CENTRE FOR
EUROPEAN
POLICY
STUDIES

CEPS WORKING DOCUMENT NO. 202
JUNE 2004

ECONOMIC POLICY COORDINATION IN EMU:
WHAT ROLE FOR THE SGP?

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This paper was prepared for the Seminar on The Stability and Growth Pact, organised by the European Institute of Public Administration (EIPA) in Maastricht (NL), 29-30 March 2004

ISBN 92-9079-497-6
Available for free downloading from the CEPS website (http://www.ceps.be)

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Abstract

The present paper discusses the implications of the recent institutional crisis in the EU provoked by the failure of the Economic and Financial Affairs Council (ECOFIN) to impose the sanction on Germany and France provided for in the Stability and Growth Pact, along with Article 104 and the associated protocol of the Maastricht Treaty. The paper situates the debate concerning the application of the Stability and Growth Pact (SGP) in a broader evolution of the struggle between two schools of thought concerning macroeconomic policy-making in the European Union: the school calling for a strengthening of competences at the EU level (federal economic government) and the school arguing for preserving national competences for budgetary policy even in the face of the transfer of competence for monetary policy to the European Central Bank (ECB). The paper argues that the SGP represents an acceptable comprise between the two views of the schools in so far as it establishes rules to be respected without actually transferring competence to the Council in the field of budgetary policy. Consequently, the SGP has not and does not add to the 'democratic deficit' within the EU institutional framework. The paper argues, nevertheless, that the excessive deficit procedure (EDP) puts too strong an emphasis on the government budget deficit and suggests that emphasis on the sustainable level of public debt would ensure a stronger basis for assessing whether a given budget deficit may be considered excessive or not.

Key words: economic policy coordination, Stability and Growth Pact, Maastricht Treaty and sustainability of fiscal policy.

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Economic Policy Coordination in EMU: What role for the SGP?

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1. Introduction

On 13 January 2004, the European Commission decided to challenge, before the European Court of Justice, the legality of the procedures under which (according to the Commission) the eurozone's disciplinary rules on budget balances as determined by the Stability and Growth Pact (SGP) may have been broken. This step was the Commission's reaction to the decision of the Economic and Financial Affairs Council (ECOFIN) on 25 November 2003 not to apply sanctions on the German and French governments for exceeding the limits to budget deficits as determined by the so-called 'excessive deficit procedure' provided for in the SGP.

The present paper first takes a step backwards with an attempt to situate the discussion of the SGP and the 'Maastricht criteria' (the criteria for economic and monetary union membership fixed in the Maastricht Treaty) in a long-term perspective of the sharing of competences for macroeconomic policy-making within the EU. It then presents the institutional set-up with respect to the preparation of the Broad Economic Policy Guidelines (BEPG), the main features of the SGP and its immediate background in the debate leading up to the Maastricht Treaty on economic and monetary union (EMU). It then moves on to some more basic thoughts on the need for fiscal consolidation in the EU, criteria for medium- and long-term sustainability of fiscal policy, and the scope and mechanisms for smoothing fiscal balances and options for reforming the SGP.

2. Coordination or policy competition?

The crisis provoked by the Council's refusal to apply the sanctions clearly justified by the SGP's provisions and its own previous recommendations brought into the open a conflict that had been brewing ever since the creation of the EEC in 1958: the sharing of competences for macroeconomic policy-making between the national governments and the EU institutions.

2.1 Development of views and systems[1]

Whereas the original Rome Treaty was overwhelmingly focussed on the creation of the customs union and the common agricultural policy (CAP), a mechanism for 'soft coordination' of economic policy was created in the early 1960s through the establishment of a Conjunctural Policy Committee in 1960, and a medium-term Economic Policy Committee and a Committee of Central Bank Governors in 1964. In practice the tasks facing these committees were not challenging: underlying economic

[1] The following sections draw in particular upon the longer presentation of the history of macroeconomic policy-making in J. Mortensen (1990).

growth was strong, unemployment was low, rates of inflation were also low and external imbalances were limited. The debates were mainly *ex post* presentations and discussions of policy measures taken by the member states, and were thus not liable to seriously influence economic and monetary policy decisions.

Following a conference of heads of state and government in the Hague in 1969, a committee under the chairmanship of Pierre Werner presented a plan in June 1970 for an economic and monetary union and a more ambitious (than prior) coordination of economic policy, proposing the creation of two new Community bodies: a Centre of Decision for Economic Policy and a Community System for Central Banks. Although this institutional innovation was not retained, in March 1971 the Council decided that economic and monetary union implied the transfer of competences for economic policy from the national to the Community level and to this end adopted the Werner Plan for EMU in stages.

Nevertheless, just a few months after the adoption of the ambitious Werner Plan, the Bretton Woods system, which had been under heavy pressure for some time owing in particular to the large external deficit of the US, broke down definitively. In May 1971 the Deutschmark and the guilder were disconnected from the US dollar and on 15 August the dollar convertibility was suspended by order of President Richard Nixon. In the course of the autumn the Benelux currencies, the lira and the yen were floated. In view of the chaotic situation in exchange markets and the large disparities within the EC with respect to the economic policy response to the new situation, the Council decided in November 1973 not to move forward to the second stage of EMU. During the following months the first oil price increase added to the chaos and uncertainties concerning policy-making both inside and outside the EC.

During the mid-1970s at least two attempts were made to reintroduce some degree of coordination to policy-making within the EU:

- A report on the prospect for economic and monetary union was prepared by a group of experts under the chairmanship of Robert Marjolin in 1975. The report argued that the failure to move to the second stage of EMU was because of both insufficient political will and a misunderstanding of the nature and the conditions for a successful functioning of an EMU.
- A report on the role of public finances in European integration was produced by an expert group. This document, known as the MacDougal report, argued in favour of a significant expansion of the EU budget, notably by increasing the role of the EU's budget with respect to redistribution among member states.

Yet a genuine move towards a certain degree of monetary coordination was made only with the creation of the European monetary system (EMS) in December 1978. During the following 15 years the EMS showed a certain capacity to constitute a basis for implementation not only on monetary but also on budgetary policy. This was essentially a result of the fact that the domestic policy of the member states, for the first time after the breakdown of the Bretton Woods agreement, was called upon to take explicit account of external constraints, in this case the observance of the limits for fluctuation of exchanges rates within the EMS limits.

The creation of the EMS and the resulting constraints on the domestic economic and monetary policy of the participating countries was hardly greeted with satisfaction by all camps. In fact, the ensuing limitation on the freedom of manoeuvre in domestic policy was considered a heresy by a number of influential economists around the world. Many argued that the EU in no way constituted an 'optimal currency area'. With a relatively low cross-frontier mobility of production factors, the EU member states were – according to this school of thought – strongly in need of exchange-rate flexibility in case of 'asymmetric shocks'. Without exchange-rate flexibility, adjustment to supply and demand shocks would be more likely to result in unemployment or demand pressures and the EMS would therefore be likely to result in welfare losses in the longer term.

Even among the supporters of the original idea of Jean Monnet (to use monetary union as a *tool* rather than a final objective for European integration)[2] there was recognition that the EMS could only constitute an intermediate stage in the move towards full monetary union. Furthermore, there was increasing awareness that the original objectives of creating a customs union and a 'level playing field' were far from being attained. Therefore in 1985, the Commission, under the new presidency of Jacques Delors, launched a programme of mass elimination of remaining (non-tariff) barriers to the movement of goods, services, labour and capital within the internal market (called the '1992 programme' owing to the fact that the target was to eliminate these barriers to 1992 at the latest). This programme was adopted by the Council, after which the EC launched a comprehensive legislative process leading to the adoption of almost 300 new directives, forming the legal basis for ensuring a level playing field in a number of areas. At the beginning of 1986, Spain and Portugal entered the EC, and the EU single market legislation was extended to the European Free Trade Area (EFTA) countries with the creation of the European Economic Area.

In April 1986, the Commission (under President Jacques Delors) asked a group of experts to investigate the economic consequences of the decision to enlarge the Community to include Spain and Portugal and to create a market without internal frontiers by 1992. The report by the group, chaired by Tommaso Padoa-Schioppa, then Deputy Director-General of the Banca d'Italia, was delivered in 1987 under the eloquent title: *Efficiency, Stability and Equity: A Strategy for the Evolution of the Economic System of the European Community.*[3]

The report argued that:

- The 1992 programme implied very strong action to improve the *efficiency of resource allocation.*
- The 1992 programme created a need for complementary action to foster macroeconomic stability. Specifically as regards to *monetary stability*, the group argued that the programme implied a need for considering afresh the case for a strengthened monetary coordination.
- There were, according to the group, serious risks of aggravating regional imbalances. Reforms and development of Community *structural funds* were therefore appropriate.

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[2] Jean Monnet is supposed to have said that "L'Europe se fera par la monnaie".

[3] The members, in addition to Mr Padoa-Schippoa were: Michael Emerson, Mervyn King, Jean-Claude Milleron, Jean Paelinck, Lucas Papademos, Alfredo Pastor and Frits Scharpf. Paul Krugman presented a paper, published as an annex to the report and certain other experts contributed to the work of the group; see Padoa-Schioppa, 1987.

- The 1992 programme enhanced the need for ensuring consistency between microeconomic and macroeconomic policy with *sustained impetus on both the supply and demand sides* of the macroeconomic ‘equation’.

The group, however, argued that as monetary integration progressed national budgets would also have to be subject to more intense common disciplines. The report also argued (p. 10) that “the decentralised model evident in the mature federations, where the capital market exerts some restraint on state borrowing, is more plausible in the long run than the power-sharing arrangements that have sometimes been considered”.

The Padoa-Schioppa group on the other hand, warned against a ‘precipitate move’ in the direction of monetary union, arguing that further adaptation of attitudes and behaviour among private ‘agents’ as well as of political attitudes was required for monetary union to be a sufficiently low-risk proposition.

Nevertheless, less than a year after the publication of the Padoa-Schippoa report, in June 1988 the European Council in Hanover decided to examine the means of achieving economic and monetary union. The task of studying and proposing concrete stages leading towards EMU was entrusted to a committee chaired by the president of the Commission, along with the participation of the central bank governors of the EC, one other member of the Commission and three experts. The report was submitted in April 1989.

2.2 The Delors Committee's outline for EMU

The report[4] first provided a brief review of past and present developments in economic and monetary integration in the Community; second, it offered a detailed examination of the key aspects of the final stage of economic and monetary union; and third, it outlined a blueprint for the attainment of this union through a gradual approach.

With regard to the basic features of economic and monetary union, the Delors report did not diverge fundamentally from the Werner report. In contrast to the latter, which saw macroeconomic policy coordination mainly as a way to increase the efficiency of demand management, the Delors report was more concerned with defining Community procedures to ensure the fixing of upper limits to budget deficits and defining the overall stance of fiscal policy in a medium-term framework. First and most importantly, however, the report recommended the establishment of a new Community institution of a status comparable to the existing ones: a European System of Central Banks. The Werner report had proposed a Community system for the central banks, but was much less specific than the Delors report as to the status of this institution within the overall institutional framework. But in sharp contrast to the Werner report, the Delors report did not propose a specific timetable for the initiation of the scheme nor for the transition to the subsequent stages of the process of creating the EMU.

Like the Padoa-Schioppa report, the Delors report considered the “principle of subsidiarity” (according to which the functions of higher levels of government should be as limited as possible and should be subsidiary to those of lower levels) an essential element for defining the appropriate distribution of power within the Community. It nevertheless expressed strong fears that “uncoordinated and divergent budgetary

[4] Hereafter this document is referred to as the ‘Delors report’ (European Commission, 1989).

policies would undermine monetary stability and generate imbalances in the real and financial sectors of the Community" (European Commission, 1989). Moreover, because the centrally-managed Community budget was seen as likely to remain a very small part of total public sector spending and much of it will not be available for cyclical adjustments, "the task of setting a Community-wide fiscal policy stance will have to be performed through the coordination of national budgetary policies". In fact, according to the Delors committee, monetary policy alone could not be expected to establish a fiscal/monetary policy mix appropriate for the preservation of internal balance or for ensuring that the Community plays its part in the international adjustment process. In sharp contrast to the MacDougall report, however, the Delors report did not envisage any significant expansion of the Community's own budget even in the later stages of the EMU.

A key condition for moving to irrevocably-locked exchange rates (the third stage of EMU), according to the committee, would be that the rules and procedures of the Community in the macroeconomic and budgetary field would become binding. This condition implied that the Council of Ministers, in cooperation with the European Parliament would have the authority to take directly-enforceable decisions with respect to national budgets, make discretionary changes in Community resources and apply terms and conditions to existing Community structural and regional policies. The latter would, however, according to the report, need to be further strengthened and their instruments and resources adapted to the needs of the economic and monetary union.

