BUDGETARY POLICY

THE RULES IN EMU

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Screening with Croatia and Turke

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OVERVIEW OF THE PRESENTATION

1. The rationale for “sound” public finances

2. The rules (the Maastricht Treaty and the Stability and Growth Pact)

3. Fiscal consolidation in 1990s and current fiscal positions: how the rules worked

4. The reformed SGP

5. Statistics for SGP/EDP

THE RATIONALE FOR SOUND PUBLIC FINANCES:learning from experience

Permanently high deficits → Instability

→ Reduced growth prospects

↓

Debt increasing both in bad and good times → High interest rates

↓

Automatic stabilizers not able to work in bad times

(Public finances are automatically affected by the economic cycle and can smooth it)

THE RATIONALE FOR SOUND PUBLIC FINANCES: Why is it important to achieve and maintain "sound" public finances?

1. PRICE STABILITY → Support ECB monetary policy
Lower interest rates
- Low interest payments
Longer time-horizon: more private investment

2. SMOOTHING THE CYCLE → Enough room to let automatic stabilizers play freely

3. STRUCTURAL REFORM and SUSTAINABILITY → Room to implement reform that have a short term cost for public finances and to cope with the impact of ageing

The EU Fiscal framework

- Treaty Articles 99 and 104 (+Protocol on EDP)
- European Council Resolution on the Stability and Growth Pact
- Preventive arm: Council Regulation 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies
- Council Regulation 1055/2005 amending Regulation (EC) No 1466/97
- Corrective arm: Council regulation 1467/97 on speeding up and clarifying the implementation of the EDP
- Council Regulation 1056/2005 amending Regulation (EC) No 1467/97

THE RULES: Maastricht Treaty on budget deficit and debt

- "Member States shall avoid excessive government deficits" (Article 104).
  - **deficit** below the reference value of **3% of GDP**, unless it has declined substantially and continuously and reached a level closed to the reference value or the excess is limited, exceptional and temporary.
  - **debt** should not exceed the reference value of **60% of GDP**, or should be on a decreasing trend and approach the reference value at a satisfactory pace.

For many Member States, it acts as an external constraint to change fiscal behaviour

THE RULES: The Stability and Growth Pact (1)

Prevention

- the medium-term budgetary position must be of "close to balance or in surplus"
- "stability programmes" and "convergence programmes".
- "significant divergences" of budgetary positions from the medium term budgetary objectives ⇒ "early warning" recommendation

THE RULES: The Stability and Growth Pact (2)

