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Public Finances in EMU - 2007

Ensuring the effectiveness of the preventive arm of the SGP

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I. INTRODUCTION

Surveillance and co-ordination of economic and budgetary policies in Member States is a requirement of the Treaty. The Stability and Growth Pact (SGP) develops the provisions of the Treaty into a set of commonly agreed rules, principles and procedures that contribute to the design, the surveillance and the co-ordination of budgetary policies in the EU Member States. The SGP includes a preventive part and a corrective part. Its functioning depends on whether deficits are considered excessive or not. In the former case, the excessive deficit procedure foresees pre-defined and codified corrective actions, recommendations and sanctions, which serve its deterrent function. The functioning under the preventive arm of the SGP, the aims of which are to avoid the occurrence of excessive deficits and ensure fiscal and economic coordination in the EU, is different. The preventive arm, although relying on a combination of numerical and procedural rules as the corrective part, focuses mainly on medium-term planning, peer support and pressure and exchanges of best practices. To function effectively, it requires a common understanding of the economic and fiscal policy challenges in the EU, and a strong political commitment to address them.

One of the central objectives of both the Commission and the Council in the 2005 SGP reform was to strengthen the preventive dimension of the Pact. This was achieved by increasing the economic rationale of the rules and favouring policies that create room for automatic stabilisation of output, ensure the sustainability of government finances, and improve their quality and efficiency. The revised SGP no longer requires Member States to aim for a uniform close-to-balance fiscal position in the medium term. Rather, differentiated medium-term objectives (MTOs) are set for each Member State, taking into account country-specific circumstances. The SGP reform introduced provisions to ensure that fiscal policies are symmetric over the cycle and that fiscal consolidation continues in the years following the correction of excessive deficits. In particular, it specified that Member States in the euro area or participating in ERM-II should pursue an annual structural adjustment of 0.5 percent of GDP as a benchmark. Finally, the reform eliminated possible disincentives to undertake structural reforms and placed more emphasis on debt and long-term sustainability in budgetary surveillance.

This Communication reviews the recent budgetary developments and functioning of the EU fiscal framework. It underlines the smooth implementation of excessive deficit procedures in the recent period but also notes some deviations from the policy rules of the preventive arm of the SGP. Now that most EU countries have just corrected or are about to correct their excessive deficit, the challenge is to use the opportunity offered by the current favourable cyclical conditions to move swiftly towards the MTOs. The provisions of the revised SGP therefore need to be applied effectively and some aspects of the 2005 SGP reform need to be further developed.

This Communication formulates concrete proposals to this end, on the basis of best practice in the EU countries. These proposals are fully in line with the spirit of the political agreement of the 2005 SGP reform, and can all be applied under the current legislation. They aim to strengthen the credibility and national ownership of medium-term targets included in the Stability and Convergence Programmes and suggest putting the surveillance of fiscal policy in a broader economic perspective, in line with the renewed Lisbon Strategy for Jobs and Growth.

II. RECENT BUDGETARY DEVELOPMENTS CALL FOR STEPS TO BE TAKEN TO ENSURE THE EFFECTIVE FUNCTIONING OF THE PREVENTIVE ARM OF THE SGP

The improvement in government finances continues

In 2006 the budgetary situation continued to improve in the EU and in the euro area. Against the background of favourable economic conditions – real GDP growth reached 3.0% in 2006 in the EU, up from 1.7% in 2005 – the EU government deficit was reduced from 2.4% of GDP in 2005 to 1.7% of GDP in 2006. The debt ratio recorded its first decline since 2002 in both the EU and the euro area. Moreover, the improvement in the overall budgetary situation was marked for the second consecutive year by a significant reduction in the structural deficit (0.9 percentage point of GDP), i.e. the government deficit net of cyclical factors and one-off and temporary measures. According to Commission calculations, the structural deficit in the EU was reduced from nearly 3% of GDP in 2004 to below 1½% of GDP in 2006.

The reduction of the government deficit in 2006 was notably driven by large positive surprises in tax revenue developments. It is estimated that the larger-than-planned increase in government revenue contributed to an improvement in the government balance by about one percentage point of GDP compared to plans formulated by Member States in the end-November 2005 updates of the Stability and Convergence Programmes (SCPs). In the meantime, however, government expenditure also increased faster than planned in a number of EU countries. Such developments cast doubt on the permanent character of the ongoing improvement in government finances.