The fear of the Delors committee that market forces would not exert sufficient disciplinary influence upon national governments' borrowing was spelled out in detail in a background paper by Alexandre Lamfalussy (1989). According to this paper, the fact that in federal states such as the US, Germany or Australia there are few constraints on the budgetary policies of sub-federal governments does not imply that such constraints will not be needed in the European Community. In fact, according to Lamfalussy, EC member states appear, by history and tradition, to exhibit much larger and persistent fiscal divergences than observed in federal states and it would not be wise to rely principally on the free functioning of financial markets to iron out any excessive differences in fiscal behaviour among member countries. Fiscal policy coordination, therefore, according to this paper, would appear to be "a vital element of a European EMU and of the process towards it" (Lamfalussy, 1989).

A strong call for tight constraints on member states' freedom of action in budgetary policy was also put forward in a paper contributed by Karl-Otto Pöhl (1989). According to this paper, whereas the national states would necessarily lose their monetary policy independence in a monetary union, they can quite easily retain certain responsibilities in the field of fiscal and economic policy, as is the case in every federation of states. Nevertheless, in order to exclude any doubts about the cohesion of the monetary union from the outset and at the same time avoid an overburdening of monetary policy, it would be necessary to ensure conformity of action in fiscal and economic policy within the Community. This is because any lack of convergence that could give rise to expectations of parity changes would need to be 'bridged' through interventions and interest-rate measures on the national money markets in order to ensure the continuing existence of the monetary or exchange-rate union. Over time it will thus be necessary to allow for the necessary transfer of economic and fiscal policy responsibilities from national authorities to the Community level.

Although necessary, the transfer of fiscal authority to Community institutions, according to Pöhl, would not be a sufficient condition for the smooth functioning of a monetary union in the Community. The procedures of income formation would also have to be flexible enough to accommodate differing rates of increase in productivity or shifts in demand, leading to divergences in regional developments. Even so, it will, he argued, be necessary to put in place a system of 'fiscal compensation' through a Community institution in favour of the structurally-weak member countries, compensating the latter "for the burdens of adjustment associated with the definitive renouncement of devaluations as a means of maintaining their competitiveness" (Pöhl, 1989).

Although, as indicated above, the Delors committee attached a high priority to the principle of subsidiarity, it argued that the approach to economic and monetary union must even more strictly respect the principle of parallelism between economic and monetary integration. While temporary deviations from parallelism are part of the dynamic process of the Community, the report argued that material progress on the economic front would be necessary for further progress on the monetary front. The report thus clearly came out quite strongly against the idea of using monetary integration as an instrument in the process of economic (and political) integration.

Whereas the Delors report on the whole turned out to be the expression of the views of central bank governors, other actors in the EMU game were not necessarily in support of further steps in the field of monetary integration. In fact, certain EU member governments, most notably the UK government, suggested retaining the EMS as a key feature in support of the completed single market. Other experts were much less keen than the central bank governors in the Delors committee to promote the idea of parallelism between economic, monetary and budgetary integration.

In fact, even within the Commission services there was not full support of the main arguments in the Delors report. Thus, an ECOFIN opinion on the EMU published after the Delors report argued that to be viable monetary union should be founded essentially (and only) on two basic principles: i) no monetary financing of the budget deficits of member governments and ii) no bail-out of national government debt by the EU.

2.3 The Maastricht Treaty

Despite the resistance of some member states, in 1990 the EC started the process that would lead to the adoption of EMU. A Conference of the Representatives of the Governments of the Member States (the EC title for the inter-governmental conference or IGC) convened in Rome on 15 December 1990 to adopt by common accord the amendments to be made to the Treaty establishing the European Economic Community, with a view to achieving political union and the final stages of economic and monetary union. The final negotiations took place in Maastricht on 7 February 1992, giving rise to the creation of the European Central Bank, along with other Treaty changes concerning Justice and Home Affairs and external policy. With respect to EMU the Maastricht Treaty (Council of the European Union, 1992) largely reflected the views of the Delors committee.

The final Treaty thus, in Art. 4a, stipulated that:

> A European System of Central Banks (hereinafter referred to as 'ESCB') and a European Central Bank (hereinafter referred to as 'ECB') shall be established in accordance with

> the procedures laid down in this Treaty; they shall act within the limits of the powers conferred upon them by this Treaty and by the Statute of the ESCB and of the ECB (hereinafter referred to as 'Statute of the ESCB') annexed thereto.

The details on the creation and functioning of the ECB were (as indicated) presented in a protocol. Another protocol specified the conditions that should be fulfilled by a member state in order to participate in the final stage of economic and monetary union that is the replacement of the national currency by the euro and acquiring the rights to become a full member of the ECB (the 'convergence criteria'). The protocol fixed the following convergence criteria:

1. that the average rate of inflation in the member state, observed over a period of one year before the examination, did not exceed by more than 1.5 percentage points that of, at most, the three best performing member states;
2. that the member state was not the subject of an excessive deficit procedure according to Art. 104c(6) of the Treaty;
3. that the member state had respected the normal fluctuation margin within the EMS for at least two years; and
4. that the average long-term interest rate had not exceeded by more than 2 percentage points that of, at most, the three best performing member states in terms of price stability.

When commenting on the results of the Maastricht IGC, the then Commissioner responsible for Economic and Financial Affairs, Henning Christophersen, stated that the Commission had been in favour of either no criteria at all or at least a higher degree of 'tolerance' for EMU membership. But at least one key member state (Germany) had insisted on the maintenance of such rigorous rules of the game in order to go forward on EMU. The Maastricht Treaty also fixed the timeframe for moving to the final phase of EMU (Art. 109j) in the following terms:

> Taking due account of the reports referred to in paragraph 1 and the opinion of the European Parliament referred to in paragraph 2, the Council, meeting in the composition of Heads of State or of Government, shall, acting by a qualified majority, not later than 31 December 1996:
>
> - decide, on the basis of the recommendations of the Council referred to in paragraph 2, whether a majority of the Member States fulfil the necessary conditions for the adoption of a single currency;
> - decide whether it is appropriate for the Community to enter the third stage, and if so
> - set the date for the beginning of the third stage.
>
> 4. If by the end of 1997 the date for the beginning of the third stage has not been set, the third stage shall start on 1 January 1999. Before 1 July 1998, the Council, meeting in the composition of Heads of State or of Government, after a repetition of the procedure provided for in paragraphs 1 and 2, with the exception of the second indent of paragraph 2, taking into account the reports referred to in paragraph 1 and the opinion of the European Parliament, shall, acting by a qualified majority and on the basis of the recommendations of the Council referred to in paragraph 2, confirm which Member States fulfil the necessary conditions for the adoption of a single currency.

3. The present institutional set-up for economic policy coordination

3.1 The Broad Economic Policy Guidelines

The Broad Economic Policy Guidelines (BEPGs) form a key economic policy document in the EU, providing guidance for the conduct of economic policies and an instrument for their coordination that is released annually. It builds on an annual cycle of policy discussion that is initiated by *The EU Economy Review* and the experience of the implementation of the previous BEPGs. The BEPGs are adopted by the ECOFIN Council on the basis of a Commission recommendation, in line with Art. 99 of the Treaty establishing the European Community.

The Commission also publishes a report on the implementation of the BEPGs. This annual report summarises Commission findings in monitoring economic developments and the conduct of economic policies. The report is thus part of the economic surveillance and policy coordination activities of the Commission. These are based on the mandate given in Art. 99 of the Treaty. Monitoring is a prerequisite for bringing to bear peer pressure as a means to induce policy adjustments, when necessary, within the EU economic policy coordination framework. The Commission's report, which is also an Economic and Financial Affairs Directorate-General (DG) working document, provides:

- an overall assessment of the implementation of the BEPGs of the preceding year;
- an assessment of the implementation of the country-specific guidelines in last year's BEPGs; and
- input for the next Commission recommendations on the BEPGs.

According to Art. 99 of the Treaty, the Commission and the Council inform Parliament on the BEPGs, and the Commission and the Council may be invited to hearings by the relevant parliamentary committees. There is no formal consultation with Parliament before the Council adopts the final version of the recommendations. Yet at least in the procedure concerning the BEPGs for 2002, on a few points the Council actually took account of drafting suggestions put forward in the resolution adopted by the Parliament.

3.2 The Stability and Growth Pact

With the ultimate limit for passing to Stage 3 (1 January 1999) approaching, some member states became increasingly concerned about the possibility of irresponsible budgetary behaviour by governments once admitted in the EMU club. The need for establishing the rules of the game once inside the EMU was recognised by the Madrid European Council in December 1995 and reiterated in Florence six months later. An agreement on the main features was reached in Dublin in December 1996 and final agreement on the text was reached on 7 July 1997 (see Annex 1).

Broadly speaking, the SGP stipulates the need for observing the Maastricht criteria even after EMU membership and provides somewhat specific guidelines for the process of deciding whether an EMU member country runs an excessive deficit. The SGP, however, goes considerably beyond the Maastricht Treaty by giving the Council the competence to impose sanctions if a participating member state fails to take the necessary steps the bring an excessive deficit to an end. Whenever the Council decides to impose sanctions it is urged to always require a non-interest bearing deposit in accordance with Art. 104(11). It is again ‘urged’ to convert a deposit into a fine after two years unless the excessive deficit has, in the view of the Council, been corrected.

As presented by the DG for Economic and Financial Affairs, the SGP is the concrete EU answer to concerns on the continuation of budgetary discipline in the EMU. Adopted in 1997 as indicated above, the SGP strengthened the Treaty provisions on fiscal discipline in the EMU foreseen by Arts. 99 and 104, and the full provisions took effect when the euro was launched on 1 January 1999.

The principal concern of the SGP was to enforce fiscal discipline as a permanent feature of EMU. Safeguarding sound government finances was considered a means for strengthening the conditions for price stability and for strong and sustainable growth conducive to employment creation. It was also recognised, however, that the loss of the exchange-rate instrument in the EMU would imply a greater role for automatic fiscal stabilisers at the national level to help economies adjust to asymmetric shocks, and would make it “necessary to ensure that national budgetary policies support stability oriented monetary policies”. This is the rationale behind the core commitment of the SGP, i.e. to set the “medium-term objective of budgetary positions close to balance or in surplus…”, which “will allow all member states to deal with normal cyclical fluctuations while keeping the government deficit within the reference value of 3% of GDP” (see Annex 1).

Formally, the SGP consists of three elements as follows:

- a political commitment by all parties involved in the SGP (the Commission, member states and the Council) to the full and timely implementation of the budget surveillance process. These are contained in a Resolution agreed by the Amsterdam European Council of 17 June 1997. This political commitment ensures that effective peer pressure is exerted on a member state failing to live up to its commitments.
- preventive elements, which through regular surveillance, aim at preventing budget deficits going above the 3% reference value. To this end, Council Regulation 1466/97 (Annex 4) reinforces the multilateral surveillance of budget positions and the coordination of economic policies. It foresees the submission by all member states of stability and convergence programmes, which will be examined by the Council.
- dissuasive elements, which in the event of the 3% reference value being breached, require member states to take immediate corrective action and, if necessary, allow for the imposition of sanctions. These elements are contained in Council Regulation 1467/97 (Annex 5) on speeding up and clarifying the implementation of the excessive deficit procedure.

Besides this legal basis, the Code of Conduct on the content and format of the stability and convergence programmes, endorsed by the ECOFIN Council on 10 July 2001, incorporates the essential elements of Council Regulation 1466/97 into guidelines to assist the member states in drawing up their programmes. It also aims at facilitating the examination of the programmes by the Commission, the Economic and Financial Committee and the Council. The right of initiative in this procedure is attributed to the Commission.

3.3 Stability and convergence programmes

Euroland member states prepare stability or convergence programmes as part of the SGP under EMU (specifically, in conformity with Council Regulation 1466/97). These are public documents drawn along the guidelines set in the Code of Conduct on the content and format of the stability and convergence programmes, and are submitted to the Commission and Council. Their aim is to strengthen and clarify Treaty provisions on multilateral economic surveillance and budgetary discipline during the third stage of EMU. Programmes are updated annually. Member states having adopted the single currency prepare *stability* programmes, while those not having adopted it prepare *convergence* programmes.

Stability and convergence programmes must present the following information:

- a medium-term objective for the budgetary position of close-to-balance or in surplus, the adjustment path and the expected path of the general government debt ratio;
- the main assumptions about expected economic developments (growth, employment, inflation and other important economic variables);
- a description of budgetary and other economic policy measures being taken or proposed to achieve the objectives of the programme (or both); and
- an analysis of how changes in the main economic assumptions would affect the budgetary and debt position.

