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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact

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1. PROGRESSING TOWARDS BETTER ECONOMIC GOVERNANCE AND SOUND PUBLIC FINANCES

On 18 June 2004, the European Council adopted a Declaration on the Stability and Growth Pact (SGP) which stressed that raising growth potential and securing sound budgetary positions are the two pillars of the economic and fiscal policy of the Union and the Member States. The present Commission Communication follows up to the European Council assertion that Member States look forward to the proposals of the Commission with regard to strengthening and clarifying the implementation of the SGP. Building on the ideas contained in the previous Communication of 24 June 2004 on "Public Finances in EMU – 2004", it provides Member States with an orientation for proposals on the future set-up and functioning of the EU fiscal framework.

The surveillance of fiscal discipline that has proven its effectiveness needs to be maintained and rigorous implementation be ensured. In this regard, the Treaty provisions including the reference values for government deficit and debt of 3 and 60 percent of GDP continue to provide the necessary strong backbone of the fiscal framework and remain the anchor of the system. Excessive deficits should be avoided, and when they occur be corrected promptly, to contribute to safeguarding price stability and to ensure sustainability of public finances. The fiscal framework is a set of common rules, to be applied equally to all Member States. However, in a European Union of 25 countries, characterised by considerable heterogeneity and diversity and given the experience of 5 years in EMU, an enriched common framework with a stronger emphasis on the economic rationale of its rules would allow to better cater for differences in economic situations across the EU. The objective is therefore to enhance the economic underpinnings of the existing framework and thus strengthen credibility and enforcement. The aim is not to increase the rigidity or flexibility of current rules but rather to make them more effective.

On this basis, this Communication examines firstly <u>how the fiscal framework - and in particular the Stability and Growth Pact - could respond to the shortcomings experienced so far through greater emphasis to economic developments in recommendations and an increased focus on safeguarding the sustainability of public finances</u>.

Secondly, this Communication addresses <u>how the instruments for EU economic governance could be better interlinked in order to enhance the contribution of fiscal policy to economic growth and support progress towards realising the Lisbon strategy</u>. Thirdly, the Communication suggests <u>possible improvements to the enforcement of the framework.</u>

In developing this approach, the Commission takes into account the implications of the ruling of the European Court of Justice of 13 July[1] that clarified the respective roles of the Commission and the Council in the application of the EU fiscal framework. The ruling also confirmed that a rules-based system is the best guarantee for commitments to be enforced and for all Member States to be treated equally.

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[1] Ruling of the European Court of Justice on the affaire C-27/04 by the Commission of the European Communities against the Council of the European Union.

2. REFOCUSING THE STABILITY AND GROWTH PACT

Five years of experience with the Stability and Growth Pact have highlighted its core role in the budgetary co-ordination process. The SGP has helped delivering macro-economic stability, which is also illustrated by the budgetary trends in the recent downturn which compare favourably to the past when economic downturns were typically accompanied by a more pronounced deterioration in underlying budgetary positions. However, over the past years tensions have accumulated in the application of the SGP, leading to a loss of credibility and ownership and institutional uncertainty. In addition, experience with the application of the framework has highlighted further possibilities to improve it.

In its June 2004 Communication, the Commission considered several elements for strengthening the SGP: (i) placing more focus on debt and sustainability in the surveillance of budgetary positions; (ii) allowing for more country-specific circumstances in defining the medium-term objectives of "close to balance or in surplus"; (iii) considering economic circumstances and developments in the implementation of the Excessive Deficit Procedure; (iv) ensuring earlier actions to correct inadequate budgetary developments.

In strengthening and clarifying the framework it would be essential to secure a proper balance between the potentially higher degree of discretion in the surveillance and co-ordination of fiscal policies and the need for keeping the rules-based framework simple and transparent. The latter has to be applied across countries in a fair and consistent way and be understood by EU public opinion. In this context, the two nominal anchors - the 3% reference value for the deficit to GDP ratio and the 60% for the debt to GDP ratio – have proven their value and continue to be the centrepiece of multilateral surveillance.

A strengthened Stability and Growth Pact could define principles and general criteria for budgetary surveillance which would provide the basis of the budgetary co-ordination framework. In addition, other more specific economic-analytical tools to assess the conduct of budgetary surveillance could be spelled out in a Code of Conduct accompanying the revised SGP in order to allow consistency in its application. The main elements of the revised approach can be described as follows.

(i) **Placing more focus on government debt and sustainability in the surveillance of budgetary positions.** Increased focus on sustainability entails enhanced surveillance of both current debt developments as well as of factors that may influence its medium and long-run dynamics. It needs to be stressed however, that the increased focus on debt developments would complement continued rigorous attention to deficit developments.

The increased focus on public debt and sustainability of public finances feeds through into three suggestions for revisiting the SGP: to identify country-specific medium-term budgetary objectives (see indent ii below), to render the debt criterion of the Treaty operational and to define the adjustment path in the excessive deficit procedure inter alia according to the degree of sustainability risks (see indent iii below).

As regards the debt criterion, the Stability and Growth Pact could clarify the basis on which the Treaty provision of a 'satisfactory pace' of debt reduction should be assessed. In defining a required rate of debt reduction the need to ensure prudent debt ratios before the impact of ageing takes place fully and to consider country specific initial debt levels and potential growth conditions should be taken into account. The latter should possibly be complemented by an assessment of additional factors related to ageing and contingent liabilities.

An important element would be the definition of the "satisfactory pace of debt reduction", which ensures to reach prudent debt ratios within a reasonable length of time. The yearly assessment of debt development can be conducted against this reference rate of reduction but taking into account country-specific current growth conditions. In practice, if growth is below its potential a slower pace of debt reduction would be consistent with the demands of the framework, while the opposite would hold if growth is above its potential.

Beyond the application of the excessive deficit procedure, increased knowledge is required of factors that affect the long-term sustainability of public finances, such as pension and contingent liabilities and assets. Further deepening the comprehension of these developments will help to integrate them better into the fiscal framework. A clearer understanding of discrepancies between debt and deficit figures would also allow a better qualification of the budgetary trends.

(ii) **Allowing for more country-specific circumstances in defining the medium-term deficit objective of "close to balance or in surplus".** The medium-term objectives complementing the Treaty provisions have two main goals. Firstly, they are intended to provide for sufficient room for manoeuvre of the budget deficit to avoid breaching the 3% reference value during an economic slowdown without recourse to pro-cyclical fiscal policy. Secondly, adherence to the medium-term target allows a reduction of the government debt-to-GDP ratio, also preparing for the budgetary impact of ageing populations. The operational specification of the medium-term budgetary objective of "close to balance or in surplus" has been left open by the SGP and in practice a balanced budget position in cyclically-adjusted terms every year throughout the cycle is currently required for most Member States. Given the increasing economic diversification in an EU of 25 Member States, uniform objectives for all countries do not appear appropriate and lack economic rationale.

In addition to the aim of avoiding exceeding the deficit reference value, the medium-term budgetary objective could be based on current debt levels, taking into account their development over the medium and long term. In practice, the medium-term objective would be more stringent (close to zero or in surplus) the higher the debt level. The identified budgetary positions should avoid breaching the 3% reference value under normal circumstances. However, for those countries that would be in a position to run a small deficit, the risk of breaching the 3% during economic slowdowns would increase.

When assessing the deviation from the medium-term objective or the path to achieve it, other factors such as potential economic growth, inflation, the existing implicit liabilities related to ageing populations, the impact of structural reforms or the need for additional net investment could be considered.

Finally, it should be stressed that there is a clear trade-off between the economic appropriateness of the definition and its complexity. In defining the guidelines to set up medium-term objectives and to assess the deviation from them, this trade-off has to be carefully considered.

(iii) **Considering economic circumstances and developments in the implementation of the Excessive Deficit Procedure.** This could be done mainly in two aspects of the procedure:

- Catering for prolonged periods of sluggish growth through the "exceptional circumstances clause". The case of slow but still positive economic growth is not fully taken into account in the current EU fiscal framework. Improvements in this sense can be achieved through a rethinking of the adjustment path once a country breaches the 3% reference value for the deficit (see below) and/or redefining the so-called "exceptional circumstances clause". Under the current framework, a protracted period of sluggish growth leading to a substantial loss of cumulated output, while leading to deficits above 3% of GDP, would not trigger the clause on exceptional circumstances which would avoid the Member State being placed in a position of excessive deficits.

The Treaty foresees some exceptions to the general principle that countries recording deficits or debts above the reference values should be considered in excessive deficit. There is a cumulative condition (exceptional and temporary and close to reference value) that may justify such an exception. The Regulation 1467/97 specifies these exceptions as concerns the application of the deficit, by setting in a quite restrictive way the conditions for applying the so called clause for 'exceptional circumstances'. In particular, the Regulation restricts the invocation of this clause only to cases of negative growth, and unless this is substantial (-2%), it requires that countries should present supporting evidence. In order to cater for periods where growth is still positive, but for protracted time very low, and when such developments are unexpected, possible improvements could include the redefinition of the severe economic downturn and a clarification of the "the abruptness of the downturn" and "the loss of output relative to past trends". The other two conditions (temporary and close to reference value) would continue to apply.

Any changes to the definition of this clause should be examined in conjunction with changes to the adjustment path, which also would cater for protracted slowdowns. The main difference of taking protracted slowdowns into account through the widening the definition of the exceptional circumstances clause rather than through the adjustment path is that by expanding the exceptional circumstances, the country breaching the 3% reference value would not be put into Excessive Deficit Procedure and thus would not be subject to the increased surveillance this implies, which could involve the risk of loosing the momentum of necessary surveillance in the right moment.

- Allowing for country-specific elements in the enforcement of the correction of excessive deficits (the adjustment path). Under the current rules, a Member State which breaches the 3% deficit to GDP ratio has to correct it "in the year following its identification unless there are special circumstances" (CR 1467/97, Art.3 §4). The Regulation fixes other deadlines and notably for effective action to be taken (four months from the start of the procedure) and for sanctions if a Member State fails to comply with Council decisions (ten months from the start of the procedure).

One-size-fits-all deadlines for the correction of excessive deficits have basic limitations because they do not permit distinguishing between countries with different cyclical developments and with different debt levels. This can lead to erroneous policy advice for instance asking for too stringent pro-cyclical adjustments or creating incentives for the recourse to one-off operations in order to stick with deadlines.

In determining an appropriate adjustment path, the SGP should better take into account the economic conditions and fundamentals of a Member State breaching the 3% reference value. This implies that the Excessive Deficit Procedure would still be launched once a country breaches the reference value and a rapid correction would continue to be expected. However, the pace of adjustment could differ across countries with the appropriate adjustment path being defined on the basis of economic conditions and debt levels. The reasons behind the excessive deficits and the appropriateness of policies should be taken into account in assessing the situation. In practice, different approaches can be explored within the Treaty framework. A first possibility is to continue considering the "year after identification" as the basic rule for correction, while allowing countries a longer adjustment path by defining the "special circumstances clause" of the SGP. A second approach would be that country-specific deadlines become the basic rule. In all cases, it would be important to set a maximum time limit for the correction of the excessive deficit and there should be no waver for bad policies.

In addition, the deadlines for exercising surveillance should be reconsidered, in order to make them more consistent with the national budgetary process Furthermore, the assessment of the Stability and Convergence Programmes should become a key moment for the evaluation of budgetary developments and policy measures. While maintaining the principle that countries under EDP are under enhanced surveillance, more emphasis in the yearly assessments of the programmes on the adjustment path seems warranted and can contribute to simplify the current procedures.

The increased focus on debt should also strengthen incentives to run prudent policies in good times, accelerating debt reduction. Considering the debt in defining an appropriate adjustment path for the correction of excessive deficits rewards countries that have reduced debt towards prudent values, by providing more room of manoeuvre in bad times.

(iv) **Ensuring earlier actions to correct inadequate budgetary developments.** Experience in the run-up to the recent protracted economic slowdown has highlighted the need to conduct prudent and symmetric-over-the-cycle policies and achieve surpluses in good times. Budgetary surveillance should ensure the appropriate peer pressure to favour the achievement of the medium-term objectives. To this end, the SGP should reaffirm the commitment to run symmetric fiscal policy over the cycle in order to prepare for the ageing of the population, create sufficient room for dealing with economic slowdowns and ensure an adequate policy mix over the cycle. A renewed and shared commitment on these objectives should increase Member States ownership of the SGP.

An efficient working of the peer review mechanism in the preventive part of the fiscal surveillance is essential in delivering the appropriate policies and budgetary outcomes and thus avoiding the need to activate the sanction parts of the SGP.

The capacity of the Commission to issue "early warnings" directly (see point 4 below) should contribute to signal early enough, the need to take action to correct inadequate budgetary developments, including in good times and when deficits are not necessarily close to 3%.

Also, the BEPGs could more effectively be used to address the issue of good policy in good times. If necessary recommendations concerning the implementation of the BEPGs could be issued if the conduct of budgetary policies appears inconsistent with them.

In case a Member State's policy implies risks as to the respect of the Treaty reference values, or for the sustainability of public finances, early warnings should be used timely.

3. COORDINATING BUDGETARY POLICIES

Placing the EU surveillance of fiscal policy into a broader perspective implies that the disciplinary side must be considered at EU level together with other elements: economic and budgetary policies need to set the right priorities towards economic reforms, innovation, competitiveness and strengthening of private investment and consumption. This would contribute to progress towards achieving the economic objectives set in the Lisbon strategy.

Reinforcing the link between the Broad Economic Policy Guidelines (BEPGs), the SGP and the national budgetary processes would improve the effectiveness of coordination of economic policies. Specifically, a simplified and more efficient contribution of the European surveillance to the conduct of national policies could be created by revisiting the timetable of the preventive part of the SGP - related to the submission and assessment of the stability and convergence programmes – and bringing it more in line with the national budgetary process.

The role of the Stability and Convergence programmes could be reinforced. First, they can spell out the medium-term budgetary strategy at the beginning of an electoral mandate for new governments. The updates of this Programme could then become a real ex-ante exercise, earlier in the year. That would allow the BEPGs and the Opinions on the programmes to be taken into account in the preparation of national budgets by governments. The assessment of the implementation of the BEPGs early in the following year would conclude the annual cycle and set the stage for the next cycle.

There are several advantages coming from such a revision of the economic policy calendar. Firstly, reorienting the Stability and Convergence Programmes towards strategic planning and away from the description of the annual budget bill would increase the focus of the exercise on the medium term. Secondly, a proper EU semester for economic policy, by increasing the interaction between European and national levels before a draft budget for the following year is prepared is likely to increase the Member States' ownership of EU policy coordination, making it easier to factor common orientations into domestic policymaking. Thirdly, this shift could provide the possibility to involve national parliaments better and at an early stage of the multi-year budgetary planning: this is likely to increase the legitimacy of the EU fiscal framework. Finally, it could allow for strengthening the assessment of implementation - of both the BEPGs and the programmes - by linking the analysis made at the end of the year about the main elements of the budget just approved with the recommendations contained in the BEPGs concerning both the quality of public finances and the budgetary aspects of other recommendations.

4. IMPROVING ENFORCEMENT

A revised design of the rules and EU processes would reinforce the economic rationale of the framework, fostering its credibility and an increased ownership by Member States. Addressing additional questions about the functioning of the preventive, dissuasive and corrective aspects of economic and budgetary surveillance and its relation to the institutional framework would also contribute to enhanced enforcement of the common rules. Enforcement of the EU framework and of related guidelines and recommendations could be improved both at national and Community level, through a clarification of the respective roles of the various institutions, an increased effectiveness of national budgetary procedures, and the involvement of all national actors. Nevertheless, enforcement in the context of the Treaty remains in the hands of Member States and their political commitment to exert fully the adequate peer pressure.

The Commission promotes the Union's objectives and monitors the respect of the Treaty and Member States' compliance with the Council recommendations, and proposes or recommends to the Council appropriate actions. Within the discretion limits set by the legal framework the Council, using the political appreciation, has then the final decision in the definition of common policy guidelines or of how much and how far Council recommendations should go in order to induce the correction of gross errors. These principles have been reaffirmed by the Court ruling on 13 July 2004.The provisions introduced in the new Constitution, such as the <u>"early warning" directly</u> issued by the Commission and the Council decisions launching the excessive deficit procedure based on Commission proposals rather than recommendations, both strengthen the economic governance system and clarify the complementary roles of the Council and the Commission.

The implementation of the fiscal framework and its credibility also relies on the <u>quality, timeliness and reliability of fiscal statistics</u> and the assessment of government budgetary positions. An improved monitoring at the EU level of the reported data will contribute to this end: following the Ecofin Council Conclusions of 2 June 2004 the Commission will prepare minimum European standards for the institutional set-up of statistical authorities. The consistency between the status and prerogatives of national statistical authorities and their task of ensuring the reliability and timeliness of statistics needs to be ensured. Full transparency will allow the financial markets to better assess the creditworthiness of the different Member States.

The dissuasive elements of budgetary coordination which centre on the use of peer pressure as a sanction mechanism, supported by the ultimate threat of financial penalties, is a key part of the EU fiscal framework.

The <u>effectiveness of peer pressure</u> to discourage Member States from not complying with their legal obligations, in the form of naming, shaming, and, if necessary, blaming, could be enhanced. Domestic public awareness of unsound economic policies would increase 'reputation costs', stimulating appropriate action, thereby reducing the deficit bias stemming, for example, from the electoral cycle. Feeding through of reputation costs to public opinion or financial markets is limited in the current framework as witnessed in recent experiences. Moreover, enhancing the functioning of dissuasion and peer pressure in the Council would significantly contribute to improving the working of the coordination of fiscal policies.

Measures should be envisaged in order to lead to <u>greater transparency and accountability</u> concerning Member State's budgetary policies. At European level this could be pursued, as a first step, by increased transparency in the surveillance activity. The Commission has already taken this avenue, since last year, by collecting and releasing most information related to the assessments of the stability and convergence programmes, but also to the implementation of the Excessive Deficit Procedure. The Commission can take further steps to increase the quantity and quality of information which it distributes and increase peer pressure on Member States. As an example, the Commission may present its assessment of the budgetary situation regularly to the European Parliament, in order to foster the debate. In this way, the European Parliament could contribute to the public awareness.

There is a case for better translating the European commitments into the national level. The Treaty duly recognises the importance of national budgetary institutions and procedures in delivering sound budgetary policies when it calls on Member States to 'ensure that national procedures in the budgetary area enable them to meet their obligations'[2]. Budgetary institutions should appropriately reflect country-specific constitutional and institutional set up.

In this context, the role played in some Member States by national counterparts for the monitoring function fulfilled by the Commission at EU level appears relevant. Following existing successful examples of national bodies as independent institutes which conduct surveillance of national budgetary and economic policies, and publicly provide views on their implementation, Member States should consider how such institutions could fit into the national institutional set up. In addition, a closer involvement of national parliaments in the coordination process could help to bolster accountability at the Member State level and thus increase the effectiveness of peer pressure.

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In the coming months, the Commission will - in consultation with the Member States - continue the work to elaborate these ideas and render them operational. The Commission will then present legislative proposals to implement the ideas on strengthening economic governance which will contribute to the maintenance of sound public finances and fostering the EUs economic growth potential.

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2 Article 3, TEC Protocol 20. The Excessive Deficit Procedure.