Avoid repeating past mistakes

The different composition of the fiscal adjustment compared to plans suggests that in some cases tax windfalls, which may be of a temporary nature, were partly used to finance increases in government expenditure. This shift suggests a risk that past policy mistakes are being repeated. The current configuration of rapid economic growth and positive surprises in tax revenues closely resembles the situation that prevailed at the turn of the decade, during which policy mistakes were made. In the years 1999-2001, several Member States failed to make use of good economic conditions to achieve healthy public finances. They subsequently found themselves in an uncomfortable position when the cycle entered a less favourable phase.

There is today a consensus among economists and policy makers that inappropriate fiscal behaviour in good economic times was at the root of the difficulties in respecting the Stability and Growth Pact experienced in the first half of this decade. As most of EU countries have corrected (or are about to correct) their excessive deficits, it is essential to keep the momentum of fiscal consolidation in the current cyclical upturn. The window of opportunity offered by the economic upturn must be used to place the government debt ratio on a durable downward trend in the EU countries.

Recent developments call for a better functioning of the preventive arm

In its early assessment on the SGP reform, the Commission noted one year ago that the reform had improved the functioning of the excessive deficit procedure. Recent

developments confirm this view. Countries with excessive deficits have used appropriately the deadlines for the correction of the excessive deficits established under the reformed SGP, and made significant structural efforts to correct the situation of excessive deficit. On average, they have improved their structural government balance by about 1 percentage point of GDP in 2006. The budgetary plans of these countries are generally consistent with the goal of correcting the excessive deficits within the time limits specified by the Council. While up to ten Member States had deficits larger than 3% of GDP in 2004, in 2008 only Hungary and the Czech Republic will be in this situation according to the most recent SCPs.

In contrast, concerns about the functioning of the preventive arm of the SGP remain. Backward-and forward-looking elements support this view. In 2006, fiscal consolidation efforts of some countries not yet at their medium-term objective were insufficient given the improving cyclical conditions. Fiscal plans are also somewhat disappointing. In a number of euro-area and ERM-II countries, the envisaged improvement in the structural balance in 2007 and subsequent years falls short of the 0.5% of GDP benchmark of the revised SGP, contrary to what the Council recommended recently,¹ and despite economic conditions that would justify going beyond it.² According to the Commission's spring 2007 economic forecast based on the assumption of no policy change, only ten of the twenty-seven EU countries will have reached their medium-term objective in 2008, after two consecutive years of above-trend growth.

III. A MORE EFFECTIVE PREVENTIVE ARM TO ENSURE PROGRESS TOWARDS SUSTAINABLE GOVERNMENT FINANCES

The preventive arm of the SGP is based on regular monitoring and surveillance of public finances in the Member States. To this end, the EU countries submit annual Stability or Convergence Programmes (SCPs) in which they present planned budgetary positions for the next three or four years. Member States which have not yet achieved their medium-term budgetary objective (MTO) present in their SCP the adjustment path towards this objective. These programmes are then appraised by the Commission and the Council delivers on Opinion on each of them.

As seen above, the fiscal plans formulated by Member States in their SCPs are not always in line with the preventive arm of the SGP, notably in terms of annual adjustment. Moreover, a number of EU countries have in the past had difficulty respecting their multiannual budgetary targets. These difficulties were due in particular to recurrent expenditure

¹ Council country-specific recommendation of March 2007 on the Integrated Guidelines for Jobs and Growth addressed to the euro-area Member States: "the euro area Member States are recommended to make use of the favourable cyclical conditions to aim at or pursue budgetary consolidation towards their medium-term objectives in line with the Stability and Growth Pact, hence striving to achieve an annual structural adjustment of at least 0.5% of GDP as a benchmark."

² The revised SGP specifies that Member States in the euro area and participating in ERM II which have not yet achieved their MTO should pursue an annual adjustment in their structural balance of 0.5% of GDP as a benchmark. The adjustment effort should be higher in good times; it could be more limited in bad times.

overruns.³ The improved track record of the last two years in respecting budget balance targets is largely due to positive surprises in government revenue.