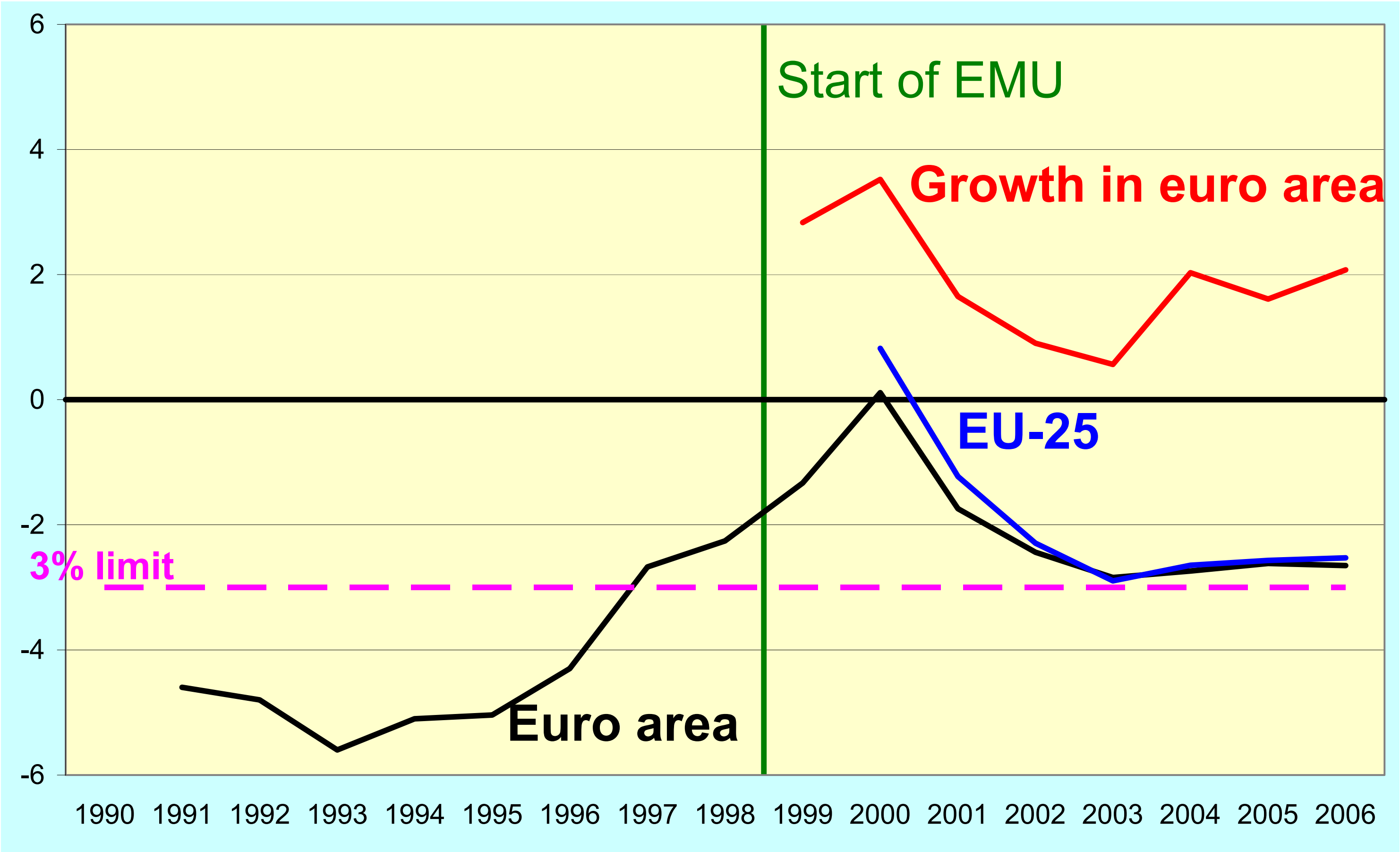
Dissuasion

– sets up a tight timetable for the *Excessive Deficit Procedure* so as to arrive at a speedy decision on the existence of an excessive deficit.

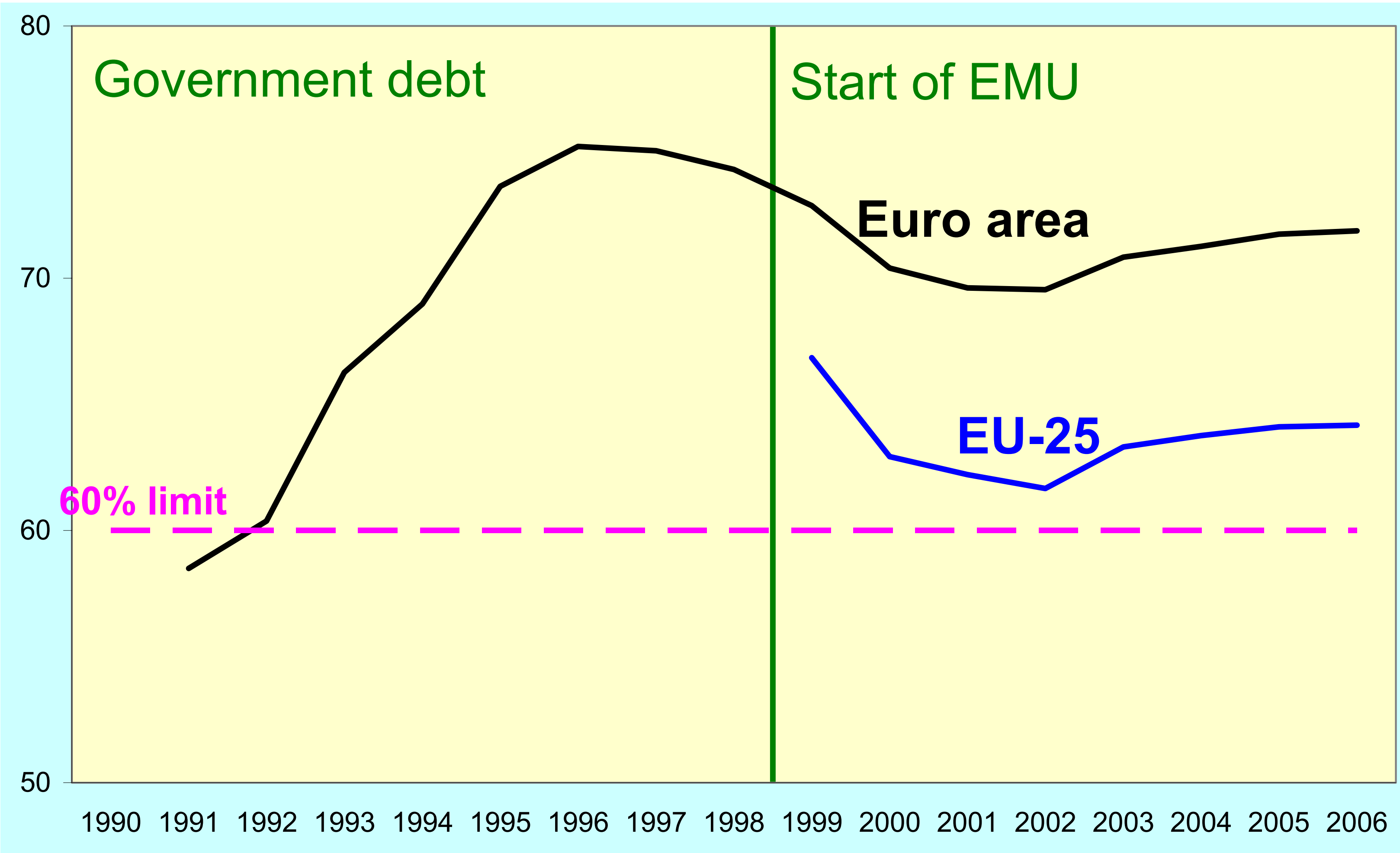
– spells out the type and scale of sanctions in the event of persistent excessive deficit of euro-area members

