECOFIN Code of Conduct revised in June 2001.

Broad Economic Policy Guidelines

The Broad Economic Policy Guidelines (BEPGs) concentrate on the contribution that economic policies can make to achieve the EU's strategic Lisbon goal 'to become the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion'. The BEPGs make both general and country-specific recommendations focusing on key economic policy priorities such as:

- underlining the need for growth and stability-oriented macroeconomic policies;
- pursuing structural reforms to raise Europe's growth potential; and
- directing actions to strengthen economic, social and environmental sustainability.

Stability and Convergence Programmes

Stability and Convergence Programmes (SCPs), which are the responsibility of member states, are prepared annually as part of the multilateral surveillance process of the SGP. member states participating in the single currency prepare Stability Programmes, while non-participating member states prepare Convergence Programmes. The United Kingdom Convergence Programme is based on the Government's Pre-Budget Report. The content of Stability Programmes and Convergence Programmes is similar and includes, *inter alia:*

- the medium-term objective for the budgetary position of close-to-balance or in surplus and the adjustment path towards the objective for the general government surplus/deficit, and the expected path of the general government debt ratio;
- assumptions of expected economic developments, such as government investment, GDP growth, employment and inflation.

Strengthening independent surveillance

Peer review by other member states is an important mechanism for independent surveillance of national fiscal policy. However, the surveillance of broader, more complex questions, such as long-term fiscal sustainability or the appropriate stance for discretionary fiscal policy, would require a greater degree of judgement in the process of evaluation and, arguably, a deeper knowledge of the economy being monitored. While retaining the principle of peer review of fiscal policies by member states, one possibility would be to strengthen the independent surveillance process in the EU as part of wider reforms to the Stability and Growth Pact as set out in *Fiscal Stabilisation and EMU* (HM Treasury, 2003). For example, the EU could establish an intergovernmental fiscal surveillance committee to conduct analysis and surveillance of national fiscal policies.

5 CONCLUSION

Rationale for SGP

5.1 This paper has set out the rationale for a strong and effective SGP to ensure long-term sustainability, promote fiscal co-ordination and information sharing, and provide the flexibility to respond to shocks. It argues that collective fiscal discipline and co-ordination are essential for a successful monetary union.

Effective macro economic frameworks

5.2 Strong macroeconomic frameworks are needed to maintain high and stable levels of growth and employment. Effective macroeconomic frameworks are those which are characterised by: credibility, so that policymakers have public trust; flexibility, allowing a prompt and timely response to economic developments; and legitimacy, meaning there is widespread support for the framework. In establishing effective macroeconomic frameworks, policymakers have recognised the importance of three key principles: clear long-term goals; a pre-commitment to sound institutional arrangements; and maximum transparency.

5.3 The SGP represents an important step forward in recognising the importance of long-term budgetary discipline and making more information available on fiscal policies. However, in order to strengthen its credibility and effectiveness, there is a case for placing greater emphasis on debt levels and longer-term fiscal challenges, giving greater attention to cyclical factors and the quality of public spending, and addressing issues over its economic rationale, consistency and evidence base.

A prudent interpretation

5.4 The UK has consistently argued for a prudent interpretation of the SGP, grounded in a sound economic rationale, which takes account of the economic cycle and is applied symmetrically throughout the cycle; which distinguishes between high and low debt countries; and which allows for borrowing for public investment within prudent limits. A prudent interpretation would lock in long-term fiscal discipline and sustainability, enhance credibility across the economic cycle, while allowing the automatic stabilisers to operate fully and symmetrically to smooth fluctuations in output, and allow appropriate increases in investment in public services.

Principles for the evolution of the Pact

5.5 In considering the development of the Pact, the issue is not fundamental overhaul or Treaty change, but evolution. There will need to be extensive discussion before specific proposals can be developed. The paper therefore sets out principles to shape future discussion and assess future proposals for reform.

5.6 This discussion paper highlights the importance, in particular, of three key principles: the need for clear long-term objectives based on the elements of a prudent interpretation; the importance of a pre-commitment to sound institutional arrangements and clear procedural rules, recognising the importance of national fiscal rules that are consistent with the Pact; and the case for independent surveillance and transparency. Using these principles to guide and evaluate future reforms should help in providing the credibility, flexibility and legitimacy necessary for an effective macroeconomic framework.

A Annex A: Operation of the Stability and Growth Pact

The Treaty

A.1 The EU fiscal framework, which applies to all EU members, has two arms: multilateral surveillance and the excessive deficit procedure (Figure A1). These arms are set out in Articles 99 (ex Article 103) and 104 (ex Article 104c) respectively of the EC Treaty as amended at Maastricht in February 1992 (and entered into force in 1993).

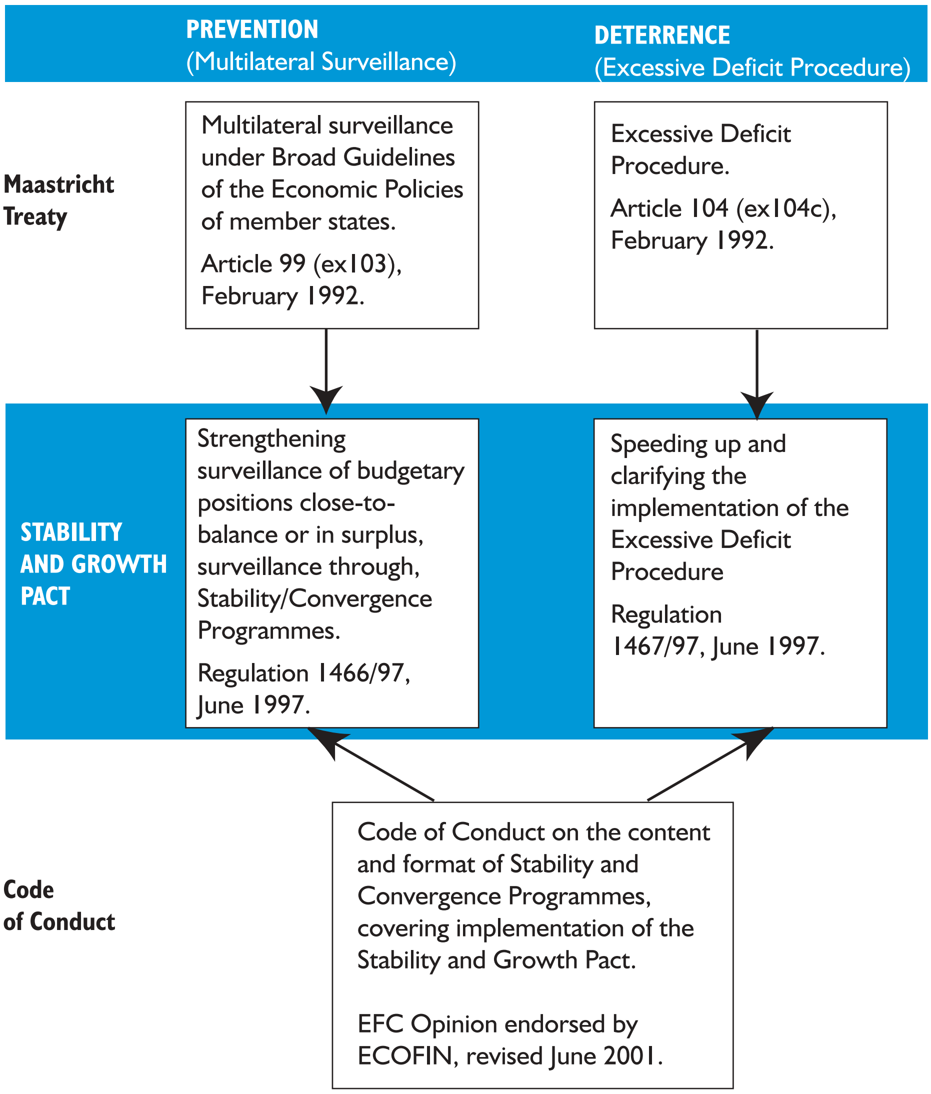
Stability and Growth Pact

A.2 The Stability and Growth Pact was adopted as a European Council Resolution at Amsterdam in June 1997, with two Council Regulations of July 1997: on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic polices; and on speeding up and clarifying the implementation of the excessive deficit procedure. The Stability and Growth Pact is often used as shorthand for the overall EU framework (a practice that is used in this paper unless otherwise specified).

Code of Conduct

A.3 The Code of Conduct, agreed as an EFC Opinion endorsed by ECOFIN in October 1998, and revised in June 2001 clarified the content and format of Stability and Convergence Programmes as part of the surveillance process.

Figure A.1: The Stability and Growth Pact: prevention and deterrence



Surveillance arm of SGP

A.4 The first arm of the Stability and Growth Pact was designed to give early warning if risks existed of a member state having an excessive deficit[1]. Member states submit annual Stability and Convergence Programmes as part of this surveillance, which should take account of relevant economic factors such as the position of a country's economic cycle, the sustainability of the public finances, and the quality of public finances (Box 4.6 discusses the scope of multilateral surveillance under the Stability and Growth Pact and Broad Economic Policy Guidelines). Surveillance of the programmes includes[2]:

- a medium-term objective of "close-to-balance or in surplus". The 2001 Code of Conduct states that close-to-balance should be measured in cyclically-adjusted terms; and
- whether the economic policies of member states are consistent with the budgetary recommendations of the Broad Economic Policy Guidelines.

Excessive Deficit Procedure arm of SGP

A.5 The second arm of the Stability and Growth Pact was designed to ensure that countries take effective action if an excessive deficit is incurred[3]. An Excessive Deficit Procedure (EDP) may be initiated under one of two criteria:

- the government deficit exceeds 3 per cent of GDP (deficit being defined as general government net borrowing); or
- government gross debt exceeds 60 per cent of GDP, unless the level of debt is "sufficiently diminishing and approaching the reference value at a satisfactory pace" (Treaty Article 104.2).

A.6 A government deficit is not excessive if the excess over 3 per cent is only exceptional and temporary and the deficit remains close to the reference value. Furthermore, any assessment of whether or not an excessive deficit exists must "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State" (Treaty Article 104.3). Under Stage II of EMU, which began on 1 January 1994, member states were not subject to sanctions or fines under the Excessive Deficit Procedure, and were committed only to endeavour to avoid excessive deficits[4]. Under Stage III of EMU, since the launch of the single currency on 1 January 1999, member states other than the UK are obliged to avoid excessive deficits and, in the last resort, euro area countries are subject to sanctions and fines (see Box A.1 for an overview of the excessive deficit procedure for France and Germany). The UK is obliged only to endeavour to avoid excessive deficits and is exempt from sanctions and fines. Sweden and Denmark should avoid excessive deficits, though along with the UK, are exempt from sanctions and fines.

Code of Conduct

A.7 The Code of Conduct on the content and format of Stability and Convergence Programmes (SCPs) was agreed as an EFC Opinion and endorsed by ECOFIN in October 1998, and revised in June 2001 (see Figure A.1). The Code of Conduct, which strengthens and clarifies the implementation of the Stability and Growth Pact, includes the strengthened objectives:

- the medium term should be interpreted over the length of the economic cycle;

[1] Council Regulation 1466/97 On the strengthening of surveillance of budgetary positions and the surveillance and co-ordination of economic policies, 7 July 1997. The Regulation has Article 99 (ex 103) of the Treaty as its legal base.
[2] See Cabral, 1002.
[3] Council Regulation 1467/97 "On Speeding up and clarifying the implementation of the excessive deficit procedure", 7 July 1997. The Regulation has Article 104 (ex 104c) of the Treaty as its legal base.
[4] Article 116 (ex Article 109e) of the EC Treaty, February 1992.

- the medium term objective of close-to-balance or in surplus should, while respecting the government deficit reference value, ensure a rapid decline in high debt ratios;
- SCPs should take account of the costs associated with ageing populations;
- measures aimed at improving the quality of public finances should be considered; and
- objectives of SCPs should be consistent with the budgetary recommendations of the Broad Economic Policy Guidelines.

Box A.1: The Excessive Deficit Procedure for France and Germany

On 13 January 2004, the European Commission announced its decision to challenge in the European Court of Justice the legal status and validity of certain elements of the Council conclusions adopted by ECOFIN on 25 November 2003, relating to the Excessive Deficit Procedure for France and Germany.[a]

Since 2002, France and Germany's deficits (measured as general government net borrowing) have been above the 3 per cent of GDP Treaty reference value. This led to an Excessive Deficit Procedure under the SGP for both countries. On 25 November 2003, ECOFIN decided not to adopt the Commission's recommendations that France and Germany had not taken effective action to reduce their deficits, placing the EDPs for each country into abeyance. ECOFIN adopted Council conclusions setting out steps that France and Germany should take to reduce their deficits.

Whilst the Commission does not dispute the economic substance of these Council conclusions, it does not agree with the procedure ECOFIN used to adopt them. In its statement on 13 January 2004, the Commission outlined its arguments for contesting ECOFIN's decisions:

> ***"... in the present case, the Council has confirmed the Commission economic analysis. This is highlighted in its recommendations (points 1 and 4 of the Council conclusions). Consequently, it recognised that additional measures to address the excessive deficit of the Member States concerned were necessary. In those circumstances the Council, although it could amend the substance of the Commission's recommendations, has no margin as to the choice of the legal instruments and should have adopted a recommendation as provided for by the Treaty."***
>
> ***"Furthermore, the Council decision to hold the excessive deficit procedure in abeyance was taken in violation of Article 9 of Regulation (EC) No 1467/97, which lays down that the excessive deficit procedure shall be held in abeyance only if the Member State concerned takes the measures recommended to correct the excessive deficit in accordance with Article 104 (7). Indeed, the Council could not, in the Commission's opinion, adopt in the form of Council conclusions elements that it should have adopted on the basis of clearly established Treaty procedures."***

Market reactions to the decisions at 25 November ECOFIN were in general low key. The majority of commentators were keen not to overstate the likely impact of the decisions on interest rates, government debt markets and on the economy in general. For example, Goldman Sachs argued that the decisions were expected, and that they would not have any real impact on demand or interest rates. They argued that the decisions did not constitute a licence for higher debt in the euro area. HSBC also argued that the decisions had been predictable and that their impact on fiscal policy should not be exaggerated. Merrill Lynch found that the risk of major fiscal excess in France and Germany was small, and that the decisions would not materially change the outlook for euro-area interest rates in 2004.

[a] The Commission's statement is available at
http://www.europa.eu.int/rapid/cgi/guesten.ksh?p_action.gettxt=gt&doc=IP/04/35|0|RAPID&lg=EN&display=

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