Against this background, this section formulates a number of concrete proposals to ensure a better functioning preventive arm of the SGP, on the basis of best practices in the EU countries. These proposals can all be applied under the current legislation and are in line with the spirit of the 2005 SGP reform. They are articulated around four main themes:

- (i) Putting fiscal policy issues in a broader economic perspective;
- (ii) Enhancing the national ownership of the medium-term budgetary targets set in the Stability and Convergence Programmes;
- (iii) Strengthening the reliability and credibility of the medium-term budgetary plans included in the SCPs;
- (iv) Moving towards sustainable fiscal positions in the medium term.

Putting fiscal policy issues in a broader economic perspective

The benefits of sound fiscal policies would be better understood if fiscal surveillance were put in a broader economic perspective, notably the context of the renewed Lisbon Strategy for Growth and Jobs. This would entail explaining more clearly how medium-term budgetary plans will contribute to macro-financial stability and how envisaged changes in the level and structure of expenditure and taxation and other economic policy measures will set the right priorities and incentives to encourage innovation and competitiveness and to strengthen private investment and employment.

In view of the ultimate objective of fostering strong sustainable growth conducive to employment creation in the EU countries, the assessment of fiscal policy developments in the context of the preventive arm of the SGP could take greater account of the overall macroeconomic situation of the country concerned and consider the quality and composition of budgetary strategies. Particular attention should be given to risks linked to developments in internal and external imbalances, inflation and competitiveness, bearing in mind that being a country inside or outside the euro area implies different effects. For example, for countries within the euro area, this requires a greater focus on real exchange rate adjustments or, in the case of convergence countries, that consideration could be given to the role of fiscal policy to support a sustainable catching-up process.

Discussions on the quality and efficiency of public expenditure and on their contribution to raising potential growth should become more systematic in the assessment of medium-term budgetary plans submitted by Member States in their SCPs. The scarcity of public resources, intensified by the spending needs stemming from an ageing population and growing tax competition, makes it even more necessary than in the past to allocate public resources according to priorities and use them efficiently, taking into account the country-specific recommendations adopted by the Council on the basis of the integrated guidelines for jobs

³ For a detailed analysis of the reasons for the difficulties to respect budgetary targets, see the 2007 edition of the Commission report on "Public Finances in EMU".

and growth. Ensuring that the SCPs and their assessments clearly highlight the medium-term consequences of structural reforms, entailing significant changes in the level and structure of government expenditure and taxation, would contribute to a better perception of those reforms and of the role they play within a comprehensive strategy. The SCPs should thus provide systematic information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programmes.

Proposal 1. To ensure the rapid achievement of sustainable budgetary positions while enhancing the contribution of budgetary policies to growth and employment, emphasis on the quality and efficiency of government finances could be strengthened in the SCPs as well as in the Commission's assessments thereof. Member States could provide clearer indications as to their policy intentions in terms of changes in the structure and/or efficiency of public spending and taxation and the expected benefits in terms of growth and employment. Such indications could also highlight links with the National Reform Programmes under the Lisbon Strategy. To allow exchanges of best practices, Member States could also provide information on reforms of budget institutions aiming at improving the quality and efficiency of government finances – e.g. introduction of performance-budgeting techniques or new fiscal rules favouring re-allocation of expenditure towards different priorities.

Proposal 2. Member States and the Commission could take greater account of the overall macroeconomic situation of the country concerned in the assessment of national fiscal policies. Particular attention could be devoted to developments in external imbalances, inflation and competitiveness. The objective would be to ensure a smooth functioning and internal adjustment in the euro area and to support a sustainable catching-up process in convergence countries. A broader economic assessment would facilitate a more comprehensive evaluation of whether the economy is experiencing "good times" and of the implications for the conduct of fiscal policy.

Enhancing national ownership of the medium-term budgetary targets set in the Stability and Convergence Programmes

The 2005 SGP reform has gone a long way towards improving the national ownership of the EU fiscal rules. The increased economic rationale of the rules and the introduction of country-specific medium-term budgetary objectives were key steps in this direction.

In the context of the 2005 SGP reform, the Council also invited Member States' governments to present SCPs and the Council opinions on them to their national parliaments. Little progress has been made on this issue in the last two years. According to a recent survey by the Commission, there is an insufficient degree of political commitment at national level to the medium-term budgetary targets set in the SCPs. In only a few EU countries is the SCP the subject of a vote or derived from a document previously adopted by the national parliament. Moreover, while SCPs present budgetary projections for the whole of the general government, there is in some cases no or little ex ante co-ordination between various government tiers prior to setting the targets.

As a consequence, the link between multiannual budgetary plans set in the SCPs and the preparation of annual budgets for the subsequent years tends to be relatively weak in the EU countries. In a number of cases the budgetary projections included in the SCPs are only indicative and are hardly taken into account in the preparation of subsequent annual budgets. This gives rise to sizeable revisions to ensure consistency between budgetary plans laid down in the SCPs and objectives set in the subsequent annual budgets. Overall, the current situation suggests that there is a significant gap between what would be desirable and the reality of the preparation and status of SCPs in the Member States.

For the euro-area Member States, the national ownership of fiscal policy coordination under the preventive arm would also benefit from the preparation of a common public document, summarising the multiannual fiscal plans submitted by all the euro-area Member States. This *Stability Programme for the euro area* would highlight the contribution of each Member State to the policy mix of the euro area. It could be discussed by Eurogroup Ministers at an early stage of the surveillance exercise, on the basis of an assessment by the Commission, therefore reinforcing the examination of the individual Stability Programmes of the euro-area Member States.

Proposal 3. Member States would benefit in their capacity to adhere to their medium-term budgetary plans from ensuring a stronger commitment of all national actors taking part in the conduct of fiscal policy to conduct policies consistent with the medium-term budgetary targets set in SCPs. To this end, as agreed in the context of the 2005 SGP reform, Member States could consider a stronger involvement of *national parliaments* in the preparation of the SCPs and in the follow-up to the Council Opinions. Multiannual budgetary targets should preferably be set following proper *coordination* between various levels of governments.

Proposal 4. With a view to strengthening the national ownership of the medium-term budgetary targets formulated in the SCPs and the consistency between SCPs and subsequent annual budgets, Member States could consider supplementing their domestic budgetary frameworks with national multiannual fiscal rules consistent with the SCPs targets. This could build on the positive experience of some Member States, where *rules-based multiannual expenditure frameworks* ensure a strong adherence to medium-term budgetary plans – notably on the expenditure side – and consistency between these plans and subsequent annual budgets.

Strengthening the reliability and credibility of medium-term budgetary targets

The primary aim of SCPs is to foster a proper coordination of fiscal policies in the EU, in a multiannual perspective. In some EU Member States SCPs are also used domestically to extend the time horizon for the conduct of fiscal policy beyond the annual budgetary cycle. If there continue to be recurrent deviations from medium-term budgetary plans, as in the past, the credibility of the projections could be undermined to the point of making them meaningless.

One area where particular attention is called for is the preparation of macroeconomic forecasts used for the budgetary projections, which in turn determine the amount of resources available in the medium-term to finance policies. In the past, medium-term

budgetary projections were in some cases based on overly optimistic macroeconomic forecasts, notably in upturns. However, the inclination to revise medium-term growth forecasts upwards in favourable growth periods seems to have been significantly less pronounced since the SGP reform. Member States should continue to base their budgetary projections on realistic assumptions. They could also consider the use of so-called *prudence factors* such as contingent budgetary reserves which can be activated only under specific conditions.

Another improvement would consist in greater transparency on the nature and magnitude of the fiscal challenges implied by the budgetary targets included in the SCPs. Member States could notably provide clearer indications in the SCPs on whether the projected path for the main budgetary aggregates is attainable under unchanged policies. The baseline "unchanged policy" scenario could notably be specified. The SGP, including the *Code of Conduct on the Content and Format of SCPs* which guides Member States in the preparation of SCPs, already specifies that the programmes should describe the budgetary and other economic policy measures being taken or proposed to achieve the budgetary objectives.⁴ In practice, however, the information on the envisaged corrective measures is relatively scarce in the SCPs.

Proposal 5. To enhance the reliability and credibility of their medium-term budgetary targets, Member States could make clearer in their SCPs whether the medium-term budgetary targets are attainable under unchanged policies, or whether they will require the implementation of additional policy measures. In the latter case, it would be important that the SCPs specify the gap between the main budgetary targets (government balance, government expenditure) and developments in government finances under unchanged policies, and provide as detailed a description as possible of the measures envisaged to bridge the gap between budgetary trends and objectives.

Moving towards sustainable fiscal positions in the medium term

The main fiscal policy objective in the EU countries is to move towards positions consistent with the long-term sustainability of government finances. In most of the EU countries, addressing the sustainability challenge requires a broad-based strategy consisting of both discretionary fiscal consolidation and structural reforms. In some Member States, important choices have to be made as to what part of the sustainability gap should be addressed through medium-term consolidation and what part should be addressed through reforms of labour markets, pensions and health systems. Medium-term budgetary objectives should be ambitious enough to address a significant part of the sustainability challenge.

Moving swiftly towards sound fiscal positions also requires a better understanding of the origins of past deviations from medium-term budgetary plans, in order to avoid them in the future. Greater emphasis should be placed on the monitoring of previous budgetary plans in the context of the assessments of SCPs by the Commission and the Council. Considering that Member States typically plan expenditure-based fiscal consolidations and that deviations

⁴ See document "Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes", endorsed by the Ecofin Council in September 2005.

from medium-term plans mainly stem from expenditure overruns, strengthened monitoring should devote specific attention to developments in expenditure.⁵

For the euro-area countries, consistency between previously set medium-term budgetary targets and annual budgets could be monitored in the context of the Mid-Term Review of Fiscal Policies. This consists of an annual discussion, each spring, on fiscal policy plans for the next year, which aims to ensure a proper coordination of national fiscal policies in the euro area and provide peer support for sound fiscal policies at national level. The Eurogroup recently decided to transform this exercise into a real strategic policy debate, organised just before the crucial decisions on the budgetary plans for the following year are taken in the Member States.⁶

Proposal 6. As agreed in the context of the SGP reform, the Commission and the Member States will step up efforts to further develop the links between medium-term fiscal policies and long-term budgetary dynamics. Country-specific medium-term budgetary objectives (MTOs) will better take into account sustainability challenges. The objective is to identify where necessary more ambitious country-specific MTOs which can help Member States to substantially improve the sustainability of government finances.

Proposal 7. When assessing SCPs, the Commission will strengthen its analysis of the track record in respecting the budgetary targets of the previous SCPs, focusing on developments in government expenditure. For euro-area countries, consistency between previously set medium-term budgetary targets – notably government expenditure targets – and annual budgets will also be monitored as part of the Mid-Term Review of Fiscal Policies.

IV. CONCLUSION

This Communication reviews the recent budgetary developments and functioning of the EU fiscal framework. It underlines the ongoing improvement of the budgetary situation and the smooth implementation of excessive deficit procedures. However, the Communication also points out concerns on the part of the Commission as regards the implementation of the preventive arm of the SGP. These relate, notably, to the insufficient fiscal consolidation efforts of Member States not yet at their MTOs in an environment of favourable cyclical conditions. In some Member States, unexpected increases in tax revenue are partly used to finance increases in government expenditure. Such developments raise doubts as to the permanent character of the ongoing fiscal consolidation.

⁵ See Commission report "Public Finances in EMU – 2007" for a detailed analysis of the reasons for the difficulties in respecting budgetary targets set in the SCPs.

⁶ In practice, Member States provide their peers and the Commission with information on the fiscal policy intentions for the following year. On this basis, a discussion takes place assessing the appropriateness of these intentions, both for the country concerned and from the perspective of the euro area as a whole.

Against this background, and in a context where most EU countries have just corrected or are about to correct their excessive deficit, the challenge is to use current favourable cyclical conditions to move decisively towards the MTOs.

With a view to strengthening the effectiveness of the preventive arm of the SGP, this Communication formulates therefore concrete proposals building on the 2005 SGP reform. These proposals will be discussed with Member States in the coming months. They deal with the way governments formulate and implement their budgetary strategies over the medium term, and the way surveillance and coordination of economic and budgetary policies should be strengthened at EU level in order to support the achievement of sustainable budgetary policies which contribute to higher growth and employment. Recent country experience and empirical work have shown that implementing these proposals would effectively support Member States' efforts to converge towards sustainable fiscal positions whilst also delivering more growth and jobs.