The Commission is the "guardian" of the Pact

Budget deficit in the EU and euro area



Government debt in the EU and euro area



The 2005 SGP reform

Diagnosis

2005 SGP reform was motivated by four circumstances:

– Deteriorating budgetary performance

– Increasing difficulties in the application of the rules

– More diverse economic conditions

– Repeated criticism on some aspects of the rules (too rigid, asymmetric)

The 2005 SGP reform

Diagnosis

Areas where improvements were deemed necessary:

– Enhance the economic rational of the rules

– Improve ownership by national policy makers

– Create incentives to use more effectively periods of 'good times' for budgetary consolidation

– Take better account of periods when economies are growing below trend

– Give more attention in budgetary surveillance to debt and sustainability

The 2005 SGP reform: Council agreement

Preventive arm: MTO

Original SGP:

All MS have a MTO CTBOIS

Council agreement:

- MTO differentiated to take into account larger diversity of economic and budgetary positions (on the basis of debt and potential growth, implicit liabilities at a later stage)
- MTO have a triple aim: (i) safety-margin against the 3%, (ii)rapid progress towards sustainability, (iii) budgetary room for manœuvre if the above conditions are secured
- Adjustment: 0.5% annual, higher in good times

The 2005 SGP reform: Council agreement

Preventive arm: early policy advice

Original SGP:

– Early warnings are adopted/addressed by the Council, upon recommendation of the Commission

Council agreement:

– Commission will issue direct early policy advices ('early warnings' in the new Constitution) to 'encourage' MS to stick to their adjustment path

– Council early warnings remain

The 2005 SGP reform: Council agreement

Preventive arm: structural reforms

Original:

Nothing about reforms in the SGP

Council agreement:

- Will be taken into account when defining adjustment path to MTO, may allow a deviation from MTO
- Reforms with indirect impact (special attention to systemic pension reforms)
- 4 conditions: (i) only major reforms (verifiable impact on sustainability), (ii) safety margin to be guaranteed, (iii) deficit returns to MTO within the programme period, (iv) detailed information to be provided in the SCP

The 2005 SGP reform: Council agreement

Corrective arm: report 104.3

Original SGP:

– The Commission does not necessarily prepare a report if deficit exceeds 3%

Council agreement:

– Commission will always prepare a report if deficit above 3%

– The report will (i) examine if exceptions 104.2 apply , (ii) take into account whether investment exceed governement expenditure and 'all other relevant factors'

The 2005 SGP reform: Council agreement

Corrective arm: severe economic downturn

Original SGP:

– 'Severe economic downturn' if there is an annual fall of real GDP of at least 2% or of at least 0.75% + accumulated loss of output arguable by MS

Council agreement:

– 'economic downturn' may be considered severe in case of negative growth rate or accumulated loss of output during a protracted period of very low growth relative to potential growth