In addition, convergence programmes must present:

- the medium-term monetary policy objectives and the relationship of those objectives to price and exchange-rate stability.

This information must cover, as well as the current and preceding year, at least the following three years.

The Commission's *convergence reports* examine in detail whether the member states satisfy the necessary conditions for the adoption of the single currency, namely:

- the convergence criteria; and
- the legal requirements.

At least once every two years, or at the request of a member state with derogation, the Commission shall report to the Council on the progress made in this respect.

At present, three member states do not participate in the eurozone – Denmark, Sweden and the UK. Sweden was assessed in 2000 as not fulfilling the necessary conditions for the adoption of the single currency and is therefore a member state with derogation. Denmark and the UK have negotiated opt-out arrangements and will therefore not be the subject of an assessment until they indicate that they wish to adopt the single currency.

3.4 Examination and monitoring of programmes

In conformity with the SGP, the Council examined the original 1999 programmes. Since then the Council assesses the annual programme updates at the beginning of each year. This examination is based on assessments by the Commission and the Economic and Financial Committee and includes considerations as to whether:

- the medium-term budget objective in the programme provides for a safety margin to ensure the avoidance of an excessive deficit;
- the economic assumptions on which the programme is based are realistic;
- the measures proposed or being taken (or both) are sufficient to achieve the medium-term budgetary objective (and, for convergence programmes, to achieve sustained convergence);
- the content of the programme facilitates the closer coordination of economic policies; and
- the economic policies of the member state concerned are consistent with the BEPGs.

On a recommendation from the Commission, and after consulting the Economic and Financial Committee, the Council delivers an opinion on each programme, and can invite the member state concerned to strengthen it. The Council monitors implementation of programmes and, to prevent an excessive deficit, can recommend to the member state concerned to take adjustment measures. If subsequent monitoring suggests worsening budgetary divergence, the Council can recommend taking prompt corrective measures.

3.5 The excessive deficit procedure

The Treaty (Art. 104) obliges member states to avoid excessive budgetary deficits, defined by a reference value of 3% of GDP (see Annex 2). Art. 104 also sets out a procedure to be followed at Community level to identify and counter such excessive deficits, including the possibility of financial sanctions. To make this a more effective deterrent, the SGP clarified and speeded up the excessive deficit procedure (EDP). The EDP refers to the procedure as specified by Council Regulation 1467/97 included in the SGP.

3.5.1 Identifying an excessive deficit and requesting the member state to correct it

The EDP sets out schedules and deadlines for the Council, following reports from and on the basis of opinions by the Commission and the Economic and Financial Committee, to reach a decision that an excessive deficit exists. Such a decision is taken within three months of the reporting deadlines for government finances of 1 March and 1 September each year, as established by Council. A government deficit exceeding the reference value of 3% of GDP is considered exceptional and temporary and not subject to sanctions when:

- it results from an unusual event outside the control of the member state concerned and has a major impact on the financial position of the general government; and
- it results from a severe economic downturn (if there is an annual fall of real GDP of at least 2%).

When it decides that an excessive deficit does exist, the Council makes recommendations to the member state concerned and establishes a deadline of four months for effective corrective action to be taken. In the absence of special circumstances, such action is that which ensures completion of the correction of the excessive deficit in the year following its identification. If, after a progressive notice procedure, the member state fails to comply with the Council's decisions, the Council normally decides to impose sanctions, ten months at the latest after reporting the data indicating an excessive deficit exists.

3.5.2 Sanctions

Sanctions first take the form of a non-interest-bearing deposit with the Commission. The amount of this deposit comprises a fixed component equal to 0.2% of GDP and a variable component linked to the size of the deficit. Each following year the Council may decide to intensify the sanctions by requiring an additional deposit, though the annual amount of deposits may not exceed the upper limit of 0.5% of GDP. As a rule a deposit is converted into a fine if, in the view of the Council, the excessive deficit has not been corrected after two years.

3.5.3 Abrogation of sanctions

The Council may decide to abrogate some or all of the sanctions, depending on the significance of the progress made by the participating member state concerned in correcting the excessive deficit. The Council will abrogate all outstanding sanctions if the decision on the existence of an excessive deficit is itself abrogated. Yet any fines already imposed are not reimbursable. Interest on the deposits lodged with the Commission, and the yield from fines, are distributed among member states without an excessive deficit, in proportion to their share in the total GDP of eligible member states.

3.6 Ongoing excessive deficit procedures

3.6.1 The case of Portugal

On 24 September 2002, the Commission adopted a report on the government finance situation in Portugal. This report constitutes the first step of the EDP provided for by Art. 104.3 of the Treaty. The Commission initiated the EDP for Portugal (IP/02/1168), after receiving official confirmation that the general government deficit in 2001 amounted to 4.1% of GDP, thereby clearly exceeding the reference value of 3% of GDP**.**

Six weeks later, on 5 November, the Council ‘decided’ that indeed an excessive deficit existed in Portugal. The decision stated that in the late 1990s, when Portugal enjoyed strong economic growth, progress in fiscal consolidation had been limited, with the general government deficit remaining well above 2% of GDP. Thus, there had been little budgetary leeway to accommodate the effects of a cyclical slowdown or for such changes in accounting as required to comply with the European System of Accounts in 1995. From 1999 to 2001, the deficit had increased from 2.4% to 4.1% of GDP, significantly exceeding the reference value of 3% in 2001. Over the same period, government gross debt remained below 60% of GDP, but rose from 54.4% to 55.5% of GDP. Part of the deficit increase in 2001 was as a result the rectification of government accounts, the other part owing to deviations of budget execution from targets. While economic growth slowed markedly, the fiscal slippage mainly reflects a weakening in the underlying budgetary position. A rectifying budget adopted in June 2001 proved insufficient as to prevent the deficit from breaching the threshold set by the Treaty. The new government that came into office in April 2002 adopted a rectifying budget providing for, inter alia, an increase in the standard VAT rate and, on the expenditure side, cuts in public investment. While the Portuguese government declared its firm commitment to the new deficit target of 2.8% of GDP set for 2002, it was, according to the Council decision, uncertain whether the excessive deficit situation would actually be corrected. Moreover, government debt was projected to rise to 59.3% of GDP in 2002, a level just under the 60% reference value. Thus, any slippage in budgetary execution or deceleration in nominal GDP growth (or both) could imply a deficit above 3% of GDP and a breach of the government debt reference value.

Following this Council decision at the end of 2002, the Portuguese government took further measures of budgetary consolidation and in its new assessment in February 2003 the Commission revised the forecasted budget deficits considerably downward, which were consequently brought just below the 3% threshold for 2003 and expected to fall further in 2004. The excessive deficit procedure was expected to be suspended in the next Council meeting in May 2004 after the clearing of the accounts by Eurostat.

3.6.2 The excessive deficit procedure concerning France and Germany

In late 2002 and early 2003 it became clear that first Germany and later France were in serious risk of running general government budget deficits in excess of the limits fixed in the Maastricht Treaty and in the SGP. In fact the Council had already decided in January 2003 that an excessive deficit existed in Germany and recommended that Germany put an end to the present excessive deficit situation as rapidly as possible. It noted the German government's expressed resolve to deal with these issues, and established a deadline of 21 May 2003 at the latest for the German government to take the measures required to ensure that the rise in public debt was brought to a halt in 2003 and reversed thereafter.

As far as France is concerned, on 3 June 2003 the Council decided that an excessive deficit existed and adopted a recommendation that France put an end to this excessive-deficit situation before 3 October 2003 and achieve a significantly larger cyclically-adjusted deficit in 2003 than that planned in June.

Since neither of the two governments had acted according to the Council recommendations later that year, the Commission recommended in October (France) and November (Germany) that the Council proceed with the adoption of the sanctions envisaged in the SGP. Nevertheless, when the Council took a vote on the Commission's draft recommendations on 25 November 2003 the required qualified majority for applying sanctions was not reached. The Council agreed in its conclusions, however, to hold the excessive deficit procedure "in abeyance for the time being" and invited both France and Germany to "regularly report on the progress made in fulfilling the commitments to reduce the deficits" (ECOFIN, 2003).

On 13 January 2004, the European Commission decided to challenge, before the European Court of Justice, the legality of the procedures under which (according to the Commission) the eurozone's disciplinary rules on budget balances as determined by the SGP had been broken by the Council. This step was the Commission's reaction to the ECOFIN Council's decision on 25 November 2003 not to apply sanctions on the

German and French governments for exceeding the limits to budget deficits as determined in the excessive deficit procedures provided for in the SGP. Yet the Commission underlined that it would continue the conduct of economic and budgetary surveillance for all member states in the framework of the Treaty and the SGP, and continue to monitor developments for countries in excessive deficit. It also announced that it would make new proposals for the strengthening of economic governance in the future, including proposals for improvements in the implementation of the SGP.

What should be done? Does the SGP contribute to aggravating the democratic deficit within the EU? Should the SGP be dropped? Should it be replaced by another mechanism for ensuring consistency of the budgetary-monetary policy mix in the EU? Should it be reformed with the aim of ensuring better overall consistency with long-term sustainability? Would there be scope for other adjustments, notably with the aim of offering a higher degree of adaptability to local conditions, including, in particular, the enlargement to 25 (and ultimately 27 or more) member states?

4. Assessment of the SGP

4.1 Does the SGP contribute to the democratic deficit?

As stressed by Moravcsik (2001), the basic case for the existence of a 'democratic deficit' in the EU lies first and most importantly on the fact that only the European Parliament is directly elected. Yet its competence is much more limited than that of national parliaments. The European Commission enjoys a powerful role as an agenda-setter and regulatory coordinator, and is broadly considered to be a technocratic body. The Council of Ministers, which has the broadest legislative power, brings together national ministers, diplomatic representatives and administrative officials from the member states and most often deliberates in secret. Consequently, neither the Commission nor the Council are directly accountable to voters. Many observers believe that this is insufficient to ensure democratic legitimacy.

Nevertheless, again according to Moravcsik, when judging by the practices of existing nation-states and in the context of a multi-level system, there is little evidence that the EU institutions suffer from a more fundamental democratic deficit. Moravcsik argues that there are, in fact, a few areas where the EU departs modestly from existing national practices without a compelling substantive justification. The most important is the structure of the European Central Bank, which is more independent of political pressure than any known national example.

Even if, as argued by Scharpf (1999), the emphasis on "negative integration" (elimination of barriers) has led to an overall reduction in the "problem-solving capacity" of the EU (greeted with satisfaction, however, by liberalists) little "discretionary competence" has in fact been transferred to the EU level. This is in particular the case for all matters concerning government income and expenditure, where the competence lies with national parliaments and governments, with the exception of matters of direct concern for the functioning of the internal market, such as the rate of VAT.[5]

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[5] The establishment of an 'Economic Government' as recommended in the original Werner Plan and frequently requested ever since (including recently), would of course result in a huge widening of the

What is important to stress is that the Maastricht Treaty and the associated Stability and Growth Pact do not involve transferring any *discretionary competence* to the Council. The Treaty and the SGP determine certain rules of the game and the SGP provides for a fine in case these rules are not observed. Although this may be the first time an EU pact actually provides for a sanction in case of non-observance, the SGP therefore as such cannot be considered to have added to the democratic deficit (if it is agreed that such a deficit exists). In fact, it could be argued (and the Commission clearly thinks so) that by *not* imposing a fine on Germany and France in line with the provisions of the SGP, the Council took a discretionary decision not envisaged in the SGP and thus *added* to a potential democratic deficit.

Another matter is that (for obvious reasons) the Maastricht protocol stipulates that the reference value for public debt and the government deficit concerns general government, that is, the central, regional or local government and social security funds. The Treaty thus, in fact, attributes to the governments of member states a power over public deficits that does not correspond to the actual distribution of competences between the various layers of public authorities and social security institutions. Here, however, Art. 3 of the Protocol states that member states "shall ensure that national procedures in the budgetary area enable them to meet their obligations in this area deriving from the Treaty" (see Annex 3).

4.2 Is the SGP discredited and thus should it be dropped?

As stressed in a recent special report of the CEPS Macroeconomic Policy Group (Gros et al., 2004) the source of the conflict that erupted in November 2003 is not the SGP but rather the prohibition of excessive deficits contained in the Treaty of Maastricht, Art. 104 (Annex 3). The SGP is in fact adopted in the form of a Council Regulation and is thus essentially a more concrete answer to, or indeed an implementation of, the provisions of the Treaty.

The issue can therefore be broken down in two questions:

- Could and should the Treaty provisions be changed?
- Should the special provisions of the Stability and Growth Pact be dropped (leaving only the more general provisions of the Treaty?

As already stressed above, the Maastricht Treaty provisions concerning the criteria for EMU membership and the excessive deficit procedure could well be questioned on the basis of arguments concerning both efficiency and stability. It is now evident that the Treaty has not prevented certain countries from suffering excessive deficits and those deficits may in recent times have contributed to the relatively tight and defensive policy stance adopted by the European Central Bank.

Recognising the relative inefficiency of the Treaty provisions and the SGP does not, however, imply that those provisions have been without effect. On the other hand, the politics of the failure to correctly implement the Treaty and SGP provisions have no doubt contributed to a certain loss of faith and confidence in the European decision-making process. These events have diverted what ought to have been a serious national

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democratic deficit unless accompanied by the unlikely attribution of the appropriate legislative competences in fiscal affairs to the European Parliament.

policy issue (in France and Germany) to a debate on whether or not ‘Brussels’ (the French Prime Minister at some stage referred to the ‘algebra’ of a bureau in Brussels) was justified in imposing sanctions on ‘innocent’ national governments. In this case, as in numerous others, the European cause has thus suffered by providing national authorities with excuses for delaying actions that were fully justified on the basis of completely national criteria.

That being said, it should be stressed that Art. 104 of the Treaty was reintroduced in the project adopted by the Convention and should probably not be expected to be removed in the later redrafting of the Constitutional Treaty if it is adopted. The key question therefore concerns the legal status of the SGP and the scope and desirability of dropping it or changing some of its provisions. In this respect it is perhaps most pertinent to consider mainly whether the provisions should be changed to correspond better to the initial objectives of the Treaty and the EMU.

4.3 Should the provisions of the SGP be reformed?

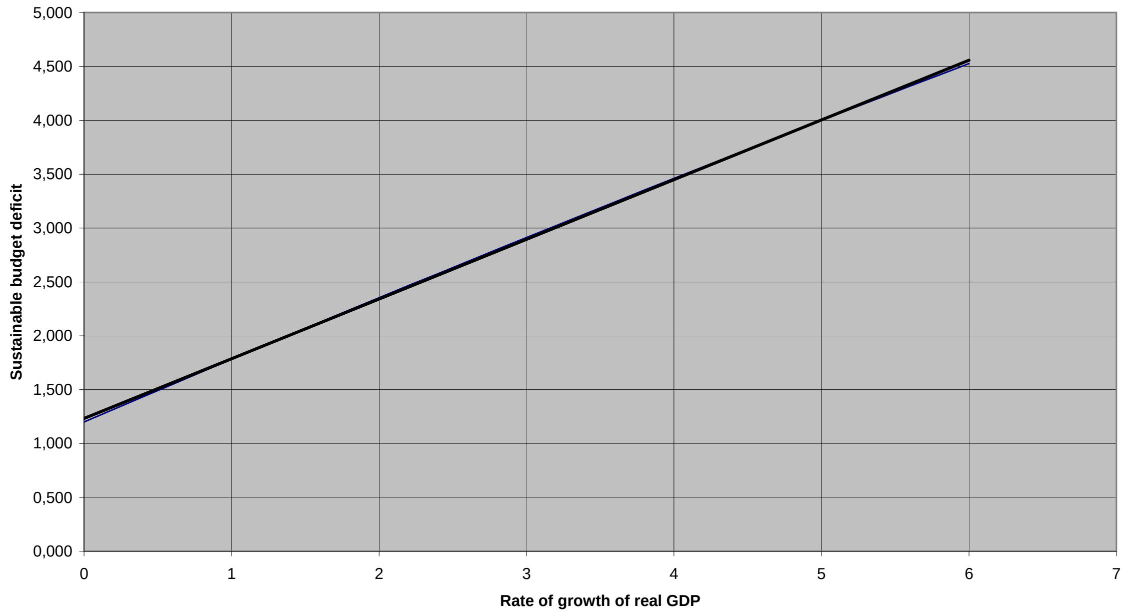
A critical aspect of the implementation of the Maastricht Treaty and the SGP is, perhaps, the rather unbalanced emphasis on the budget deficit. The very term ‘excessive deficit procedure’ in fact illustrates that the second reference value, keeping public debt below the limit of 60% of GDP, has been left completely in the shadow. One reason for having omitted the debt criteria in the EDP may have been that certain member states (notably Belgium and Italy) at that time had public debt levels far above the 60% threshold. The Commission and the Council possibly considered that discussing the enormous divergence of debt levels and finding valid arguments for admitting Belgium and Italy in the EMU despite this debt level would simply be too complicated for the political establishment to cope with. Consequently the focus was put on the deficit and it was argued, somewhat against the spirit of the Treaty provisions, that those countries were on track to reduce the level of their debt. Admittedly, while deficits are difficult to forecast and final data comes only with considerable delay, forecasts for debt are even less reliable and subject to even more controversy, and are revised several times even after publication to some extent because of the revaluation of items of public debt that are not directly influenced by the budget balance.

Nevertheless, as already stressed above, in the long-term the level of general government debt and not the budget deficit is the main criteria for the sustainability of public finance. Admittedly, the limit of 60% fixed in the Maastricht Protocol was not based on a very rigorous macroeconomic analysis and, worse, does not include hidden liabilities for the countries where pensions are provided on a PAYG basis. The Maastricht limit could nonetheless be considered a reasonable cap likely to be accepted by and in most EU member states and could have even been a reasonable target for those countries where the level at that time was in excess of 60%.

More emphasis on the debt criteria would also make it possible to take more explicit account of cross-country differences with respect to the potential rate of growth: countries with a higher potential rate of growth (notably low-income countries with a potential for reducing a productivity gap vis-à-vis the high-income countries) could be allowed to run a higher budget deficit and yet respect the debt limit. For high-income countries with a lower potential rate of growth in productivity and lower growth in the labour force (such as, notably, Germany) respecting the debt limit would involve keeping the budget deficit well below the limit of 3% fixed in the Maastricht Protocol.

This feature is illustrated in Figure 1, which shows the levels of budget deficit compatible with a constant level of government debt (at 60% of GDP) for different rates of nominal GDP growth. The latter includes an assumption of a constant rate of inflation at 2% per annum, despite the fact that there could be a certain link between the rate of inflation and the rate of real GDP growth. What emerges from this graph is that at a rate of nominal GDP growth of 5% per annum (3% real growth and 2% inflation) a budget deficit of just below 3% is compatible with a steady state debt-ratio of 60%. Yet with growth of real GDP above or below the 3% threshold, the budget deficits compatible with a constant debt-ratio are respectively higher or lower than the threshold of 3% (for the formal derivation of the relationship see Box 1 on the budget constraint).

Figure 1. Sustainability of government budget deficits (with debt equal to 60% of GDP and 2% of inflation)



Box 1. The government budget constraint

The relationship between the budget balance and government debt can be expressed by the following budget constraint:

d(t) = d(t-1)*(1/(1+g)(1+i)) + b(t)

where d(t) = the debt/GDP ratio at the end of period 't', b(t) = the general government budget deficit in period 't', 'g' = the real rate of growth of GDP and 'i' = the rate of inflation (GDP deflator).

By assuming a constant debt/GDP ratio d(t) must be equal to d(t-1) and the equation can be reduced to:

b(t) = d(t)*(1-(1/(1+g)*(1+i)))

Introducing an assumption concerning the rate of inflation 'i', and the desired level of public debt, the equation can be solved for 'b' and different values of 'g' as expressed in 0.

Taking more explicit account of the sustainability of the budget deficit would not require major changes in the Treaty, nor indeed in the SGP. In fact the SGP already explicitly provides for the possibility that a deficit exceeding 3% of GDP may not be excessive. But it is then up to the Commission to present in writing to the Council the reasons for not considering a deficit over 3% of GDP to be excessive and therefore not requiring further action on behalf of the Council.

Nevertheless, as stressed in Gros et al. (2004), the rate of potential GDP growth in a number of EU countries must be considered to be lower than 3% per annum and possibly even below 2% over the coming decades. In this case even a budget deficit of 2% of GDP may result in a steady rise in the public debt ratio and, consequently, be characterised as being unsustainable, that is, excessive. This possibility is not covered by the Maastricht Protocol, but on this point the SGP is in fact more restrictive than the Treaty: according to the SGP, adherence to the objective of *sound budgetary position close to balance or in surplus* will allow all member states to deal with normal cyclical fluctuations while keeping the government deficit within the 3% of GDP reference value. To make the excessive deficit procedure more meaningful will therefore not require any changes in the basic texts but only a more ‘sophisticated’ assessment of budgetary trends and a more explicit reference to the debt criteria.

In the context of undertaking the necessary changes in the implementation of the protocol and the SGP it would nevertheless, as argued by Gros et al., be desirable to enhance both the monitoring and the forecasting capabilities of the DG for Financial Affairs. It may be desirable to expand the resources allocated to (or charge an external agency with) undertaking detailed assessments of the potential rate of growth of the various EU member states and the associated rate of inflation.

4.4 Could the incentive mechanism be redesigned?

The problem, however, with the current design of the SGP according to Gros et al. (2004) is that sanctions arrive too late in the process and that, as seen, the Council may not be able to assume the political responsibility of imposing fines on one of their own peers. It would therefore be desirable to increase the political cost of not complying with the SGP, although it is far from evident how this could be obtained in practice.

An even better option might be to introduce a higher degree of automatic application of sanctions in the excessive deficit procedure. One option, for example, could be to request a deposit of 0.2% of GDP at the point at which the Council decides that an excessive deficit exists, which would be released when the appropriate corrective measures have been taken. This option would allow the Council to avoid the difficult decisions and to take the more positive ones when governments have complied.

Additionally, it would be desirable to strengthen the early warning mechanism. The Commission and the Council could start putting pressure on member states sooner. Such pressure will impose at least a political cost on the governments early enough so that they can take a gradual approach to reducing the deficit. If the warning is made too late the government is left with very drastic and unpopular options to regain sustainability and the costs of complying become much higher than the costs of being criticised by the Commission and the Council. Again, this would require more resources for long-term budgetary analysis by the DG for Economic and Financial Affairs or by an external specialised body.

5. Budgetary sustainability and the challenge of population ageing

5.1 The ageing of populations

Populations in practically all European countries are ageing as a result of the combined effect of the improvement in life expectancy, the decline in fertility rates and the greying of baby-boom cohorts, who will start retiring by 2015. Life expectancy at birth has increased by more than one year every five years since 1960 in EU countries, and is still expected to increase from an average of 75.5 years for men and 81.6 for women in 2001 to 80 and 85.5 years[6] respectively in 2050. At the same time, fertility rates have decreased to a current level of 1.47 children per woman, which is below the necessary level that ensures a replacement of the population (estimated at 2.1).

Although the importance of each of these factors varies from one country to another, the old-age dependency ratio (share of older persons over the working-age population) is expected to increase everywhere. For the EU on average this measure will rise from 24% in year 2000 to 40% in 2030 and further to 49% in 2050.[7] Increases will be particularly pronounced in Italy and Germany. Similar tendencies are found in accession countries. Thus in Poland the old-age dependency ratio is forecasted to increase from 20.4% in 2000 to 38.3% in 2035 and in Hungary from 23.7% to 35% during the same period (Dang et al., 2001).[8]

Public expenditure on pensions, which in year 2000 reached 12.5% of GDP on average for the EU,[9] will be boosted by population ageing, presenting an important challenge to public finances. The extent of this financial challenge will, however, not only depend on a country's demographic dynamics, but also on the performance of its labour market, on the design and characteristics of its pension system, and on its current level of public debt.

The impact that demographic changes are expected to have on the public spending on pensions in the next 50 years has been assessed in a common exercise for the different EU countries (EPC, 2001),[10] considering no further changes in the pension systems from 2000. Given the high degree of uncertainty over such a long period, these projections cannot be taken as forecasts, but they give an indication of spending trends and their relative importance to public finances. The most serious increases in pension expenditures are projected for Portugal, Spain and Greece. Italy and Sweden are among the countries where the lowest increases (of between 2% and 2.5% of GDP by year 2030) are projected. More recent updated projections, including the 2001 reform in

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[6] Eurostat projections.

[7] Eurostat, central scenario projections; old-age dependency ratio: population aged 65 or more, over population aged 15-64.

[8] Old-age dependency ratio: population aged 65 or more, over population aged 20-64.

[9] Eurostat, ESSPROS; it includes disability pensions, early-retirement benefits owing to reduced capacity to work, old-age pensions, anticipated old-age pensions, partial pensions, survivors' pensions and early-retirement benefits for labour market reasons.

[10] Projections are based on national models, but use common assumptions; they are also based on Eurostat demographic projections, which consider a net migration inflow in all member states. An increase in participation rates of women and older workers, and a decrease in unemployment are also assumed. EPC projections include all public pensions and income transfers to the elderly (old-age pensions, early-retirement pensions, survivors and children's pensions, disability pensions and other income transfers to persons aged 55 and over).

Germany and the 2003 reform in France, estimate an increase of around 3% of GDP by 2030 in these two countries (EPC, 2003). Based on the same macroeconomic framework, future pension expenditure has also been projected for other OECD countries (Dang et al., 2001).[11] In the case of Hungary, an initial reduction in pension expenditure is projected until year 2010, and then it will start increasing. In Poland, pension expenditure is also expected to first decline, until year 2015, but increase again in 2015-25 and then from year 2045, owing to the retirement of the two baby-boom cohorts.

But the potential tension on public expenditure is not limited to a possible boost of spending on public pensions. In fact, although the impact is difficult to estimate, population ageing is also likely, in all countries, to entail a rise in health expenditure, possibly of the same order of magnitude as the rise in pension expenditure. With unchanged policy, most of the EU countries, and certainly not only the countries that are or have been concerned with the excessive deficit procedure, will therefore be almost permanently confronted with the challenge of coping with pressures on public budgets over the next two or three decades.

5.2 Challenges to public finance

According to estimates prepared by McMorrow and Roeger (1999), in the absence of any corrective action, age-related pressures on public expenditure are likely to result in a progressive (*ex ante*) increase in government expenditure equivalent to more than 5 percentage points of GDP in the EU from 2000 to 2050.

As far as health expenditure is concerned, the direct effect of population ageing on government budgets is, according to McMorrow and Roeger, equivalent to an increase of about 1.25% to 1.5% of GDP. The authors, however, underline that these projections only refer to the direct effects of the demographic factors and do not incorporate any estimates for non-demographic cost-push factors. The latter have, in the past, been the major reason for the rise in publicly funded health spending in the period from 1960 to 1995.

As far as the demographic impact on education is concerned, they argue that the direct budgetary effect of the relative decline in the number of persons in the younger age classes will be rather small.

In the (totally unrealistic) case of debt-financing for the emerging deficits, the primary budget balance (general government budget-balance excluding interest payments on public debt) for the EU-15 would on average shift from a surplus of 3% of GDP in year 2000 to a deficit of some 4% of GDP in 2050. The debt-to-GDP ratio would consequently increase from around 70% on average in 2000 to some 210% in 2050. On the given assumptions concerning productivity and employment, interest on public debt would thus rise to some 14% of GDP, implying an overall general government budget deficit of more than 20% of GDP.

Given that an unconstrained (and continuing) rise in public debt is clearly unsustainable and indeed unimaginable, at least in times of peace, an alternative scenario would be to

[11] Pension spending includes: old-age pension spending, early retirement pensions within the public pension system (does not include disability or unemployment pensions), survivors and minimum pensions, and social assistance.

explore the conditions for keeping public debt more or less constant over the whole and assume an adaptation of government income and expenditure so as to avoid any increase in the debt-to-GDP ratio.

Keeping the debt-to-GDP ratio constant over the whole period would formally require debt to rise only in line with nominal GDP, that is, the ‘sum’ of the rise in real GDP per person employed and the rate of increase in the GDP deflator. This option would require either increasing taxes so as to finance the projected rise in government spending on pensions and health care or reduce other categories of spending so as to keep the tax rate constant. Another alternative would be to allow the tax rate to increase somewhat today but to build up budgetary reserves as a counterpart to the accrued pension liabilities of the PAYG system. As illustrated in Box 2, borrowed from a report from Gros et al. (2003), an appropriate response could be to run a budget surplus of some size during the early phase of the population ageing process, in order to reduce

Box 2. Criteria for fiscal smoothing

The key assumption is that because of the ageing of the EU population, desired public spending will go up in about 20 years. (Supplementary assumption: a new steady state will start as soon as 2020.)

Standard model:

Social loss is increasing in tax rate (= tax take as % of GDP), denoted by ‘t’, and is increasing in deviation of public expenditure, ‘g’ (again % of GDP) from target ‘G’.

Time is divided into two periods: Period 1 (runs from the present to 2020) and Period 2 (runs from 2020 to infinity, a new steady state).

The core is the usual quadratic social welfare loss function:

(1) Social loss = $[at_1^2 + (g_1 - G_1)^2] + (1+d)^{-1}[at_2^2 + (g_2 - G_2)^2]$

where ‘a’ denotes the weight of taxes in social loss and ‘d’ is the inter-temporal discount factor.

Minimising social loss subject to the budget constraint:

(2) $t_2 = g_2 + (1+r)(g_1 - t_1)$

yields the result that (‘r’ denotes the interest rate, and assuming d=n):

(3) $t_1 = t_2 = t$ and $(g_1 - G_1) = (g_2 - G_2)$

which can be rewritten as:

(4) $(g_1 - t) - (g_2 - t) = G_1 - G_2$

In other words, as it is optimal to keep tax rates constant, it is also optimal to have in the first period a stronger fiscal policy if target expenditure is higher during the second period. What are the magnitudes?

Recent careful estimates suggest that population ageing will lead (*ceteris paribus*) to additional expenditure of 3 to 5% of GDP on average for the eurozone, implying that $G_1 - G_2$ should be worth approximately this value.

What should $(g_2 - t)$ be? The second period should represent the steady state at which the EU economy will settle after 2020. For the reasons explained above it is difficult to imagine a steady state deficit even approaching 3% of GDP after 2020 as the old EU, with a stagnating population is then unlikely to grow quickly, otherwise debt ratios would explode.

If one takes the two figures together, the result is that the optimum would be to have today a surplus of 1-2% of GDP over the next decade to prepare for population ageing.

Source: Gros et al. (2003).

public debt now or build up reserves to be run down later.

In order to illustrate the order of magnitude of the budgetary adjustments required, let us assume that for the EU on average it would be considered appropriate not to exceed a limit of 60% on public debt in proportion to GDP. The key parameter in this equation is then the rate of nominal GDP growth, which will determine the level of the budget deficit compatible with a constant debt-to-GDP ratio. Consequently, the lower the prospective rate of nominal GDP growth, the lower the level of the budget deficit compatible with a constant-debt ratio.

With a plausible rate of nominal GDP growth of, say, 3.5% per year over the coming decades (composed by a real growth rate of 1.5% and a rate of increase in the GDP deflator of 2% per year), the annual, general government budget deficit on average for the EU-15 should not exceed some 2% of GDP. This is about 1 percentage point less than the limit of 3% stipulated in the Maastricht Treaty, implying that the latter threshold, in fact, is not compatible with budgetary sustainability in the long term.

The principal conclusion to draw from this examination is therefore that the SGP in its present formulation is not an appropriate tool for ensuring the sustainability of public finance in the EU in the long term. In fact, by lending a certain degree of credibility to budget balances that can not be maintained in the long term, the SGP may unfortunately contribute to aggravating the sustainability problems already unfolding in several EU member states.

6. Conclusions

An institutional crisis emerged as the result of the ECOFIN Council's failure to 'overcome the obstacle' and take sanctions against France and Germany in accordance with the excessive deficit procedure according to the Treaty's Art. 104, the associated protocol and the Stability and Growth Pact. The crisis can be seen as a symptom of a latent and lasting conflict between two equally valid features of the construction of the European Union:

1. the need to ensure a high degree of consistency, notably in the medium and long term, between monetary and budgetary policy; and
2. the principle of 'subsidiarity', which can be taken as the theological argument for assigning full competence in the field of fiscal affairs and social policy to the national (or regional) governments.

The need to ensure consistency between budgetary and monetary policy can, from the point of view of economic analysis, be based on the argument that in the long term, monetary and budgetary policy cannot be considered to be completely independent policy instruments. There can be little doubt that a prospective building up of public debt in proportion to GDP in the long term will put enormous pressure on monetary policy and make it increasingly costly for the economy to keep inflation under control. The monetary authorities' concern with respect to the long-term sustainability of budget balances of EU member states is therefore legitimate.

The need to ensure a high degree of consistency between budgetary and monetary policy should, however, not be interpreted as an argument in favour of assigning increased discretionary competences to the Council in the field of budgetary policy, at least not in the foreseeable future. Admittedly, views differ with regard to the existence or the gravity of the democratic deficit within the EU's decision-making procedures. Although a large number of directives are adopted by the Council, their implementation most often requires national legislative acts as well. There can be little doubt, however, that assigning discretionary competences with regard to public expenditure and taxation to the Council would run counter to the normal functioning of democratic institutions. Allowing the Council to take *binding* decisions in fiscal affairs would be against the normal assignment of legislative powers to the elected Parliament. At the level of the EU such competences should therefore only be transferred from the national parliaments to the European Parliament. Although such transfers may well take place in a more distant future, this is not to be counted upon as a way to ensure consistency between budgetary and monetary policy.

The Maastricht criteria, the protocol and the SGP do not involve any transfer of discretionary competence to the Council and consequently do not run counter to the normal democratic functioning of the EU institutions. From the point of view of legal status the provisions contained in these acts are equivalent to rules frequently found in federations putting a cap on allowable budget balances or obliging regional authorities to keep expenditure within the limits of available resources. The Treaty provisions and the SGP may therefore be considered an appropriate trade-off between the need to ensure long-term consistency between budgetary and monetary policy and the respect for the principle of subsidiarity.

Yet it may well be argued that the excessive emphasis on the budget deficit as the main criteria for sustainability is a source of ambiguity and is not based on sound economic analysis. Fiscal sustainability is essentially determined by the level and evolution of public debt and not by the level of the budget deficit per se. As shown in the present paper, the sustainability of budgetary policy is the combined effect of the potential rate of GDP growth and the budget balance, and a constant debt-to-GDP ratio may be compatible with different combinations of growth and budget balance. It would therefore be preferable to put a much larger emphasis of the level of public debt in the excessive deficit procedure. Examination of the relevant legal texts and the SGP suggests little or no need for actually changing the wording in order to shift the emphasis from budget deficits to public debt.

Nevertheless, this does not imply that the present excessive deficit procedure is satisfactory – as it seems that sanctions arrive too late in the process and there may now be justification for doubts as to the capacity of the Council to impose such sanctions on one of the peers. It would therefore be desirable to increase the political costs of not complying and possibly to introduce a higher degree of automatic application of sanctions in the EDP, for example by requesting a deposit (as a kind of guarantee) when the Council decides that an excessive deficit exists, which can then be reimbursed when the appropriate measures have been taken.

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Annex 1
The Stability and Growth Pact

The Stability and Growth Pact was agreed on 7 July 1997 and principally consists of two Council regulations. Essentially, the Pact consists of the convergence criteria for the introduction of the single currency, which had been defined in the Maastricht Treaty.

I. Meeting in Madrid in December 1995, the European Council confirmed the crucial importance of securing budgetary discipline in stage three of Economic and Monetary Union (EMU). In Florence, six months later, the European Council reiterated this view and in Dublin, in December 1996, it reached an agreement on the main elements of the Stability and Growth Pact. In stage three of EMU, Member States shall avoid excessive general government deficits: this is a clear Treaty obligation.[12]

The European Council underlines the importance of safeguarding sound government finances as a means to strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. It is also necessary to ensure that national budgetary policies support stability oriented monetary policies. Adherence to the objective of sound budgetary positions close to balance or in surplus will allow all Member States to deal with normal cyclical fluctuations while keeping the government deficit within the 3 per cent of GDP reference value.

II. Meeting in Dublin in December 1996, the European Council requested the preparation of a Stability and Growth Pact to be achieved in accordance with the principles and procedures of the Treaty. This Stability and Growth Pact in no way changes the requirements for participation in stage three of EMU, either in the first group or at a later date. Member States remain responsible for their national budgetary policies, subject to the provisions of the Treaty; they will take the necessary measures in order to meet their responsibilities in accordance with those provisions.

III. The Stability and Growth Pact, which provides both for prevention and deterrence, consists of this resolution and two Council Regulations, one on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies and another on speeding up and clarifying the implementation of the excessive deficit procedure.

IV. The European Council solemnly invites all parties, namely the Member States, the Council and the Commission, to implement the Treaty and the Stability and Growth Pact in a strict and timely manner. This resolution provides firm political guidance to the parties who will implement the Stability and Growth Pact. To this end, the European Council has agreed upon the following guidelines:

The Member States

1. commit themselves to respect the medium-term budgetary objective of close to balance or in surplus set out in their stability or convergence programmes and to take the corrective budgetary action they deem necessary to meet the objectives of their stability or convergence programmes, whenever they have information indicating actual or expected significant divergence from those objectives;

2. are invited to make public, on their own initiative, the Council recommendations made to them in accordance with Article 99(4);

3. commit themselves to take the corrective budgetary action they deem necessary to meet the objectives of their stability or convergence programmes once they receive an early warning in the form of a Council recommendation issued under Article 99(4);

4. will launch the corrective budgetary adjustments they deem necessary without delay on receiving information indicating the risk of an excessive deficit;

[12] † Under Article 5 of Protocol 25, the obligation does not apply to the UK unless it moves to the third stage; the obligation under Article 116(4) to endeavour to avoid excessive deficits shall continue to apply to the UK.

5. will correct excessive deficits as quickly as possible after their emergence; this correction should be completed no later than the year following the identification of the excessive deficit, unless there are special circumstances;

6. are invited to make public, on their own initiative, recommendations made in accordance with Article 104(7);

7. commit themselves not to invoke the benefit of Article 2 paragraph 3 of the Council Regulation on speeding up and clarifying the excessive deficit procedure unless they are in severe recession; in evaluating whether the economic downturn is severe, the Member States will, as a rule, take as a reference point an annual fall in real GDP of at least 0.75%.

The Commission

1. will exercise its right of initiative under the Treaty in a manner that facilitates the strict, timely and effective functioning of the Stability and Growth Pact;

2. will present, without delay, the necessary reports, opinions and recommendations to enable the adoption of Council decisions under Article 99 and Article 104; this will facilitate the effective functioning of the early warning system and the rapid launch and strict application of the excessive deficit procedure;

3. commits itself to prepare a report under Article 104(3) whenever there is the risk of an excessive deficit or whenever the planned or actual government deficit exceeds the 3% of GDP reference value, thereby triggering the procedure under Article 104(3);

4. commits itself, in the event that the Commission considers that a deficit exceeding 3% of GDP is not excessive and this opinion differs from that of the Economic and Financial Committee, to present in writing to the Council the reasons for its position;

5. commits itself, following a request from the Council under Article 115, to make, as a rule, a recommendation for a Council decision on whether an excessive deficit exists under Article 104(6).

The Council

1. is committed to a rigorous and timely implementation of all elements of the stability and growth pact in its competence; it will take the necessary decisions under Article 99 and Article 104 as quickly as is practicable;

2. is urged to regard the deadlines for the application of the excessive deficit procedure as upper limits; in particular, the Council, acting under Article 104(7), shall recommend that excessive deficits will be corrected as quickly as possible after their emergence, no later than the year following their identification, unless there are special circumstances;

3. is invited always to impose sanctions if a participating Member State fails to take the necessary steps to bring the excessive deficit situation to an end as recommended by the Council;

4. is urged always to require a non-interest bearing deposit, whenever the Council decides to impose sanctions on a participating Member State in accordance with Article 104(11);

5. is urged always to convert a deposit into a fine after two years of the decision to impose sanctions in accordance with Article 104(11), unless the excessive deficit has in the view of the Council been corrected;

6. is invited to always state in writing the reasons which justify a decision not to act, if at any stage of the excessive deficit or surveillance of budgetary positions procedures the Council did not act on a Commission recommendation, and, in such a case, to make public the votes cast by each Member State.

Annex 2
The Treaty of Maastricht
Article 104

Article 104 (ex-Article 104c)

1. Member States shall avoid excessive government deficits.

2. The Commission shall monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors. In particular it shall examine compliance with budgetary discipline on the basis of the following two criteria:

(a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, unless:

– either the ratio has declined substantially and continuously and reached a level that comes close to the reference value;

– or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

(b) whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The reference values are specified in the Protocol on the excessive deficit procedure annexed to this Treaty.

3. If a Member State does not fulfil the requirements under one or both of these criteria, the Commission shall prepare a report. The report of the Commission shall also 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.

The Commission may also prepare a report if, notwithstanding the fulfilment of the requirements under the criteria, it is of the opinion that there is a risk of an excessive deficit in a Member State.

4. The Committee provided for in Article 114 shall formulate an opinion on the report of the Commission.

5. If the Commission considers that an excessive deficit in a Member State exists or may occur, the Commission shall address an opinion to the Council.

6. The Council shall, acting by a qualified majority on a recommendation from the Commission, and having considered any observations which the Member State concerned may wish to make, decide after an overall assessment whether an excessive deficit exists.

7. Where the existence of an excessive deficit is decided according to paragraph 6, the Council shall make recommendations to the Member State concerned with a view to bringing that situation to an end within a given period. Subject to the provisions of paragraph 8, these recommendations shall not be made public.

8. Where it establishes that there has been no effective action in response to its recommendations within the period laid down, the Council may make its recommendations public.

9. If a Member State persists in failing to put into practice the recommendations of the Council, the Council may decide to give notice to the Member State to take, within a specified time-limit, measures for the deficit reduction which is judged necessary by the Council in order to remedy the situation.

In such a case, the Council may request the Member State concerned to submit reports in accordance with a specific timetable in order to examine the adjustment efforts of that Member State.

10. The rights to bring actions provided for in Articles 226 and 227 may not be exercised within the framework of paragraphs 1 to 9 of this Article.

11. As long as a Member State fails to comply with a decision taken in accordance with paragraph 9, the Council may decide to apply or, as the case may be, intensify one or more of the following measures:

– to require the Member State concerned to publish additional information, to be specified by the Council, before issuing bonds and securities;

– to invite the European Investment Bank to reconsider its lending policy towards the Member State concerned;

– to require the Member State concerned to make a non-interest bearing deposit of an appropriate size with the Community until the excessive deficit has, in the view of the Council, been corrected;

– to impose fines of an appropriate size.

The President of the Council shall inform the European Parliament of the decisions taken.

12. The Council shall abrogate some or all of its decisions referred to in paragraphs 6 to 9 and 11 to the extent that the excessive deficit in the Member State concerned has, in the view of the Council, been corrected. If the Council has previously made public recommendations, it shall, as soon as the decision under paragraph 8 has been abrogated, make a public statement that an excessive deficit in the Member State concerned no longer exists.

13. When taking the decisions referred to in paragraphs 7 to 9, 11 and 12, the Council shall act on a recommendation from the Commission by a majority of two thirds of the votes of its members weighted in accordance with Article 205(2), excluding the votes of the representative of the Member State concerned.

14. Further provisions relating to the implementation of the procedure described in this Article are set out in the Protocol on the excessive deficit procedure annexed to this Treaty.

The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the ECB, adopt the appropriate provisions which shall then replace the said Protocol.

Subject to the other provisions of this paragraph, the Council shall, before 1 January 1994, acting by a qualified majority on a proposal from the Commission and after consulting the European Parliament, lay down detailed rules and definitions for the application of the provisions of the said Protocol.

Annex 3
Protocol on the Excessive Deficit Procedure

Origin: Treaty of Maastricht.
Protocol annexed to the Treaty establishing the European Community.

THE HIGH CONTRACTING PARTIES,

DESIRING to lay down the details of the excessive deficit procedure referred to in Article 104 of the Treaty establishing the European Community,

HAVE AGREED upon the following provisions, which shall be annexed to the Treaty establishing the European Community.

Article 1

The reference values referred to in Article 104(2) of this Treaty are:

– 3% for the ratio of the planned or actual government deficit to gross domestic product at market prices;

– 60% for the ratio of government debt to gross domestic product at market prices.

Article 2

In Article 104 of this Treaty and in this Protocol:

– government means general government, that is central government, regional or local government and social security funds, to the exclusion of commercial operations, as defined in the European System of Integrated Economic Accounts;

– deficit means net borrowing as defined in the European System of Integrated Economic Accounts;

– investment means gross fixed capital formation as defined in the European System of Integrated Economic Accounts;

– debt means total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government as defined in the first indent.

Article 3

In order to ensure the effectiveness of the excessive deficit procedure, the governments of the Member States shall be responsible under this procedure for the deficits of general government as defined in the first indent of Article 2. The Member States shall ensure that national procedures in the budgetary area enable them to meet their obligations in this area deriving from this Treaty. The Member States shall report their planned and actual deficits and the levels of their debt promptly and regularly to the Commission.

Article 4

The statistical data to be used for the application of this Protocol shall be provided by the Commission.

Annex 4
Council Regulation (EC) No. 1466/97 of 7 July 1997

COUNCIL REGULATION (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies

THE COUNCIL OF THE EUROPEAN UNION, Having regard to the Treaty establishing the European Community, and in particular Article 103 (5) thereof, Having regard to the proposal from the Commission (1), Acting in accordance with the procedure referred to in Article 189c of the Treaty (2),

(1) Whereas the Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation;

(2) Whereas the Stability and Growth Pact consists of this Regulation which aims to strengthen the surveillance of budgetary positions and the surveillance and coordination of economic policies, of Council Regulation (EC) No 1467/97 (3) which aims to speed up and to clarify the implementation of the excessive deficit procedure and of the Resolution of the European Council of 17 June 1997 on the Stability and Growth Pact (4), in which, in accordance with Article D of the Treaty on European Union, firm political guidelines are issued in order to implement the Stability and Growth Pact in a strict and timely manner and in particular to adhere to the medium term objective of budgetary positions of close to balance or in surplus, to which all Member States are committed, and to take the corrective budgetary action they deem necessary to meet the objectives of their stability and convergence programmes, whenever they have information indicating actual or expected significant divergence from the medium-term budgetary objective;

(3) Whereas in stage three of Economic and Monetary Union (EMU) the Member States are, according to Article 104c of the Treaty, under a clear Treaty obligation to avoid excessive general government deficits; whereas under Article 5 of Protocol (No 11) on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland to the Treaty, Article 104c(1) does not apply to the United Kingdom unless it moves to the third stage; whereas the obligation under Article 109e(4) to endeavour to avoid excessive deficits will continue to apply to the United Kingdom;

(4) Whereas adherence to the medium-term objective of budgetary positions close to balance or in surplus will allow Member States to deal with normal cyclical fluctuations while keeping the government deficit within the 3 % of GDP reference value;

(5) Whereas it is appropriate to complement the multilateral surveillance procedure of Article 103 (3) and (4) with an early warning system, under which the Council will alert a Member State at an early stage to the need to take the necessary budgetary corrective action in order to prevent a government deficit becoming excessive;

(6) Whereas the multilateral surveillance procedure of Article 103 (3) and (4) should furthermore continue to monitor the full range of economic developments in each of the Member States and in the Community as well as the consistency of economic policies with the broad economic guidelines referred to in Article 103 (2); whereas for the monitoring of these developments, the presentation of information in the form of stability and convergence programmes is appropriate;

(7) Whereas there is a need to build upon the useful experience gained during the first two stages of economic and monetary union with convergence programmes;

(8) Whereas the Member States adopting the single currency, hereafter referred to as ‘participating Member States’, will, in accordance with Article 109j, have achieved a high degree of sustainable convergence and in particular a sustainable government financial position; whereas the maintenance of

sound budgetary positions in these Member States will be necessary to support price stability and to strengthen the conditions for the sustained growth of output and employment; whereas it is necessary that participating Member States submit medium-term programmes, hereafter referred to as 'stability programmes'; whereas it is necessary to define the principal contents of such programmes;

(9) Whereas the Member States not adopting the single currency, hereafter referred to as 'non-participating Member States', will need to pursue policies aimed at a high degree of sustainable convergence; whereas it is necessary that these Member States submit medium-term programmes, hereafter referred to as 'convergence programmes'; whereas it is necessary to define the principal contents of such convergence programmes;

(10) Whereas in its Resolution of 16 June 1997 on the establishment of an exchange-rate mechanism in the third stage of Economic and Monetary Union, the European Council issued firm political guidelines in accordance with which an exchange-rate mechanism is established in the third stage of EMU, hereafter referred to as 'ERM2'; whereas the currencies of non-participating Member States joining ERM2 will have a central rate vis-à-vis the euro, thereby providing a reference point for judging the adequacy of their policies; whereas the ERM2 will also help to protect them and the Member States adopting the euro from unwarranted pressures in the foreign-exchange markets; whereas, so as to enable appropriate surveillance in the Council, non-participating Member States not joining ERM2 will nevertheless present policies in their convergence programmes oriented to stability thus avoiding real exchange rate misalignments and excessive nominal exchange rate fluctuations;

(11) Whereas lasting convergence of economic fundamentals is a prerequisite for sustainable exchange rate stability;

(12) Whereas it is necessary to lay down a timetable for the submission of stability programmes and convergence programmes and their updates;

(13) Whereas in the interest of transparency and informed public debate it is necessary that Member States make public their stability programmes and their convergence programmes;

(14) Whereas the Council, when examining and monitoring the stability programmes and the convergence programmes and in particular their medium-term budgetary objective or the targeted adjustment path towards this objective, should take into account the relevant cyclical and structural characteristics of the economy of each Member State;

(15) Whereas in this context particular attention should be given to significant divergences of budgetary positions from the budgetary objectives of being close to balance or in surplus; whereas it is appropriate for the Council to give an early warning in order to prevent a government deficit in a Member State becoming excessive; whereas in the event of persistent budgetary slippage it will be appropriate for the Council to reinforce its recommendation and make it public; whereas for non-participating Member States the Council may make recommendations on action to be taken to give effect to their convergence programmes;

(16) Whereas both convergence and stability programmes lead to the fulfilment of the conditions of economic convergence referred to in Article 104c,

HAS ADOPTED THIS REGULATION:

SECTION 1 PURPOSE AND DEFINITIONS

Article 1

This Regulation sets out the rules covering the content, the submission, the examination and the monitoring of stability programmes and convergence programmes as part of multilateral surveillance by the Council so as to prevent, at an early stage, the occurrence of excessive general government deficits and to promote the surveillance and coordination of economic policies.

Article 2

For the purpose of this Regulation 'participating Member States' shall mean those Member States which adopt the single currency in accordance with the Treaty and 'non-participating Member States' shall mean those which have not adopted the single currency.

SECTION 2 STABILITY PROGRAMMES

Article 3

1. Each participating Member State shall submit to the Council and Commission information necessary for the purpose of multilateral surveillance at regular intervals under Article 103 of the Treaty in the form of a stability programme, which provides an essential basis for price stability and for strong sustainable growth conducive to employment creation.

2. A stability programme shall present the following information:

(a) the medium-term objective for the budgetary position of close to balance or in surplus and the adjustment path towards this objective for the general government surplus/deficit and the expected path of the general government debt ratio;

(b) the main assumptions about expected economic developments and important economic variables which are relevant to the realization of the stability programme such as government investment expenditure, real gross domestic product (GDP) growth, employment and inflation;

(c) a description of budgetary and other economic policy measures being taken and/or proposed to achieve the objectives of the programme, and, in the case of the main budgetary measures, an assessment of their quantitative effects on the budget;

(d) an analysis of how changes in the main economic assumptions would affect the budgetary and debt position.

3. The information about paths for the general government surplus/deficit ratio and debt ratio and the main economic assumptions referred to in paragraph 2 (a) and (b) shall be on an annual basis and shall cover, as well as the current and preceding year, at least the following three years.

Article 4

1. Stability programmes shall be submitted before 1 March 1999. Thereafter, updated programmes shall be submitted annually. A Member State adopting the single currency at a later stage shall submit a stability programme within six months of the Council Decision on its participation in the single currency.

2. Member States shall make public their stability programmes and updated programmes.

Article 5

1. Based on assessments by the Commission and the Committee set up by Article 109c of the Treaty, the Council shall, within the framework of multilateral surveillance under Article 103, examine whether the medium-term budget objective in the stability programme provides for a safety margin to ensure the avoidance of an excessive deficit, whether the economic assumptions on which the programme is based are realistic and whether the measures being taken and/or proposed are sufficient to achieve the targeted adjustment path towards the medium-term budgetary objective.

The Council shall furthermore examine whether the contents of the stability programme facilitate the closer coordination of economic policies and whether the economic policies of the Member State concerned are consistent with the broad economic policy guidelines.

2. The Council shall carry out the examination of the stability programme referred to in paragraph 1 within at most two months of the submission of the programme. The Council, on a recommendation from the Commission and after consulting the Committee set up by Article 109c, shall deliver an

opinion on the programme. Where the Council, in accordance with Article 103, considers that the objectives and contents of a programme should be strengthened, the Council shall, in its opinion, invite the Member State concerned to adjust its programme.

3. Updated stability programmes shall be examined by the Committee set up by Article 109c on the basis of assessments by the Commission; if necessary, updated programmes may also be examined by the Council in accordance with the procedure set out in paragraphs 1 and 2 of this Article.

Article 6

1. As part of multilateral surveillance in accordance with Article 103 (3), the Council shall monitor the implementation of stability programmes, on the basis of information provided by participating Member States and of assessments by the Commission and the Committee set up by Article 109c, in particular with a view to identifying actual or expected significant divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, as set in the programme for the government surplus/deficit.

2. In the event that the Council identifies significant divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, it shall, with a view to giving early warning in order to prevent the occurrence of an excessive deficit, address, in accordance with Article 103 (4), a recommendation to the Member State concerned to take the necessary adjustment measures.

3. In the event that the Council in its subsequent monitoring judges that the divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, is persisting or worsening, the Council shall, in accordance with Article 103 (4), make a recommendation to the Member State concerned to take prompt corrective measures and may, as provides in that Article, make its recommendation public.

SECTION 3 CONVERGENCE PROGRAMMES

Article 7

1. Each non-participating Member State shall submit to the Council and the Commission information necessary for the purpose of multilateral surveillance of regular intervals under Article 103 in the form of a convergence programme, which provides an essential basis for price stability and for strong sustainable growth conducive to employment creation.

2. A convergence programme shall present the following information in particular on variables related to convergence:

(a) the medium-term objective for the budgetary position of close to balance or in surplus and the adjustment path towards this objective for the general government surplus/deficit; the expected path for the general government debt ratio; the medium-term monetary policy objectives; the relationship of those objectives to price and exchange rate stability;

(b) the main assumptions about expected economic developments and important economic variables which are relevant to the realization of the convergence programme, such as government investment expenditure, real GDP growth, employment and inflation;

(c) a description of budgetary and other economic policy measures being taken and/or proposed to achieve the objectives of the programme, and, in the case of the main budgetary measures, an assessment of their quantitative effects on the budget;

(d) an analysis of how changes in the main economic assumptions would affect the budgetary and debt position.

3. The information about paths for the general government surplus/deficit ratio, debt ratio and the main economic assumptions referred to in paragraph 2 (a) and (b) shall be on an annual basis and shall cover, as well as the current and preceding year, at least the following three years.

Article 8

1. Convergence programmes shall be submitted before 1 March 1999. Thereafter, updated programmes shall be submitted annually.

2. Member States shall make public their convergence programmes and updated programmes.

Article 9

1. Based on assessments by the Commission and the Committee set up by Article 109c of the Treaty, the Council shall, within the framework of multilateral surveillance under Article 103, examine whether the medium-term budget objective in the convergence programme provides for a safety margin to ensure the avoidance of an excessive deficit, whether the economic assumptions on which the programme is based are realistic and whether the measures being taken and/or proposed are sufficient to achieve the targeted adjustment path towards the medium-term objective and to achieve sustained convergence.

The Council shall furthermore examine whether the contents of the convergence programme facilitate the closer coordination of economic policies and whether the economic policies of the Member State concerned are consistent with the broad economic policy guidelines.

2. The Council shall carry out the examination of the convergence programme referred to in paragraph 1 within at most two months of the submission of the programme. The Council, on a recommendation from the Commission and after consulting the Committee set up by Article 109c, shall deliver an opinion on the programme. Where the Council, in accordance with Article 103, considers that the objectives and contents of a programme should be strengthened, the Council shall, in its opinion, invite the Member State concerned to adjust its programme.

3. Updated convergence programmes shall be examined by the Committee set up by Article 109c on the basis of assessments by the Commission; if necessary, updated programmes may also be examined by the Council in accordance with the procedure set out in paragraphs 1 and 2 of this Article.

Article 10

1. As part of multilateral surveillance in accordance with Article 103 (3), the Council shall monitor the implementation of convergence programmes on the basis of information provided by non-participating Member States in accordance with Article 7 (2) (a) of this Regulation and of assessments by the Commission and the Committee set up by Article 109c of the Treaty, in particular with a view to identifying actual or expected significant divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, as set in the programme for the government surplus/deficit.

In addition, the Council shall monitor the economic policies of non-participating Member States in the light of convergence programme objectives with a view to ensure that their policies are geared to stability and thus to avoid real exchange rate misalignments and excessive nominal exchange rate fluctuations.

2. In the event that the Council identifies significant divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, it shall, with a view to given early warning in order to prevent the occurrence of an excessive deficit, address in accordance with Article 103 (4), a recommendation to the Member State concerned to take the necessary adjustment measures.

3. In the event that the Council in its subsequent monitoring judges that the divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, is

persisting or worsening, the Council shall, in accordance with Article 103 (4), make a recommendation to the Member State concerned to take prompt corrective measures and may, as provided in that Article, make its recommendation public.

SECTION 4 COMMON PROVISIONS

Article 11

As part of the multilateral surveillance described in this Regulation, the Council shall carry out the overall assessment described in Article 103 (3).

Article 12

In accordance with the second subparagraph of Article 103 (4) the President of the Council and the Commission shall include in their report to the European Parliament the results of the multilateral surveillance carried out under this Regulation.

Article 13

This Regulation shall enter into force on 1 July 1998.
This Regulation shall be binding in its entirety and directly applicable in all Member States.
Done at Brussels, 7 July 1997
For the Council

The President
J.-C. JUNCKER

(1) OJ No C 368, 6. 12. 1996, p. 9.

(2) Opinion of the European Parliament of 28 November 1996 (OJ No C 380, 16. 12. 1996, p. 28), Council Common Position of 14 April 1997 (OJ No C 146, 30. 5. 1997, p. 26) and Decision of the European Parliament of 29 May 1997 (OJ No C 182, 16. 6. 1997).

(3) See p. 6 of this Official Journal

Annex 5
Council Regulation
(EC) No. 1467/97 of 7 July 1997

COUNCIL REGULATION (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular the second subparagraph of Article 104c (14) thereof,

Having regard to the proposal from the Commission (1),

Having regard to the opinion of the European Parliament (2),

Having regard to the opinion of the European Monetary Institute,

(1) Whereas it is necessary to speed up and to clarify the excessive deficit procedure set out in Article 104c of the Treaty in order to deter excessive general government deficits and, if they occur, to further their prompt correction; whereas the provisions of this Regulation, which are to the above effect and adopted under Article 104c (14) second subparagraph, constitute, together with those of Protocol (No 5) to the Treaty, a new integrated set of rules for the application of Article 104c;

(2) Whereas the Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation;

(3) Whereas the Stability and Growth Pact consists of this Regulation, of Council Regulation (EC) No 1466/97 (3) which aims to strengthen the surveillance of budgetary positions and the surveillance and coordination of economic policies and of the Resolution of the European Council of 17 June 1997 on the Stability and Growth Pact (4), in which, in accordance with Article D of the Treaty on European Union, firm political guidelines are issued in order to implement the Stability and Growth Pact in a strict and timely manner and in particular to adhere to the medium term objective for budgetary positions of close to balance or in surplus, to which all Member States are committed, and to take the corrective budgetary action they deem necessary to meet the objectives of their stability and convergence programmes, whenever they have information indicating actual or expected significant divergence from the medium-term budgetary objective;

(4) Whereas in stage three of Economic and Monetary Union (EMU) the Member States are, according to Article 104c of the Treaty, under a clear Treaty obligation to avoid excessive government deficits; whereas under Article 5 of Protocol (No 11) to the Treaty, paragraphs 1, 9 and 11 of Article 104c do not apply to the United Kingdom unless it moves to the third stage; whereas the obligation under Article 109e (4) to endeavour to avoid excessive deficits will continue to apply to the United Kingdom;

(5) Whereas Denmark, referring to paragraph 1 of Protocol (No 12) to the Treaty has notified, in the context of the Edinburgh decision of 12 December 1992, that it will not participate in the third stage; whereas, therefore, in accordance with paragraph 2 of the said Protocol, paragraphs 9 and 11 of Article 104c shall not apply to Denmark;

(6) Whereas in stage three of EMU Member States remain responsible for their national budgetary policies, subject to the provisions of the Treaty; whereas the Member States will take the necessary measures in order to meet their responsibilities in accordance with the provisions of the Treaty;

(7) Whereas adherence to the medium-term objective of budgetary positions close to balance or in surplus to which all Member States are committed, contributes to the creation of the appropriate

conditions for price stability and for sustained growth conducive to employment creation in all Member States and will allow them to deal with normal cyclical fluctuations while keeping the government deficit within the 3% of GDP reference value;

(8) Whereas for EMU to function properly, it is necessary that convergence of economic and budgetary performances of Member States which have adopted the single currency, hereafter referred to as 'participating Member States', proves stable and durable; whereas budgetary discipline is necessary in stage three of EMU to safeguard price stability;

(9) Whereas according to Article 109k (3) Articles 104c (9) and (11) only apply to participating Member States;

(10) Whereas it is necessary to define the concept of an exceptional and temporary excess over the reference value as referred to in Article 104c (2) (a); whereas the Council should in this context, inter alia, take account of the pluriannual budgetary forecasts provided by the Commission;

(11) Whereas a Commission report in accordance with Article 104c (3) is also to 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;

(12) Whereas there is a need to establish deadlines for the implementation of the excessive deficit procedure in order to ensure its expeditious and effective implementation; whereas it is necessary in this context to take account of the fact that the budgetary year of the United Kingdom does not coincide with the calendar year;

(13) Whereas there is a need to specify how the sanctions provided for in Article 104c could be imposed in order to ensure the effective implementation of the excessive deficit procedure;

(14) Whereas reinforced surveillance under the Council Regulation (EC) No 1466/97 together with the Commission's monitoring of budgetary positions in accordance with paragraph 2 of Article 104c should facilitate the effective and rapid implementation of the excessive deficit procedure;

(15) Whereas in the light of the above, in the event that a participating Member State fails to take effective action to correct an excessive deficit, an overall maximum period of ten months from the reporting date of the figures indicating the existence of an excessive deficit until the decision to impose sanctions, if necessary, seems both feasible and appropriate in order to exert pressure on the participating Member State concerned to take such action; in this event, and if the procedure starts in March, this would lead to sanctions being imposed within the calendar year in which the procedure had been started;

(16) Whereas the Council recommendation for the correction of an excessive deficit or the later steps of the excessive deficit procedure, should have been anticipated by the Member State concerned, which would have had an early warning; whereas the seriousness of an excessive deficit in stage three should call for urgent action from all those involved;

(17) Whereas it is appropriate to hold the excessive deficit procedure in abeyance if the Member State concerned takes appropriate action in response to a recommendation under Article 104c (7) or a notice issued under Article 104c (9) in order to provide an incentive to Member States to act accordingly; whereas the time period during which the procedure would be held in abeyance should not be included in the maximum period of ten months between the reporting date indicating the existence of an excessive deficit and the imposition of sanctions; whereas it is appropriate to resume the procedure immediately if the envisaged action is not being implemented or if the implemented action is proving to be inadequate;

(18) Whereas, in order to ensure that the excessive deficit procedure has a sufficient deterrent effect, a non-interest-bearing deposit of an appropriate size should be required from the participating Member State concerned, whenever the Council decides to impose a sanction;

(19) Whereas the definition of sanctions on a prescribed scale is conducive to legal certainty; whereas it is appropriate to relate the amount of the deposit to the GDP of the participating Member State concerned;

(20) Whereas, whenever the imposition of a non-interest-bearing deposit does not induce the participating Member State concerned to correct its excessive deficit in due time, it is appropriate to intensify the sanctions; whereas it is then appropriate to transform the deposit into a fine;

(21) Whereas appropriate action by the participating Member State concerned in order to correct its excessive deficit is the first step towards abrogation of sanctions; whereas significant progress in correcting the excessive deficit should allow for the lifting of sanctions in accordance with paragraph 12 of Article 104c; whereas the abrogation of all outstanding sanctions should only occur once the excessive deficit has been totally corrected;

(22) Whereas Council Regulation (EC) No 3605/93 of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community (5) contains detailed rules for the reporting of budgetary data by Member States;

(23) Whereas, according to Article 109f (8), where the Treaty provides for a consultative role for the European Central Bank (ECB), references to the ECB shall be read as referring to the European Monetary Institute before the establishment of the ECB,

HAS ADOPTED THIS REGULATION:

SECTION 1
DEFINITIONS AND ASSESSMENTS

Article 1

1. This Regulation sets out the provisions to speed up and clarify the excessive deficit procedure, having as its objective to deter excessive general government deficits and, if they occur, to further their prompt correction.

2. For the purpose of this Regulation 'participating Member States' shall mean those Member States which adopt the single currency in accordance with the Treaty and 'non-participating Member States' shall mean those which have not adopted the single currency.

Article 2

1. The excess of a government deficit over the reference value shall be considered exceptional and temporary, in accordance with Article 104c(2) (a), second indent, when resulting from an unusual event outside the control of the Member State concerned and which has a major impact on the financial position of the general government, or when resulting from a severe economic downturn.

In addition, the excess over the reference value shall be considered temporary if budgetary forecasts as provided by the Commission indicate that the deficit will fall below the reference value following the end of the unusual event or the severe economic downturn.

2. The Commission when preparing a report under Article 104c (3) shall, as a rule, consider an excess over the reference value resulting from a severe economic downturn to be exceptional only if there is an annual fall of real GDP of at least 2%.

3. The Council when deciding, according to Article 104c (6), whether an excessive deficit exists, shall in its overall assessment take into account any observations made by the Member State showing that an annual fall of real GDP of less than 2% is nevertheless exceptional in the light of further supporting evidence, in particular on the abruptness of the downturn or on the accumulated loss of output relative to past trends.

SECTION 2
SPEEDING UP THE EXCESSIVE DEFICIT PROCEDURE

Article 3

1. Within two weeks of the adoption by the Commission of a report issued in accordance with Article 104c (3), the Economic and Financial Committee shall formulate an opinion in accordance with Article 104c (4).

2. Taking fully into account the opinion referred to in paragraph 1, the Commission, if it considers that an excessive deficit exists, shall address an opinion and a recommendation to the Council in accordance with Article 104c (5) and (6).

3. The Council shall decide on the existence of an excessive deficit in accordance with Article 104c (6), within three months of the reporting dates established in Article 4 (2) and (3) of Regulation (EC) No 3605/93. When it decides, in accordance with Article 104c (6), that an excessive deficit exists, the Council shall at the same time make recommendations to the Member State concerned in accordance with Article 104c (7).

4. The Council recommendation made in accordance with Article 104c (7) shall establish a deadline of four months at the most for effective action to be taken by the Member State concerned. The Council recommendation shall also establish a deadline for the correction of the excessive deficit, which should be completed in the year following its identification unless there are special circumstances.

Article 4

1. Any Council decision to make public its recommendations, where it is established that no effective action has been taken in accordance with Article 104c (8), shall be taken immediately after the expiry of the deadline set in accordance with Article 3 (4) of this Regulation.

2. The Council, when considering whether effective action has been taken in response to its recommendations made in accordance with Article 104c (7), shall base its decision on publicly announced decisions by the Government of the Member State concerned.

Article 5

Any Council decision to give notice to the participating Member State concerned to take measures for the deficit reduction in accordance with Article 104c (9) shall be taken within one month of the Council decision establishing that no effective action has been taken in accordance with Article 104c (8).

Article 6

Where the conditions to apply Article 104c (11) are met, the Council shall impose sanctions in accordance with Article 104c (11). Any such decision shall be taken no later than two months after the Council decision giving notice to the participating Member State concerned to take measures in accordance with Article 104c (9).

Article 7

If a participating Member State fails to act in compliance with the successive decisions of the Council in accordance with Article 104c (7) and (9), the decision of the Council to impose sanctions, in accordance with paragraph 11 of Article 104c, shall be taken within ten months of the reporting dates pursuant to Regulation (EC) No 3605/93 as referred to in Article 3 (3) of this Regulation. An expedited procedure shall be used in the case of a deliberately planned deficit which the Council decides is excessive.

Article 8

Any Council decision to intensify sanctions, in accordance with Article 104c (11), other than the conversion of deposits into fines under Article 14 of this Regulation, shall be taken no later than two months after the reporting dates pursuant to Regulation (EC) No 3605/93. Any Council decision to abrogate some or all of its decisions in accordance with Article 104c (12) shall be taken as soon as possible and in any case no later than two months after the reporting dates pursuant to Regulation (EC) No 3605/93.

SECTION 3
ABEYANCE AND MONITORING

Article 9

1. The excessive deficit procedure shall be held in abeyance:

- if the Member State concerned acts in compliance with recommendations made in accordance with Article 104c (7),

- if the participating Member State concerned acts in compliance with notices given in accordance with Article 104c (9).

2. The period during which the procedure is held in abeyance shall be included neither in the ten month period referred to in Article 7 nor in the two month period referred to in Article 6 of this Regulation.

Article 10

1. The Commission and the Council shall monitor the implementation of action taken:

- by the Member State concerned in response to recommendations made under Article 104c (7),

- by the participating Member State concerned in response to notices given under Article 104c (9).

2. If action by a participating Member State is not being implemented or, in the Council's view, is proving to be inadequate, the Council shall immediately take a decision under Article 104c (9) or Article 104c (11) respectively.

3. If actual data pursuant to Regulation (EC) No 3605/93 indicate that an excessive deficit has not been corrected by a participating Member State within the time limits specified either in recommendations issued under Article 104c (7) or notices issued under Article 104c (9), the Council shall immediately take a decision under Article 104c (9) or Article 104c (11) respectively.

SECTION 4
SANCTIONS

Article 11

Whenever the Council decides to apply sanctions to a participating Member State in accordance with Article 104c (11), a non-interest-bearing deposit shall, as a rule, be required. The Council may decide to supplement this deposit by the measures provided for in the first and second indents of Article 104c (11).

Article 12

1. When the excessive deficit results from non-compliance with the criterion relating to the government deficit ration in Article 104c (2) (a), the amount of the first deposit shall comprise a fixed component equal to 0.2% of GDP, and a variable component equal to one tenth of the difference between the deficit as a percentage of GDP in the preceding year and the reference value of 3% of GDP.

2. Each following year, until the decision on the existence of an excessive deficit is abrogated, the Council shall assess whether the participating Member State concerned has taken effective action in response to the Council notice in accordance with Article 104c (9). In this annual assessment the Council shall decide, in accordance with Article 104c (11), and without prejudice to Article 13 of this Regulation, to intensify the sanctions, unless the participating Member State concerned has complied with the Council notice. If an additional deposit is decided, it shall be equal to one tenth of the difference between the deficit as a percentage of GDP in the preceding year and the reference value of 3% of GDP.

3. Any single deposit referred to in paragraphs 1 and 2 shall not exceed the upper limit of 0.5% of GDP.

Article 13

A deposit shall, as a rule, be converted by the Council, in accordance with Article 104c (11), into a fine if two years after the decision to require the participating Member State concerned to make a deposit, the excessive deficit has in the view of the Council not been corrected.

Article 14

1. In accordance with Article 104c (12), the Council shall abrogate the sanctions referred to in the first and second indents of Article 104c (11) depending on the significance of the progress made by the participating Member State concerned in correcting the excessive deficit.

Article 15

In accordance with Article 104c (12), the Council shall abrogate all outstanding sanctions if the decision on the existence of an excessive deficit is abrogated. Fines imposed in accordance with Article 13 of this Regulation will not be reimbursed to the participating Member State concerned.

Article 16

Deposits referred to in Articles 11 and 12 of this Regulation shall be lodged with the Commission. Interest on the deposits, and the fines referred to in Article 13 of this Regulation constitute other revenue referred to in Article 201 of the Treaty and shall be distributed among participating Member States without a deficit that is excessive as determined in accordance with Article 104c (6) in proportion to their share in the total GNP of the eligible Member States.

SECTION 5
TRANSITIONAL AND FINAL PROVISIONS

Article 17

For the purpose of this Regulation and for as long as the United Kingdom has a budgetary year which is not a calendar year, the provisions of sections 2, 3 and 4 of this Regulation shall be applied to the United Kingdom in accordance with the Annex.

Article 18

This Regulation shall enter into force on 1 January 1999.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 7 July 1997.
For the Council

The President
J.-C. JUNCKER

(1) OJ No C 368, 6. 12. 1996, p. 12.
(2) OJ No C 380, 16. 12. 1996, p. 29.
(3) See p. 1 of this Official Journal.
(4) OJ No C 236, 2. 8. 1997, p. 1
(5) OJ No L 332, 31. 12. 1993, p. 7.

ANNEX

TIME LIMITS APPLICABLE TO THE UNITED KINGDOM

1. In order to ensure equal treatment of all Member States, the Council, when taking decisions in Sections 2, 3 and 4 of this Regulation, shall have regard to the different budgetary year of the budgetary year of the United Kingdom, with a view to taking decisions with regard to the United Kingdom at a point in its budgetary year similar to that at which decisions have been or will be taken in the case of other Member States.

2. For the provisions specified in Column I below there shall be substituted the provisions specified in Column II.