– 'Closeness' and 'temporariness' still constraining

The 2005 SGP reform: Council agreement

Corrective arm: other relevant factors

Original SGP:

– No clear definition of ORF and of their role in EDP

Council agreement:

– Developments in the medium-term economic position (potential growth, cyclical conditions, implementation of policies)

– Developments in the medium-term budgetary position (public investment, quality of public finances, fiscal consolidation in 'good times', debt sustainability

– Any other factors that MS consider relevant to assess the excess over the 3%

– Only if the excess over the reference value is'close and temporary ', in all steps of EDP except abrogation and repeating steps

The 2005 SGP reform: Council agreement

Corrective arm: increasing the focus on debt and sustainability

Original SGP:

– Nothing in the Regulation on the application of debt criterion (it will remain the case)

Council agreement:

– Debt criterion, and the concept of a debt ratio ‘sufficiently diminishing and approaching the reference value at a satisfactory pace’ will be applied in qualitative terms

– Council will formulate recommendations on the debt dynamics in its opnions on the stability and convergence programmes.

The 2005 SGP reform: Council agreement

Corrective arm: extending deadlines for taking effective action

Council agreement:

– **Objectives:** (i) better frame the action within the national budgetary procedure, (ii) develop a more articulated package of measures, (iii) take updated Commission forecasts

– **Extended deadlines:**

– For a decision under 104.6 from 3 to 4 months after notification

– For taking effective action following 104.7 from 4 to 6 months

– For moving to 104.9 from 1 to 2 months

– For taking action after a notice under 104.9 from 2 to 4 months

The 2005 SGP reform: Council agreement

Corrective arm: initial deadline for correcting the excessive deficit

Original SGP:

– ED has to be corrected in the year after its identification unless ‘special circumstances’

Council agreement:

– The rule remains but ORF will be taken into account

– Annual fiscal effort for countries in EDP of at least 0.5% of GDP in structural terms

The 2005 SGP reform: Council agreement

Corrective arm: repetition of steps in EDP

Original SGP:

– Not possible to repeate steps in the EDP

Council agreement:

– Deadlines for correcting the ED could be extended if (i) unexpected adverse economic events with major unfavourable budgetary effects occur during the procedure, (ii) effective action has been taken by the MS concerned in compliance with the initial recommendation

– The growth forecast contained in the recommendation would be the reference against which unforseeable growth developments would be assessed

The 2005 SGP reform: Council agreement

Governance

Original SGP+renewed commitments to:

– Implement the Treaty and the Pact in an effective and timely manner

– Motivate and make public their positions and decisions in the application of the Pact

Additional statements:

– Usefulness of national budgetary rules and institutions

– Need to base budgetary projections on realistic macroeconomic forecasts

– SCP for the legislature

– National Parliaments increased role (discuss SCP and Council opinions, follow up recommendations to EW and EDP

Statistics for SGP/EDP

Legal basis

Protocol on the excessive deficit procedure

Regulation 3605/93, as amended by Regs. 475/2000, 351/2002 and 2103/2005

Regulation 2223/96 (ESA95), as amended several times.

Statistics for SGP/EDP

Protocol (Main elements)

- Harmonised accounting rules
  - ESA95: European System of Accounts
- Data are compiled by Member States
  - Subsidiarity and efficiency
- Data are officially provided by the Commission
  - Transparency and equity

Statistics for SGP/EDP

Reg 3605/93 (reporting and provision of data)

- Definitions of deficit and debt (by reference to ESA95)
- Reporting deadlines (by 1 April and 1 October)
- Format of data transmitted
- Quality of data (Eurostat responsibility; Reg 2103/2005)
    - Dialogue with Member States
    - Checking the quality of data (questionnaires & on-the-spot visits)
    - Authority to interpret accounting rules
    - Official provision of data, including the power to amend data reported by Member States

Statistics for SGP/EDP

Lessons from experience

- Experience has shown:
  - Compilation of statistics is not a trivial exercise
  - Member States need time to acquire the required expertise and to align themselves with ESA95
  - High-quality data are indispensable (low-quality data are bad for credibility and reputation)
  - Data of bad quality are publicly identified and/or amended by Eurostat
  - Indispensable link between deficit and debt data and other macroeconomic statistics (ESA95)

The 2005 SGP reform: Council agreement

DG ECFIN website on the Stability and Growth Pact and fiscal surveillance:

http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm