

THE NINE LIVES OF THE STABILITY PACT

**A SPECIAL REPORT
OF THE
CEPS MACROECONOMIC POLICY GROUP**

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This special report by the CEPS Macroeconomic Policy Group (MPG) is concerned with the implementation of the Stability and Growth Pact and the prohibition of excessive deficits contained in the Treaty of Maastricht. Specifically, it deals with the controversy that was provoked by the failure of the ECOFIN Council of 25 November 2003 to endorse recommendations by the European Commission to put France and Germany on notice that they had violated the Treaty.

The CEPS MPG is composed of distinguished economists who have undertaken to carry out independent, in-depth research on current developments in the European economy. Unless otherwise indicated, the views expressed are attributable only to the authors in a personal capacity and not to any institution with which they are associated. The members of the MPG wish to express their appreciation to Leonor Coutinho for her contribution to this report.

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DANIEL GROS, THOMAS MAYER & ANGEL UBIDE

Summary and Overview

This report has three parts. Part I provides an overview of the political and institutional issues confronting the EU after the Economic and Financial Affairs Council (ECOFIN) declined to endorse the recommendations of the European Commission to continue taking further steps in the excessive deficit procedure as specified in the Treaty of Maastricht against France and Germany. We conclude that France and Germany scored only a pyrrhic victory on 25 November 2003. They are likely to realise sooner rather than later that the political costs of flouting the Treaty will mount unless they change their attitude. At any rate, the Treaty provisions and the Stability and Growth Pact (SGP) imply that the excessive deficit procedure cannot be halted until the country found in violation undertakes additional measures to bring its deficit under control. Thus, unless France and Germany change their fiscal policy, the clash that arose at the end of 2003 is likely to continue for some time.

Part II summarises the main economic arguments in support of prudent fiscal policy, especially in the context of the low potential growth that characterises the EU today. France and Germany face an unsustainable debt accumulation if they persist with their current structural deficits.

Based on the evaluation in the previous parts, we argue in Part III, that there is no need to soften either the Treaty or the Stability Pact. On the contrary, their enforcement should be strengthened. We also propose a concrete mechanism to minimise the political element in the early warning system and to place it on an objective basis.

Key Policy Conclusions

1. The source of the conflict between the European Commission and the Council that erupted in November 2003 was not the Stability and Growth Pact, but rather the prohibition of excessive deficits contained in the Treaty of Maastricht. This clause, which states that deficits should normally be below 3% of GDP, should not be altered. It is even more appropriate now than when it was first agreed in 1991, because of the slowdown of potential growth in Europe.

2. The powers of the European Commission in the excessive deficit procedure (EDP) should be enhanced as proposed by the draft Constitutional Treaty still under discussion by governments. The Commission should be given more resources to improve budget monitoring and forecasting.
3. To avoid a repetition of the debacle of November 2003, two main changes are necessary:
 - Monitoring of national budgets should be enhanced during upswings, to avoid a deterioration of structural balances; and
 - Incentive structures should be strengthened through a system that, starting from the initial stages of the process, exacts a political cost for non-compliance.
4. Announcements of the death of the Stability and Growth Pact are premature. The Pact is likely to come back as France and Germany perceive the mounting political costs of flouting the Treaty.
5. Present French and German fiscal policy is not sustainable, because if continued, it leads to massive debt accumulation. Hence, one would have to call France and Germany to order even under a revised SGP that had shifted the emphasis to debt build-up.
6. The EU rules would not have forced France and Germany to conduct a pro-cyclical policy. Most forecasts for 2004 point to above-trend growth, so a reduction in cyclically adjusted deficits is entirely appropriate.
7. Both the Commission and the Council should concentrate on the quickest way to achieve a correction of fiscal policy in France and Germany. No one stands to gain by letting the legal challenge regarding the procedure used by ECOFIN (Economic and Financial Affairs Council) in November escalate into an inter-institutional confrontation.
8. *Pacta sunt servanda*. It is extremely dangerous to argue that a country is not obliged to follow EU rules simply because some economists do not agree with them. This rationale might in future be applied to other issues, such as state aids and central bank independence, and creates a very bad precedent for the enlargement process.

Part I. Legal and Institutional Issues

On 25 November 2003, the Economic and Financial Affairs Council (ECOFIN) was presented with a recommendation from the European Commission to take further steps in the excessive deficit procedure against France and Germany. This procedure, foreseen in Article 104 of the Treaty, had been started in early 2003 when it had become clear that both countries had violated the 3% limit on public deficits in 2002. In early 2003, both France and Germany therefore did not object to the launch of the excessive deficit procedure against them. Both countries then accepted concrete recommendations on how they should rein in their deficits during 2003.

By November of last year, however, it had become clear that neither country had reduced its deficit. On the contrary, in fact, their deficits had expanded. In the view of the European Commission (which we support), this meant that both countries had not followed the recommendations that had been formally decided – with the cooperation of France and Germany – in January of 2003. Since the Treaty specifies quite clearly that further steps have to be taken when a country fails to follow the recommendations it has received in the context of the excessive deficit procedure, it was thus natural that the European Commission felt duty-bound to present a recommendation to the Council that further action be taken against the two offending countries.

In early November of 2003, the Commission thus decided to recommend to the Council that two further steps should be taken under the relevant Treaty provisions against France and Germany at the ECOFIN meeting of November 25. To come into force, however, these recommendations required a qualified majority in the Council, but this did not happen. A majority of the member countries voted for the recommendations of the Commission, but this did not, by far, constitute a qualified majority as the large member countries did not support the Commission. After a long and heated discussion, ECOFIN then adopted in the early morning (technically already on November 26) Council Conclusions in which it stated it had “decided” not to proceed against Germany and “agreed to hold in abeyance” the excessive deficit procedure against France and Germany. To understand the ensuing legal battle, it is important to underline that although ECOFIN used the wording “The Council decided” these Council Conclusions most probably did not constitute a legally binding decision in the sense of the Treaty.

In January 2004, the Commission then decided to ask the European Court of Justice to rule whether ECOFIN had used the proper procedure in arriving at the Conclusions that were made public in the morning of 26 November 2003.

1. The Stability Pact, post-November 25?

The refusal by the Economic and Financial Affairs Council on November 25 to apply the excessive deficit procedure against France and Germany (not really a legally binding decision to “hold in abeyance”, see Box 1) combined with the decision of the Commission to take the Council to the European Court of Justice has provoked much talk about the need to reform the Stability Pact. Many commentators, particularly in the Anglo-Saxon world, have long argued against the provision that member states should aim at a balanced budget over the cycle. However, this is the one provision of the Stability Pact that has been completely irrelevant so far.

It is not widely appreciated that the unfortunate ECOFIN “decision” of November 25 concerned exclusively the application of Article 104(8) and (9) of the Treaty of Maastricht. No reform of the Stability Pact would have changed the situation at that stage.

Emphasising the difference between the Stability Pact and the Treaty is not just nit-picking. It has important legal and political implications. Avoiding repetitions of the conflict that arose in November 2003 would require a change in the Treaty, which in turn would require ratification by all parliaments (probably all 25). One might argue that this should now be easy since the Treaty revision process is already underway. However, the draft Constitutional Treaty as elaborated by the Convention has left all the economic provisions of the Maastricht Treaty intact for no one had argued in the Convention that the prohibition of excessive deficits in the Treaty needed to be changed. If France and Germany (and potentially other allies) wanted to change the economic provisions of the Treaty, they would inject another highly contentious element in the on-going intergovernmental conference (IGC). Moreover, countries like Spain would certainly exact a high price for their agreement to any attempt to weaken the excessive deficit procedure.

This implies that there will probably be an animated discussion over the next few months concerning the need to reform the Stability Pact, but that will be beside the point. The real reason why the public discussion is focusing on the SGP (instead of the Treaty prohibition of excessive deficits) is, of course, that the SGP never enjoyed the same degree of acceptance as did the Treaty.

Moreover, it is often overlooked that the ECOFIN decision of November 25 did not even intend to settle the matter once and for all. Indeed ECOFIN only said the following (see Annex 3 for the full text of the Council Conclusions):

... the Council decided not to act, at this point in time, on the basis of the Commission Recommendation for a Council decision under Article 104(9).

The Council agrees to hold the Excessive Deficit Procedure for Germany in abeyance for the time being.

Box 1. The night of the long knives

The formal ECOFIN meeting of November 25th was preceded by the (informal) Eurogroup meeting the day before at which the different positions were thrashed out. The formal decision, however, had to be taken by the full ECOFIN under Article 104 of the Treaty.

The first point for ECOFIN on this day was the vote on two Council Recommendations, prepared by the Commission, under Article 104(8) on the excessive deficit procedure – one for France and another for Germany. The Commission proposed that Germany should cut its structural deficit by 0.8% and 0.5% over the next two years and that France should make an adjustment of 0.8% and 0.6% over the same period (see Annexes 1 and 2 for details). These votes had to be taken because France and Germany had not delivered the deficit reductions they had undertaken under Article 104.7 (although they had implemented some of the specific actions recommended to them). Under Article 104(8), all EU member countries have a vote, except the country concerned. The result was the same in both cases: each of the Commission's recommendations obtained a majority of member countries (8 for, 6 against), but this did not constitute the required qualified majority. (The five supporting the Franco-German axis were: Italy, Ireland, Luxembourg, Portugal and, of course, the UK.)

A second point for ECOFIN was the vote on two Recommendations to the Council, prepared by the Commission, under Article 104(9) on the excessive deficit procedure – again one for Germany and another for France (see Annexes 1 and 2). Under this article, only euro area member countries have a vote (again except the country concerned). The result was in both cases the same: Each of the Commission's recommendations obtained a majority of euro area member countries (6 for, 5 against), but this did not constitute the required qualified majority. (The four euro area members supporting the Franco-German axis were: Italy, Ireland, Luxembourg and Portugal.)

As the Commission's proposals had not received the required qualified majority, the next question was whether a different position could muster such a majority. A long discussion ensued. One option would have been to simply adjourn the meeting, but the (Italian) presidency preferred not to end the meeting without at least some results. This was highly contentious, but in a second round of voting on the wording of the Council Conclusions (not a formal decision) proposed by the Council Presidency (see Annex 3), a qualified majority was reached, but barely: 7 countries for, 4 against. The hold-outs for the strict application of the Treaty were at this point only Spain, Austria, the Netherlands and Finland. These countries together have 20 votes. A blocking minority would have been 21 votes. It is thus clear that if one other small country had stuck to its guns, the contested ECOFIN conclusions would not have passed.

Leaving aside the fact that it is not quite clear from a legal point of view what was meant by the verbs “decided” and “agrees”, it is apparent that the political signal that ECOFIN wanted to give was not that France and Germany were off the hook for good. But what was meant by “for the time being”? A further paragraph in the Council Conclusions says clearly that the next occasion will be when Germany has to present its bi-annual update to its Stability Programme. This implies that by early (March or April) 2004, the EU will be back to square one because at that point:

The Council stands ready to take a decision under Article 104(9), on the basis of the Commission Recommendation, should Germany fail to act in accordance with commitments set out in these conclusions...

The commitments taken by Germany in the ECOFIN meeting of November 25 are thus binding only from a political point of view because the Council Conclusions have no legal value (for details, see Box 2). But this text had the explicit support of the German delegation. Germany is thus committed to reducing the cyclically adjusted deficit by 0.6% of GDP in 2004 and by a further 0.5% of GDP in 2005. This is not onerous, but Germany has so far had a tendency not to stick to any of its commitments (it promised repeatedly during 2002 and 2003 that it would avoid an excessive deficit – see below). No change in the Stability Pact, however quickly agreed, could change the situation in early 2004: if Germany has failed to stick even to this commitment, the Commission will again have to resubmit the proposal that did not find the required qualified majority in November of this year.

The key issue that will not go away is the following: Should the prohibition of excessive deficits in the Treaty be kept? If the answer is yes, the conclusion must be that something like the Stability Pact is needed just to make sure that the Treaty is observed. Whatever one might think about the fines foreseen in the Stability Pact, peer pressure has been shown not to work. If the answer is no, the Stability Pact can indeed be scrapped. But in this case one should be honest and also scrap the relevant Treaty provisions.

The choice should be clear: there can be little doubt that for slow-growth economies like Germany and France, the prohibition of excessive deficits makes sense. The accelerating ageing of the population will predictably increase pressures on health and pension spending in the medium term. In order to avoid having to increase taxes even more in the future, this means that member countries should start reducing their debt levels as soon as possible. There is thus a strong case for the exhortation (it is not more than that) contained in the Stability Pact that member countries should aim at a balanced budget over the cycle. The 3% limit is thus not only needed, but probably already too generous. In sum, there is a strong economic case for keeping the prohibition of the 3% limit in the Treaty (see Part II).

Box 2. The day after: Field day for the lawyers ... and judges?

The first point to keep in mind is that what was voted upon in the early morning of 26 November 2003 was the wording of Council Conclusions, not a formal Council Decision. Although only Council Conclusions, the text included the wording:

the Council decided not to act, at this point in time, on the basis of the Commission Recommendation for a Council decision under Article 104(9).

It seems clear that the use of the word “decided” does not change the fact that Council Conclusions have no legal value under the excessive deficit procedure and that these Conclusions do not constitute a “decision” under Article 104 of the Treaty. The Council seems to have taken the position that the matter was thus closed (at least for the time being) from a legal point of view. However, it is quite clear that the Excessive Deficit Procedure is still valid. The Commission entered the following statement into the minutes: “The Commission therefore considers that the Council recommendations based on Article 104(7) remain in force”.

The legal point is that Article 104(13) specified clearly that when taking decisions in these matters “the Council shall act on a recommendation from the Commission”. What happens when the Council acts by not taking a formal decision (only adopting Council Conclusions) and in the absence of a recommendation is not quite clear.

What is clear, however, is that there is a potential for a serious legal and political conflict between the two key institutions of the EU, the Commission and the Council. Legal specialists can now argue endlessly whether the Council “Decision” of November 25 was arrived at using proper procedures and whether it brings the Excessive Deficit Procedure back to the previous stage, etc... An additional point that will need to be clarified is whether Council Conclusions could be adopted with only the eurozone countries voting (as was the case). Some of these questions might be resolved by the Court of Justice, but the Court will not be able to solve the fundamental problem that the Treaty does not specify what happens if the recommendation from the Commission does not find the required qualified majority.

The announcement of the Commission that it will ask the European Court of Justice to rule on the question whether the ECOFIN Council used the proper procedure in issuing its Council Conclusions on November 25-26 attracted a lot of attention and was seen by many as unprecedented. However, legal battles between the Commission and the Council are in reality quite frequent. Every year the European Court of Justice has to rule on several cases between the Commission and the Council. The latest one, to give just one example, concerned the procedure used by the Council in arriving at a decision concerning the energy efficiency labelling of electrical office machinery.

2. How did we get there? The excessive deficit procedure in action

It pays to revisit the chain of events that led to the controversial ECOFIN decision(s) of November 25 (see Box 3 for the legal background). The case of Germany is perhaps the most interesting. Formally it started in January 2003, when the budget numbers for the year 2002 could be considered final and it turned out that the 2002 deficit had been widely above the 3% of GDP limit in the Treaty. As nothing indicated that this would be ‘temporary’, the ECOFIN had no choice but to take note of this fact and start the excessive deficit procedure against Germany under Article 104(2-4) of the Treaty.¹

Once the EDP has started, the country concerned has to show how the excessive deficit will be corrected (Article 104(2-7) of the Treaty). Germany thus agreed in early 2003 to a Council recommendation² to reduce its deficit during the year 2003 to 2.75%. This was made explicitly conditional on growth reaching 1.5% because it had become clear by early 2003 that the growth projections for the year were based on shaky foundations. The general commitment in terms of the overall budget balance, which was also equivalent to a reduction in the (cyclically adjusted) deficit of 1% of GDP, was made more concrete in a series of measures that were supposed to reach this goal. The German authorities also promised (see Council Conclusions of 21 January 2003 in Annex 4) that they would avoid taking “discretionary measures that could aggravate the budgetary position” and that the deficit would go below 3% of GDP in 2004. All of these promises were subsequently broken. France had similar obligations imposed upon it, but these were formally decided only in June (see Annex 5).

In May 2003, the Commission made public its assessment of Germany’s compliance record:

¹ As background, it is also important to note that one year earlier (in January 2002), the German authorities had averted receiving an ‘early warning’ that the deficit was heading towards the 3% limit by issuing a solemn promise that it would “endeavour to ensure” that the limit was not breached.

² See Annex 4. This document also contains the following passages: “The Council regrets that it has proven not to be possible for the German authorities to fulfil their commitment of 12 February 2002 ... The Council notes that the rise in the nominal deficit from 2001 to 2002 cannot be explained only by the unexpected slowdown in growth and that there have once more been expenditure overruns in the health sector ...”

Based on currently available information, it is our assessment that the consolidation impact of the implemented measures is likely to reach the required 1% of GDP.³

In November of the same year, the assessment suddenly changed. The 2003 autumn forecast projected the German deficit on a cyclically adjusted basis to run at 3.6% of GDP; one full percentage point more than estimated in April of the same year (see Table 1).

Table 1. Estimate of cyclically adjusted, general government balances (as a percentage of GDP) for the year 2003

	IV-2002	XI-2002	III-2003	X-2003
Germany	-1.9	-2.4	-2.6	-3.5
France	-1.9	-2.8	-3.5	-3.9

Source: Autumn 2003 forecast of the European Commission.

One might be tempted to argue (as do the German authorities) that this deterioration had been due to the lower-than-expected growth. But this should have been captured by the cyclical adjustment of the deficit; the deterioration thus appears to have come on top of the effects of the growth slowdown. For France, one can observe a similar surprise: more than one full percentage point deterioration between the time the budget for 2003 was known (end of 2002) and the latest forecast.

Box 3. The excessive deficit procedure in the Treaty

The excessive deficit procedure (indeed a rather complicated procedure) can be broken down into a number of discrete steps, the first four of which form one group and were not really contentious in this case:

Step 1: 'If a member state does not fulfil the requirements under one or both of these criteria, the Commission shall prepare a report' (104c(3)).

Step 2: The Monetary Committee (which will be called differently in EMU) 'shall formulate an opinion on the report of the Commission' (104c(4)).

Step 3: 'If the Commission considers that an excessive deficit in a member state exists or may occur, the Commission shall address its opinion to the Council' (104c(5)).

Step 4 is the decisive one: 'The Council shall, acting by a qualified majority on a recommendation from the Commission . . . decide after an overall assessment whether an excessive deficit exists' (104c(6)).

In the case of both France and Germany, there could not be, and never was, any contention of the fact that an excessive deficit does exist. But the more

³ Transcript of European Commission press conference of 21 May 2003.

interesting question is: What happens once the (ECOFIN) Council has found that an excessive deficit exists?

Step 5 follows: ‘the Council shall make recommendations to the member state concerned with a view to bringing that situation to an end within a given period’ (104c(7)). (This is what happened in early 2003.) If the country follows its recommendations, that is the end of the procedure. If not,

Step 6 is next: ‘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’ (104c(8)). This provision is already obsolete, since most member countries decided on their own to publish the recommendations of the first (non-binding) excessive deficit exercise held in 1994. Since the mere publication of recommendations cannot be expected to produce results,

Step 7 follows: ‘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’ (104c(9)). One of the Commission’s recommendations for November 25 concerned this article. It is usually overlooked that the recourse to this article does not automatically imply sanctions because this ultimate enforcement mechanism comes only later:

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 that the member state concerned shall 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 that the member state concerned makes 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 about the decision taken.

If the Commission’s recommendation had been accepted on November 25, sanctions could thus have been imposed on France and Germany only in case they had not complied with this recommendation. Thus, the provisions of the Stability Pact would have come into play only later in detailing what sanctions would have to be imposed on Germany and France if they had been found (say, in early 2004) not to have complied with the Commission’s recommendation.

3. Problems with the lynchpin of the EDP: Budget forecasting

This confusing succession of budget plans that were never implemented shows a deeper problem: An essential element of the Excessive Deficit Procedure is that budgets (in the sense of planned expenditure and receipts of the general government during the year) must be realistic. The key institution in this respect should be the Commission, which is supposed to be the neutral arbiter who checks the budget plans presented by member countries for their reliability. Without realistic budgets, the Treaty provisions against excessive deficits become unenforceable. Events during 2003 suggest that the Commission has encountered difficulties to perform this aspect of its general task as the “Guardian of the Treaty”.

At first sight, it is difficult to understand how this succession of surprises came about. Germany is a particularly interesting case: After all, at the beginning of 2003, Germany gave a solemn undertaking that it would take the appropriate measures to keep its deficit for 2003 under control after having breached the 3% limit already during 2002. Little noticed by the outside world, Germany was given by ECOFIN until May 2003 to implement a series of measures designed to keep its deficit under control. This deadline passed and the Commission and ECOFIN were apparently satisfied that Germany had actually done what it promised and that hence the budget for 2003 would be under control. As we now know, this was not the case.

If one looks more closely at how cyclically adjusted deficits are produced, it appears that part of this error is due to the way in which the cyclical adjustment is calculated for Germany. During 2003, the growth prospects of Germany had to be considerably revised downward (again), because the actual growth rate had been much below what had been anticipated earlier. For most of the other member countries, one more year of a growth disappointment would not have mattered much for the estimate of the longer-term growth prospects, but in the case of Germany the Council had actually more or less forced the Commission to use a particular statistical technique which had this effect.⁴ See also Box 4 for more details on how cyclically adjusted deficits are calculated.

⁴ In 2002, the Council had in effect instructed the Commission to use the so-called HP filter to estimate the potential growth rate, and hence the output gap for Germany. For almost all other member countries, the so-called production function technique is used, which reacts somewhat less to current data (but has other problems). (See Council Conclusion of 12 July 2002.)

Box 4. The cyclically adjusted deficit: A moving target

To understand cyclical adjustment to budget balances, assume that in the absence of fiscal policy changes government revenues change in proportion to nominal GDP, and that government expenditures vary in proportion to nominal potential GDP. These assumptions reflect the view that government revenues are influenced by cyclical variations of GDP, while expenditures vary only little. Hence, the cyclical component of government deficits depends on the difference between actual and potential GDP, that is, the so-called output gap. When the latter is zero, the cyclical budget balance would be zero as well. When the output gap is positive (potential above actual GDP), there would be a cyclical deficit; when it is negative, there would be a cyclical surplus.

In Euroland, the share of government revenues and expenditures in GDP is close to 50%. Hence, if actual nominal GDP is 1% above potential nominal GDP – implying a negative output gap of 1% of GDP – cyclical effects raise revenue by 0.5% above expenditures. Thus, the cyclical component of the government's budget balance would be 0.5% of GDP. This calculation can be simplified by applying the "elasticity" of government revenue to actual GDP – in the above case 0.5% – directly to the output gap. To arrive at the structural deficit, the cyclical component – calculated as the product of output gap and revenue 'elasticity' – is then subtracted from the actual deficit.

In practice, elasticities of revenues and expenditures with respect to cyclical variations of GDP – and hence the elasticity of the cyclical budget balance with respect to the output gap – are estimated or calibrated rather than simply assumed. The European Commission estimates the revenue elasticity at 0.4 and the expenditure elasticity at - 0.1, giving an output gap elasticity of 0.5. Hence, the Commission's results are broadly in line with those of the simple procedure described above. In its autumn forecast, the Commission estimated the actual Euroland budget balance at 2.8% of GDP. At the same time, it estimated the output gap for 2003 at 1.2%. Using an elasticity of the cyclical budget balance with respect to the output gap of 0.5, the cyclical component of the deficit was put at about 0.5%. The structural deficit was therefore estimated at 2.3% of GDP.

Estimating cyclical components of government budget balances is subject to three possible forecast errors: First, the output gap may be incorrectly estimated, because of either a forecasting error for actual GDP or for potential GDP. Second, the actual budget balance may be projected incorrectly. Third, the output gap elasticity may be wrong. In its forecast revisions this autumn, the Commission changed its estimates for both the actual deficit and potential GDP growth (and hence the output gap). Criticism of the Commission's estimate of Germany's structural deficit has focused on the assumed elasticities. German government officials and observers have argued that especially the Commission's estimate has been too low for the elasticity of government spending with respect to cyclical effects.

Because the economic weakening has been longer and shallower than usual, it has been argued that the government has incurred larger cyclically-induced spending increases on unemployment compensation than in the past. The drop in employment during the recent episode of weakness was even stronger than during the 1993 recession, while the output gap (as estimated by the Commission) did not increase by as much. Hence, it has been argued that cyclical spending rose by more than in the past in response to the output gap. The cyclical component of the German government budget deficit would therefore be larger – and the structural component smaller – than estimated by the Commission.

In our view, the – now rather low – potential growth estimates for Germany that the Commission has produced under the procedure imposed by the Council actually reflect more accurately reality than the still rather optimistic estimates that are used for other member countries. As explained below, the continuing overestimate of the long-term growth potential had been one of the key driving factors behind the current problems with fiscal policy.

The key fact that remains, however, is that this extraordinary *derapage* surfaced only a couple of months after Germany was essentially certified as having brought its budget under control. We have considered also more systematically the performance of the budget forecasts of the Commission (see Box 4), which reveals that the errors in budgetary forecasting are so large systemically that it becomes clear that the Commission simply does not have adequate resources to forecast budgetary balances. Even within-the-year forecasts have a margin of error not much less than 1% of GDP.

This very large forecast error has a serious implication: the Stability Pact is becoming unenforceable. This conclusion is already difficult to avoid under a simple technicality: The German authorities have actually done more or less what they promised to do. Once they do that, the rules of the Stability Pact imply that no further steps can be undertaken against the offender. The founders of the Stability Pact (and the drafters of the Treaty) envisaged fines being imposed on the country in question after it failed to undertake the steps it was required to take by ECOFIN in formal recommendations. What no one apparently anticipated was that the country could take all the required measures and still see its budget deteriorating (even on a cyclically adjusted basis).

The inability to predict budgets with any precision also implies that the promises that France and Germany made concerning their budgets for 2005 or even 2006 are of little value. In spring 2002, the Commission's forecast for the German deficit for 2003 was 1.9%, whereas the end result is 2 full percentage points higher (to repeat: the lower-than-expected growth does not matter here because these are cyclically adjusted deficits). For France the error was almost as large. It is thus surprising that there was a hot discussion

whether France should agree to plan for 2004 an improvement of 0.7% (as proposed by the French) or 1% (as apparently requested by the Commission). The outcome is likely to be much worse anyway. As for the longer-term promises, one can only conclude that a promise by either France or Germany to go under the 3% limit by 2006 means that by that time the deficit might actually be closer to 5% than to 3% of GDP.

We have so far concentrated on a particular case, namely Germany. But was this case exceptional? In other words: How accurate are the Commission's budget forecasts in general?

Any statistical analysis of the Commission's forecasts for the budget deficits of euro area countries can only be made on a preliminary basis, since the sample period is so short. In our analysis we used all the forecasts published by the Commission from the spring of 1998 to the autumn of 2003, regarding two variables: the non-cyclically adjusted budget deficits and, from the spring of 1999 to the autumn of 2003, the cyclically adjusted budget deficits.

Our main findings are:

1. Across the 12 member countries of the euro area, the average standard error of these forecasts is rather high. It depends on the forecast horizon, but it is never much below 1% of GDP (see table below). This implies that the spring forecast for the current year has a more than 1 in 3 chance of being off by one full percentage point of GDP. (For example, a forecast deficit of 2% of GDP might turn out to be either 1 or 3% of GDP with a probability of about 33%.) However, we also find that there are large differences across member countries. The budgets of some countries were apparently much harder to predict than others (the highest standard deviation was five times the lowest).

Table 2. Unweighted averages of the Commission's forecast errors for national budget deficits in the euro area, at different forecasting horizons

	Non-cyclically adjusted		Cyclically adjusted	
	Bias	Standard deviation	Bias	Standard deviation
1 quarter ahead	-0.10	0.79	-0.64	0.78
3 quarter ahead	-0.13	1.05	-0.72	1.03
5 quarter ahead	-0.15	1.06	-0.92	0.81
7 quarter ahead	-0.09	1.45	-0.84	1.23

Note: The sample includes forecast errors from 1999 to 2002, except in the case of the 5 and 7 quarters ahead forecasts for cyclically adjusted deficits, which are not available for 1999.

2. The non-cyclically adjusted deficits are actually more accurate than the cyclically adjusted deficits in the sense that the cyclically adjusted deficits were on average underestimated by about 0.7% of GDP over the period 1999-2002 (and on average across the 12 euro area member countries). This is probably due to the fact that the Commission (along with many others) has constantly overestimated actual (and potential) growth over this period. This is another illustration of the importance of recognising the trend growth slowdown Europe emphasised in previous reports (see Gros et al., 2001, 2002 and 2003).

Regarding the forecast horizon, it is not surprising that we also find that shorter-term forecasts have a much higher precision. The standard error of the estimates seven to five quarters ahead is higher than that of one to three quarters ahead.

The purpose of the Treaty is not to punish countries, but to prevent the emergence of excessive deficits. This is why budgets for the current year and the future play such a central role in the excessive deficit procedure (and the Stability Pact). If the Treaty is ever to be applied properly, the quality of budget forecasting by the Commission must be improved. To this end, the Commission must be given more resources and early warning systems must be strengthened.

4. What next?

King Pyrrhus is reported to have exclaimed “one more such victory and I am lost”, while counting his losses after a victory against tenacious Roman legions. This thought must also have occurred to the leaders of France and Germany when they surveyed the battlefield after November 25th. The political price for their ‘victory’ over the Commission is now apparent and it is destined to mount over time. The position of the German government was widely criticised in Germany and the widespread impression that the larger member countries are exempt from the rules of the Treaty certainly had a strong impact on the discussions within the IGC concerning the draft EU Constitution and contributed to the failure of the Brussels summit. The position of France and Germany that the smaller countries should give up part of their voting powers in a future Constitution now encounters constantly the argument that the small countries should retain a large voting power because they are the only ones that can be relied upon to uphold the Treaty.

As explained above, the ‘victory’ is short-lived: France and Germany are now obliged to report back to the Council in early 2004 and have to show that they have actually reached the targets set in the infamous Council

decision of November 25.⁵ If they fail in this, they will again have to put pressure on other member countries to vote in their favour.

Another problem is destined to emerge after the accession of the ten new member countries. Some of them are likely to push for early membership in the euro area. Hungary, for example, has announced its ambition to join the euro area as quickly as possible, although it still has a fiscal deficit above the 3% limit and would thus not be eligible under the Maastricht criteria. An early and massive enlargement of the euro area is widely perceived as undesirable in France and Germany, but until recently it was thought that a tough application of the Maastricht criteria would be sufficient to prevent this 'dilution' of the euro with a large number of poorer countries that still need to converge in terms of income per capita. But as long as France and Germany fail to submit to the Treaty prohibition of excessive deficits, it will become politically untenable to use the same provisions to keep the new member states out.

Both France and Germany thus have a strong political interest in getting out of this situation as quickly as possible. As the eurozone recovery is expected to be really happening in 2004 (after the false starts in 2002 and 2003), it is thus possible that by early 2004 France and Germany will have been able to stick to the commitments they undertook on November 25. However, a recovery alone is not sufficient as these commitments concern cyclically adjusted deficits. The recovery would have to be extraordinarily strong to allow France and Germany to go below the 3% limit.

⁵ King Pyrrhus' first victory against the Romans was also short-lived. He lost the second encounter so decisively that he had to leave Italy forever.

Part II. Economic Issues

It has been widely noted that the November 25th debacle did not have any direct impact on financial markets: the euro continued to appreciate and interest rates did not increase. This absence of a reaction by the markets, however, does not imply that limits on fiscal deficits are not needed. On the contrary, the lack of a reaction by the markets illustrates actually one of the reasons why the excessive deficit procedure was instituted in the first place. It was recognised that the reaction of financial markets often comes rather late, but then turns quickly into credit rationing. The case of New York City is a classic example of this phenomenon: until shortly before it went bankrupt, the city had been able to obtain new loans at moderate rates. But when its financial problems became apparent, credit was suddenly cut off. Thus, the purpose of the excessive deficit procedure (and the Stability Pact) thus was, and remains, to ensure that fiscal problems do not accumulate such that they become so serious that financial markets (over-)react with credit rationing.

As explained above, the real problem now is how to deal with the refusal of France and Germany to abide by the Treaty. The Stability and Growth Pact was introduced to ensure that the prohibition of excessive deficits enshrined in the Treaty could actually be enforced in practice. The prohibition of excessive deficits was specially designed to make fiscal policy sustainable, which was clearly needed in view of the rising share of public debt as a proportion of GDP year after year during the 1980s and early-to-mid-1990s. There is little disagreement over the desirability to stabilise debt/GDP ratios at reasonable levels. This is also the reason why the 60% upper limit on debt makes sense (although it is difficult to base on an economic model) and is not really disputed at the political level...except when the implications for current fiscal policy hurt.

Notwithstanding this general consensus, the central prescription of the SGP – namely that governments should aim, over the cycle, at balanced budgets or small surpluses – has been subject to a lot of criticism. Many have argued that this goal does not make sense because it implies that debt/GDP ratios should over time go to zero, which would in general not be the appropriate aim for fiscal policy. We will come back to this argument later, after first briefly analysing the nature of the present problems with fiscal policy. We then turn to the implications of a permanent (as opposed to a cyclical) slowdown in growth for fiscal policy. This leads us to the next question: What to do when the future threatens to become even more difficult? We find that the predictable effects of an ageing population provide a surprising rationale for the strictures of the SGP. We then ask whether a one-shot fiscal stimulus might nevertheless be useful in kick-starting the economy. We

conclude this chapter with a comparison of reaction of fiscal policy to a post-bubble environment.

The purpose of this chapter is merely to recall a number of arguments that have been known for some time and show how they apply with particular force to Europe, and in particular to the case of France and Germany today. For a survey of the issues raised by large deficits, see Federal Reserve Bank of Kansas City (1995) and, more recently, Rubin et al. (2004).

1. Macroeconomic policy and slow growth

The fiscal problems of France and Germany are widely blamed on the prolonged weakness of the economy. But why has growth in Euroland been so weak – for so long? It is no longer possible to view this dismal performance as a result of external shocks, such as the September 11th terrorist attacks in the US or the Iraq war. The assertion that external shocks were the key reason for the weakness of the Euroland economy can be tested in a simple way: if it were true, one would expect that small countries would be hit stronger than the large countries because the smaller member countries have much larger exposure to the rest of the world than the larger members. However, the data indicate exactly the contrary. As the table below shows, the small euro area countries continued to outperform the ‘big three’ (D+F+IT) by a considerable margin during both 2001 and 2002, and this is likely to continue for 2003, for which no final data are yet available.

Table 3. Real growth: Big vs. small economies (%)

	2001	2002	2003 (est.)
Big euro-3	1.39	0.59	0.2
Small euro-8	1.98	1.34	1.2

Note: Big euro = D+F+IT. Small euro = euro-12 minus D+F+IT+ES.

Data source: European Commission, AMECO.

Could one then argue that the weak demand is the result of excessively tight monetary and fiscal policy? This also seems difficult to do.

Regarding *monetary policy*, the evidence would rather indicate the opposite: all the indicators point to an expansionary stance. For example, real interest rates are not high by historical standards. After adjusting for HCPI, short-term inflation rates hover between zero and 1%, much below the longer-term averages. The difference between long-term interest rates and inflation is also at around 2% – considerably below historical averages and certainly much below the values of over 3% reached before EMU started. Moreover, the money supply continues to expand at more than 7% per annum, which is much above the rate the ECB considers compatible with medium-term

liquidity needs. Finally, a number of estimates of the ECB's reaction function indicate that the ECB has broadly tended to follow economic developments in much the same way as one would expect from other central banks and in particular the US Federal Reserve.

Fiscal policy also cannot be blamed. Fiscal policy has actually been broadly expansionary – at least if one takes into account the fact that cyclically adjusted deficits have increased over the last years, from 1.9% of GDP in 2000, to 2.3% in 2001 and 2.4% in 2002. If one adheres to the view that a higher deficit actually leads to stronger demand, one would have to conclude that over the last three years fiscal policy actually provided a small positive impulse.

It is interesting to note that the difference between small and large countries can also be seen in terms of fiscal policy. For some time now, the smaller euro area countries have consistently had lower deficits, but this does not seem to have had a negative impact on their growth prospects as documented in Table 3 above.

The fact that the high fiscal deficits of the larger member countries have apparently not stimulated growth should also induce one to reflect again on the fundamental issue of whether higher deficits actually lead to stronger demand. A number of academic publications show that the more recent evidence suggests that higher deficits do not necessarily stimulate demand (see Gros et al., 2002 and 2003 and references therein).

It is interesting to note that the scepticism of the academic economists seems to be shared by the population (although politicians are still professing Keynesian views). Recent opinion polls in Germany asked people whether they would start spending more if the government were to anticipate a reduction in taxes. The answers (see Annex 6 for details) are revealing: between 80% and 90% of consumers indicate that they would not increase their spending in response to a lowering of taxes. This makes it difficult to believe the claim of the German government that it had to embark on this route (tax cutting in 2004) in order to avoid endangering the recovery.

2. The interest costs of higher deficits

In 1985-95 – before EMU was a realistic prospect – euro area deficits averaged 4.7% of GDP. In 1996-2004, they are likely to average 2.2% of GDP. Hence, one can calculate that the pressure for fiscal discipline emanating from the Maastricht criteria and the SGP has reduced the longer-term average of the Euroland budget deficit ratio by some 2.5% of GDP.

Economic theory and experience suggest that a return to the times of fiscal profligacy is likely to lead to higher interest rates and hence higher interest

spending for Euroland governments. How strong would be this effect? It might be useful to turn to the models used by financial market institutions. For example, according to Deutsche Bank's bond yield model (DByield), an increase in the Euroland budget deficit ratio by 1 percentage point raises long-term government bond yields by 24 basis points. Moreover, the ECB has indicated that it would have to follow a tighter monetary policy in the absence of fiscal discipline. Hence, a return to the fiscal policies of 1985-95 – implying a sustained increase of 2.5% of GDP in the deficit ratio from the 2002 level – could raise interest rates on government debt by 0.60 percentage points across the yield curve. Based on our estimate of the average maturity of Euroland government debt, it would take about four years from now until the new rate would apply to the entire stock of debt. Thus, assuming nominal GDP growth of 4% per year in 2003-07 and an increase in the deficit ratio from 2.2% of GDP in 2002 to 4.7% in 2007, annual debt service payments could increase by €37 billion or 0.6% of GDP by 2007. We wish to emphasise that the numbers presented here are actually at the lower end of the spectrum of the available estimates. For example, Rubin et al. (2004) argue that a 1% increase in the deficit ratio (in the US) should lead to an increase in interest rates of between 30 and 30 basis points. Applied to the case of the eurozone, this would imply that the increase in interest rates might be between 0.75 and 1.5 percentage points so that the increase in interest rate expenditure would easily reach 1% percentage of GDP.

3. Implications of lower growth for fiscal policy

One key assumption of the Maastricht Treaty had been that a deficit of 3% of GDP would be the maximum that member countries could allow themselves if they wanted to keep debt levels under control. We question this assumption below, but first we want to ask why a number of member countries are breaching the 3% deficit ceiling at present. Governments are claiming that it is not their fault, that their economies are the victims of an unfavourable business cycle. In our view, this is overly optimistic. As documented above (see also CEPS, 2003, for more detail), the potential growth rate of the eurozone is declining, due primarily to the fact that productivity growth has slowed to a snail's pace in Europe (while it has accelerated in the US).

Productivity is a slow-moving variable and the exact numbers are available only after a delay of several years. There can nevertheless be little doubt that productivity growth is now significantly lower than it was 10 years ago, when the Maastricht Treaty was signed. During the 15 years leading up to 1990, labour-productivity growth had been increasing annually at 2.3%. Over the 1990s, this measure of productivity has decelerated and is now running at around 1.3-1.4%, a decline of almost a full percentage point.

Moreover, there is no reason to hope for a quick rebound (as happened in the US over the 1990s).

Most policy-makers are loathe to admit that potential growth may have declined. They maintain that all one has to do is to wait for growth to get back to its full potential, which they estimate to be growing at over 2.5% per annum. A modest 1.2-1.8% might be a more realistic target, however, especially for the larger eurozone member countries.⁶

The decline in potential growth has two immediate implications for fiscal policy:

- i) A first implication of lower growth is that many estimates of structural balances are too low. Given that the share of general government in GDP is around 50%, every percentage point of lower potential growth implies an overestimate of structural balances by 0.5% of GDP. If potential growth is in reality 1.5% p.a., or one percentage point lower than the officially assumed figure of 2.5%, then the 'excessive' deficits of Germany in 2002 and 2003 would have to be regarded as almost totally structural and not cyclical, as is often assumed. The German example is particularly instructive as this is also the country with the lowest estimates of potential growth. For example, Germany's deficit for 2002 amounted to about 3.7% of GDP. During that year, growth in Germany was only about 0.5%. It is thus not surprising that the Commission's estimate of the structural deficit of Germany in 2002 was 3.2% of GDP. The data for 2003 are broadly similar (but a bit worse). The excessive deficits of Germany are thus clearly not due to a weak business cycle, but to a structural weakness of fiscal policy.
- ii) A second implication of lower potential growth pertains to the sustainability of debt levels. If potential growth is as low as 1.5% and if the ECB achieves an average inflation rate of 1.5%, the maximum allowable deficit to keep public debt at 60% of GDP is only 1.8% of GDP (not the 3% as assumed under Maastricht parameters). Again, the German example is instructive in this respect. If Germany were to continue with its structural deficit of close to 3%, its debt-to-GDP ratio would soon start to rise and would eventually stop only at 100% of GDP.

The very low productivity growth in Europe thus imposes some hard constraints on fiscal policy that have not been sufficiently recognised so far. Policy-makers should face up to this problem and stop blaming an anonymous global business cycle.

⁶ See, for example, "Euroland: Assessing Potential Growth", *Global Markets Research*, Deutsche Bank, 1 October 2003.

As noted above, it is mainly the large countries that have a problem with fiscal policy. All three ‘large’ eurozone countries (France, Germany and Italy) are currently violating or close to violating their commitments, whereas most of the small countries (with the notable exception of Portugal) have been able to stick to their commitments. The reason for this is quite clear. The eight ‘virtuous’ small eurozone countries were able to cut expenditure on average by around 1.5% of GDP over the last three years, whereas the three large members (and the sinner Portugal) were not able to manage even one-third of this. It is thus not surprising that the deficits are under control in the smaller eurozone countries. It seems that the body politic of the smaller countries has been quicker to realise the merit of meeting their obligations under the Stability Pact.

Many US observers have dismissed the 3% deficit of the Maastricht Treaty as arbitrary and useless. This position might be coloured by the quite different experience of the US, which in our view is also justified by the more promising long-term growth prospects of the US economy. The US is poised to grow substantially faster than the EU (and in particular the eurozone) economy not only because its productivity growth is now much higher, but also because its working age population is certain to increase whereas that of the EU is certain to stagnate over the next ten years and then likely to actually start falling. These two factors together imply that the growth differential between the US and the EU might be around two full percentage points per annum. This discrepancy has huge implications for the sustainability of fiscal policy. Table 4 shows what combinations of growth and trend deficits would lead to what steady state debt level.

Table 4. Steady state debt levels (as % of GDP)

		Cyclically adjusted deficit in % of GDP			
		2%	3%	4%	5%
Trend growth of real GDP in % p.a.	Germany: 1.5%	57	86	114	143
	EU today (?): 2%	50	75	100	125
	Maastricht: 3%	40	60	80	100
	US today (?): 4%	33	50	67	83

Source: Own calculations. The calculations assume an inflation rate of 2% so that nominal GDP growth is 2 percentage points higher than the real rates indicated in the first column.

Table 4 shows that for a slow-growth economy such as Germany even a deficit of only 2% of GDP that persisted over the cycle would barely keep the debt-to-GDP ratio close to the 60% limit. Continuing deficits of 4% of GDP by all member countries would bring the EU debt ratio to 100% of GDP. The contrast between Germany and the US is particularly striking. The latter could run indefinitely deficits about twice as high (4% of GDP) and still end up with a similar debt ratio (67% of GDP).

4. Even leaner times ahead?

We have so far argued that the lean years (in terms of low productivity growth) are here to stay and that this provides a reason to restrict deficits in order to prevent the debt-to-GDP ratios from increasing. But there are reasons to assume that the environment for fiscal policy will become even more challenging over the next decades.

The basic reason is the accelerating aging of the population throughout Euroland, which implies additional burdens on public expenditure because of an increase in pensions (people live longer) and health expenditure.

Basic economic theory suggests that a sound fiscal policy should set tax rates today not only on the basis of current expenditure needs, but also on those expenditures that can be expected in the future. This is called 'tax-smoothing'. The standard arguments for tax-smoothing suggest that one should prepare for the increase in expenditure from ageing by saving already today (or rather by accumulating less public debt today). This provides another argument why the goal of the SGP, to have public sector balances close to equilibrium, or in surplus, on average, over the cycle, might be appropriate for most Euroland countries for the next few decades (see CEPS, 2003, for more details).

The general argument for tax-smoothing is quite clear: ideally one should keep tax rates as constant as possible and prepare for future increased expenditure by generating surpluses today. What are the magnitudes? We start from the assumption that deficits should still be bound by the limit of 3% of GDP in the far future when the demographic profile has stabilised.

The next step in determining how ageing should influence fiscal policy today is to estimate the additional fiscal burden that it engenders. A careful analysis has recently been provided by the 2003 report of the Commission on Public Finances in EMU (European Commission, 2003). The main conclusion of this analysis is that the ageing that one can already foresee today with considerable certainty implies an additional net burden for public finances of around 3-5% of GDP. Taking into account the 3% limit for the future, this leads to a very simple conclusion: If tax rates are to be held roughly constant even as the European population ages dramatically, most member countries

should run budgets today that should be between balance and a 2% surplus, which is exactly as foreseen by the Stability and Growth Pact.

This leads us to the following conclusion: It may be difficult to make the argument that a balanced budget over the cycle is always the best choice because this would lead to the public debt level dropping to zero as a percentage of GDP. In the specific situation of most eurozone member countries, however, which have to confront the burden of a rapidly ageing population, it would be advisable to prepare for the future by running a fiscal policy today that allows countries to avoid excessive increases in tax rates. It turns out that estimates of the fiscal cost of ageing imply that the fiscal policy needed today is approximately what is prescribed by the Stability and Growth Pact. Balanced budgets (or actually small surpluses) would in this view be needed ‘only’ during the transition to the new steady state in demographic terms, i.e. according to most projections until around 2020.

Prudent fiscal policy today is not a question of adhering to a rigid rule, but rather ensuring the sustainability of fiscal policy for the future.

5. A false excuse: Payments to the EU budget

Representatives of the German government like to point out that that Germany is the largest net payer to the EU and is therefore entitled to some preferential treatment. This argument cannot be used in the context of the excessive deficit procedure, however, for the simple reason that the net contribution of Germany to the EU budget cannot be held responsible for the ever-increasing German deficits. As Table 5 below shows, the net contribution of Germany to the EU’s budget has actually declined continuously in recent years to reach only 0.24% of Germany’s GDP. At the same time the fiscal deficit of Germany increased to around 4% of GDP. Germany would thus breach the 3% Treaty ceiling even if it was not a net contributor to the EU budget.

Table 5. National net payments to the EU budget, by the big three euro area countries, 1999-2002

	1999	2000	2001	2002
Germany	-0.44	-0.42	-0.34	-0.24
France	0.00	-0.05	-0.14	-0.14
Italy	-0.07	0.11	-0.17	-0.23

Source: European Commission (2003).

It is true that some smaller member countries (and also Spain) receive substantial net transfers from the EU. Except for the minor element of the cohesion fund, however, none of these transfers constitutes fiscal receipts for

the recipients. Most of these transfers come in the form of structural funds which typically require at least 50% co-financing from the host country's public sector. This implies that for a country like Spain, which is a net beneficiary of the EU budget of over 1% of GDP, the net impact of the inflows of structural funds on its budget is likely to be close to zero, and might even be negative.

Part III. What to do?

Our economic analysis shows that the upper limit of 3% of GDP for fiscal deficits should now even be considered as generous, given the low long-term growth potential of the EU's economy. We would therefore not advocate any change in the Treaty provisions concerning the prohibition of excessive deficits. Our political analysis has shown that France and Germany are starting to perceive that their apparent obstruction of the Treaty carries a higher political cost. In our view the Commission has therefore perhaps lost one battle, but not necessarily the war.

The key question now is how to make the enforcement mechanism work. The main practical problem in this respect is that any efficient enforcement mechanism requires accurate budget forecasting. If one can determine deficits only several months after the year has finished, it is impossible to prevent excessive deficits. This suggests that early warnings should be issued well in advance. This will make it possible to avoid further crises and breaches of the Treaty and the SGP. Unfortunately, however, the data for France and Germany presented above as an example show large errors in forecasting budget deficits.

In this part we first show how the uncertainty surrounding budget forecasting could be explicitly recognised while still providing an objective criterion for deciding whether to issue an early warning. We then turn to the question of how the uncertainty in forecasting could be reduced.

1. Early warnings: Recognising uncertainty in budget forecasts

The early warning system is the appropriate instrument to take this inherent uncertainty into account. The purpose of an early warning is not to punish a member state, but to serve notice that there is a considerable chance that the 3% deficit ceiling will be breached. Our statistical analysis suggests a simple approach that could be easily implemented: The Commission could construct confidence intervals for three and five quarters-ahead forecasts and issue early warnings whenever the lower end of the confidence band indicates with a certain probability that the deficit will be higher than 3%.

Table 6 shows confidence intervals based simply on the average standard errors that we calculated on the basis of past experience. We assumed that there is no difference across countries in terms of the precision of the forecasts. In technical terms this implies that we used the same standard deviation for all countries. In a practical application, and once the Commission has been given the additional resources we argue it needs, it might be possible to discriminate between member countries in terms of the risks involved in their stability programmes.

Table 6. Lower bands for confidence intervals for the Commission's forecasts, using half of one standard deviation

3-quarter ahead 'warnings' based on confidence intervals for 3-quarters ahead forecasts (F_{t+3,t}) (spring forecasts for the same year)					
	$F_{2000,2000-S}$	$F_{2001,2001-S}$	$F_{2002,2002-S}$	$F_{2003,2003-S}$	$F_{2004,2004-S}$
Belgium	-1.0	0.1	-0.7	-0.7	-
Fr/Germany	-1.5	-2.2	-3.3	-3.9	-
Greece	-1.8	-0.5	-0.2	-1.6	-
Spain	-1.2	-0.4	-0.7	-0.9	-
France	-2.0	-1.1	-2.4	-4.2	-
Ireland	1.2	3.4	0.1	-1.1	-
Italy	-2.0	-1.8	-1.8	-2.8	-
Netherlands	0.5	0.3	-0.5	-2.1	-
Austria	-2.2	-1.2	-0.6	-1.6	-
Portugal	-2.0	-2.0	-3.1	-4.0	-
Finland	3.6	4.8	2.8	2.8	-

5-quarter ahead 'warnings' based on confidence intervals for 5-quarters ahead forecasts (F_{t+5,t}) (autumn forecasts of the previous year)					
	$F_{2000,1999-A}$	$F_{2001,2000-A}$	$F_{2002,2001-A}$	$F_{2003,2002-A}$	$F_{2004,2003-A}$
Belgium	-1.2	0.2	-0.7	-0.5	-0.9
Fr/Germany	-1.7	-2.0	-3.2	-3.6	-4.4
Greece	-2.1	-0.8	-0.2	-1.6	-2.9
Spain	-1.3	-0.4	-0.7	-0.8	-0.4
France	-2.2	-0.5	-2.5	-3.4	-4.3
Ireland	2.6	4.0	1.3	-1.7	-1.7
Italy	-2.2	-1.6	-1.7	-2.7	-3.3
Netherlands	-0.6	0.1	0.0	-1.7	-3.2
Austria	-3.1	-1.3	-0.9	-2.1	-1.1
Portugal	-1.7	-1.9	-2.1	-3.4	-3.8
Finland	3.6	3.9	2.4	2.6	1.2

Note: Intervals are constructed using the average standard deviation shown in Table 2 above.

Source: Own calculations.

We report the lower bound (the higher deficit) using a band of one half of one standard deviation because under certain technical assumptions (normal distribution of errors) this implies that the probability that the actual

government net balance will be lower than the lower bound is approximately 30%. This exercise should serve as a sufficiently strict interpretation of the Stability Pact, which stipulates that an early warning should be issued “in order to prevent the occurrence of an excessive deficit” (Article 6.2).

How would our system have worked? If the Commission had used our calculations, it would have given an early warning to France in the autumn of 2002 (as opposed to early 2003). In the case of Germany, the early warning would have come in the autumn of 2001, which would have had the advantage of giving the German government more time to take action before the election campaign had started in 2002. But this was not done, and by early 2002, it turned out that the election was so close that it was politically impossible to deliver an early warning to the government at that stage. Our approach would thus have been a useful and objectively based guide for these two countries to take early action.

But this method would not have been foolproof as it would have failed to trigger an early warning to Portugal before the spring of 2002. In any case, it would have been very difficult to predict the Portuguese budgetary slippage in 2001, because there were problems in the reporting of the data by this country.

Notice that our method would also have triggered early warnings to Italy and to the Netherlands in 2003, regarding their budget deficits in 2004. The estimated lower band for Greece in 2004 is very close to 3%, but given that the method already allows for a 70% probability of compliance, it might be better to wait and see if the spring forecasts in 2004 reaffirm the need for an early warning.

2. Improving forecasts and applying pressure during good times

In our view Germany and France are likely to realise that it is not in their interest to run excessive deficits for the foreseeable future. Moreover, even the contested ECOFIN decision of November 25 provided a rendezvous for early 2004. By that time higher growth might have taken care of at least part of the problem, thus allowing these two countries to start following the Treaty and applying the Stability Pact.

But it is crucial that if deficits were to decline below 3% owing to higher-than-expected growth, that should be no reason for complacency. In fact, the fundamental lesson from this episode is that it is very difficult politically to implement fiscal consolidation measures during downturns, even if technically policy remains countercyclical. Thus, a key aspect of any revision of the Stability Pact is to focus on prevention: monitoring and incentive mechanisms have to be designed in a way to ensure that countries

do not worsen their structural fiscal positions during upswings, thereby making room for the cyclical increase in nominal deficits that occurs during downturns.

In view of the above, consideration should be given to making two sets of improvements:

- *Enhanced monitoring and forecasting capabilities.* This can be accomplished by increasing the resources allocated to these functions. At present, the Commission sometimes does not even have one full-time person to deal only with budget projections. This person then has to rely on data and plans provided by the government concerned, which makes it difficult to formulate an independent point of view. National independent budget agencies in member countries could help in the process of arriving at realistic budget projections, if they were similar to the Congressional Budget Office in the US, i.e. if they would perform independent budget analysis and monitoring. Such independent agencies could then also report to the European Commission. Given that governments are increasingly allocating budgetary activities to agencies beyond the realm of the general government, standard budgetary analysis should be accompanied by ‘below the line’ monitoring – that is, debt issuance and credit to the government – which would provide a cross-check to the picture provided by the national accounts and, because of its greater frequency, serve as an early warning device. The Commission would incorporate the information from these agencies into their decision process.
- *Redesign of the incentive mechanism.* The problem with the current design of the SGP is that sanctions arrive too late in the process. Peer review has been shown not to be effective in precluding pro-cyclical policies during upswings, and the threat of financial sanctions arrives too late and is not credible. This is a political arrangement, and the cost of non-compliance should be political as well. Thus, as a complement to the multi-year fiscal planning process, we propose that governments commit to testify before their own parliaments following a negative report from the Commission. They would be obliged to explain the reasons for the slippages with respect to their own medium-term plans and the measures that will be taken to remedy the slippages.⁷ This would increase the government’s ownership of the medium-term plan (otherwise the medium-term objectives appear as a requirement coming from Brussels, which is not always a popular image) and, if applied from

⁷ It is very important in this respect that bygones are not allowed to become bygones, and that slippages are clawed back promptly and as part of the multi-year review process.

the very beginning of the process, could prevent pro-cyclical fiscal policies and thus breaches of the 3% limit during downturns

We have emphasised debt sustainability as the main *raison d'être* to uphold the Treaty on excessive deficits. Some find this approach too narrow and recommend focusing on structural reform from this point onwards. We think this is misguided because after all, the main issue is that sustainability is at risk. Moreover, experience shows over and over that governments typically behave in time inconsistent ways. Trusting that a government will implement a structural reform may be foolish (see the cases of Germany and Italy, for example). In this case, the SGP, if strengthened along the lines we propose, can become some sort of conditionality attached to the implementation of structural reforms.

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Annex 1

Commission Recommendation to the Council on an Excessive Deficit Procedure for Germany

Commission Press Room IP/03/1560

Brussels, 18 November 2003

Commission proceeds with Excessive Deficit Procedure for Germany

The Commission adopted today two recommendations for the Council in relation to the Excessive Deficit Procedure for Germany. The first, under article 104(8) establishes that the action taken by Germany in 2003 is proving inadequate and as a result the excessive deficit will persist in 2004. The second, under Article 104(9), requests Germany to take new measures to reduce the budget deficit and remedy the situation by 2005 at the latest. In order to avoid the risk that the excessive deficit continues for the fourth year in a row in 2005, the Commission considers that the budgetary adjustment in 2004 should be larger than the one contained in the draft Budget for 2004. It is recommended to reduce the cyclically-adjusted deficit by 0.8% of GDP in 2004. Overall, budgetary consolidation measures should secure a lasting improvement in the general government balance. When drawing up the measures to be taken in order to comply with these recommendations, Germany should take into account the recommendations issued by the Council in the framework of the 2003-2005 Broad Economic Policy Guidelines¹. They highlight the need for structural reforms as the main solution to the growth under-performance of the German economy. Today's decision follows the Council Recommendation under Article 104(7) of the Treaty on 21 January 2003.

The Commission Autumn forecast, published on 29 October, shows a deficit for 2003 of over 4% of GDP, implying that, contrary to expectations in Spring, neither the nominal nor the cyclically-adjusted deficit were reduced despite the measures taken by Germany. The forecast confirms, therefore, the German authorities' publicly expressed view that the general government deficit in 2004 is likely to exceed 3% of GDP.

Despite the budgetary consolidation measures taken during 2003, Germany is therefore in non-compliance with the second Art. 104(7) Council recommendation issued on 21 January 2003. Germany therefore will not put an end to the excessive deficit situation by 2004 as required by the Council. The Commission has an obligation under the rules laid down in the Treaty Article 104(8) and Regulation 1466/97 of the Stability and Growth Pact to inform the Council of this fact and recommend further steps to be taken according to Article 104(9) of the Excessive Deficit Procedure.

The Commission has considered several arguments when preparing its recommendations:

- the cumulated loss of real GDP growth over the period 2003-2004 compared with what was expected in the earlier Autumn 2002 forecast amounts to about 2 percentage points.
- the fiscal effort necessary to bring the general government deficit below the Treaty reference value of 3% of GDP in 2004 is now larger than what was expected in January 2003, when the Council adopted the recommendation according to Article 104(7). Based on the Autumn 2003 Commission forecast, the required improvement in the cyclically-adjusted balance, is currently estimated to be of the order of 1.3 percentage points.
- The increase in the general government deficit in Germany in recent years is a matter of serious concern. If not corrected, it will lead to a continuous and large increase in the debt to GDP ratio, which may in turn weigh on economic agents' expectations and be damaging for growth. Moreover, the impact of the ageing population on public finances will start accelerating from 2010 onwards, making it even more urgent to reduce rapidly the general government deficit and debt.

Weighing these arguments, the Commission has opted for granting an extra year for the correction of the excessive deficit, as it has proposed for France. In order to avoid risks of persistence of the excessive deficit situation in 2005, the Commission is of the opinion that roughly two thirds of the required overall fiscal consolidation of 1.3% over two years (2004-05) should take place the first year, i.e. in 2004. This is in relative terms the same effort as requested for France.

On this basis, the Commission has submitted to the Council an Article 104(9) recommendation stipulating that Germany shall:

put an end to the present excessive deficit situation as rapidly as possible and at the latest by 2005;

achieve in 2004 an annual reduction in the cyclically-adjusted balance by 0.8 percentage points of GDP;

achieve in 2005 a further reduction in the cyclically-adjusted deficit by at least 0.5 percentage points of GDP or by a larger amount so as to ensure that the general government deficit is well below 3% of GDP; and

allocate any higher-than-expected revenue to deficit reduction and, should the recovery in economic activity be stronger than currently expected, accelerate the reduction in the cyclically-adjusted deficit.

When drawing up the measures to be taken in order to comply with these recommendations, Germany should take into account the recommendations issued by the Council in the framework of the 2003-05 Broad Economic Policy

Guidelines. Moreover, budgetary consolidation measures should secure a lasting improvement in the general government balance. They should be geared towards an enhancement of the quality of public finances and a reinforcement of the growth potential of the economy.

The Germany authorities are requested to submit by 9 January 2004 a report to the Commission outlining the announced decisions to respect the recommendations under Article 104(9). Moreover, the German authorities shall submit four implementation reports over the next two years, allowing the Commission and the Council to assess progress made by the German government in correcting the excessive deficit. Such reports should be submitted in April and in October of each year following the bi-annual Excessive Deficit Procedure notification of deficit and debt data.

Annex 2

Commission Recommendation to the Council on an Excessive Deficit Procedure for France

Commission Press Room, IP/30/1420

Brussels, 21 October 2003

Commission asks France to take new measures to reduce the budget deficit in 2004

The Commission adopted today a recommendation for the Council to request France, in accordance with Article 104(9) of the EC Treaty, to take new measures to reduce the budget deficit and remedy the situation of excessive deficit. The Commission considers that the budgetary adjustment in 2004 should be larger than the one contained in the draft Budget for 2004. Specifically, it is recommended to reduce the cyclically-adjusted deficit by one percentage point of GDP in 2004, which implies additional deficit reduction measures of around 0.4 % of GDP. Through such action, the French government should put an end to the present excessive deficit situation as rapidly as possible and by 2005 at the latest. When drawing up the measures to be taken in order to comply with these recommendations, France should take into account the recommendations issued by the Council in the framework of the 2003-2005 Broad Economic Policy Guidelines¹. The need to curb the dynamics of spending in the health sector is explicitly included in the Guidelines. Overall, budgetary consolidation measures should secure a lasting improvement in the general government balance. They should be geared towards an enhancement of the quality of public finances and a reinforcement of the growth potential of the economy. Today's decision follows the Commission recommendation to the Council under Article 108(8) two weeks ago (IP/03/1353) establishing that France took no effective action in response to the Council's recommendations last June.

When presenting the budgetary plans for 2004, the French authorities projected a decline in the general government deficit from 4.0% of GDP in 2003 to 3.6% of GDP in 2004 and to 2.9% in 2005, under the assumption of an increase in real GDP by 0.5% in 2003 and 1.7% in 2004. Most of the reduction in the deficit between 2003 and 2004 would be achieved through restraint in general government expenditure growth. Discretionary measures on the revenue side would - on a net basis - reduce the general government deficit by 0.1 percentage point of GDP. As far as the years after 2005 are concerned, the French multi-annual projection for government finances projects a reduction in the general government deficit to 2.2% in 2006 and 1.5% in 2007, under the most plausible macroeconomic scenario of real GDP growth at 2.5% in 2006 and 2007.

In June, when issuing its recommendation according to Article 104(7), the Council had set the deadline of 2004 for the correction of the excessive deficit of

France. When defining the new recommendations issued under Article 104(9), the Commission has taken the following factors into account:

The worsening in the economic situation in 2003, which contributed to the deterioration of the budgetary situation, was abrupt and unexpected. According to the Commission calculations, the cumulated loss of real GDP growth over the period 2003-2004 amounts to about 1.5 percentage points compared to what was expected in the Spring forecast.

The deterioration of cyclical conditions has made the effort needed to bring the deficit below 3% of GDP in 2004 significantly larger than envisaged last June. To obtain such an outcome in 2004 would require a reduction in the cyclically adjusted balance of about 1.5% of GDP. Even if budgetary consolidation is not necessarily harmful for growth, such a large effort may prove economically costly if undertaken in a single year, in particular given the downward revision in growth prospects.

The budgetary plans for 2004 submitted to Parliament in September are targeted at a reduction in the cyclically-adjusted deficit slightly larger than the minimum amount of 0.5 percentage point of GDP recommended by the Council in June.

The increase in the general government deficit in France in the recent years is a matter of serious concern. If not corrected, it will lead to a continuous and large increase in the debt to GDP ratio, which may in turn weigh on economic agents' expectations and be damaging for growth. Moreover, the impact of the ageing population on public finances will start accelerating from 2005-2006, making it even more urgent to reduce rapidly the general government deficit and debt.

Against this background, the Commission proposes the following recommendations to the Council:

The French authorities shall achieve in 2004 an improvement in the cyclically-adjusted balance of one percentage point of GDP. This would allow to catch up in 2004 for the lack of adjustment in 2003 and to set a credible basis for bringing the deficit below 3.0% of GDP in 2005. Given its size, and provided that it is of the right composition, the additional adjustment compared to current plans needs not be harmful for growth in the short term and, by enhancing the sustainability of public finances, will have favourable effects in the longer run.

In 2005, the French authorities have to achieve an adjustment in the cyclically-adjusted deficit of at least 0.5 percentage point of GDP or by a larger amount so as to ensure that the general government deficit is brought below 3% of GDP.

Any higher-than-expected revenue in 2004 shall be allocated to deficit reduction and, should the recovery in economic activity be stronger than currently expected, the improvement in the underlying budgetary position should be accelerated.

When drawing up the measures to be taken in order to comply with these recommendations, France should take into account the recommendations issued

by the Council in the framework of the 2003-05 Broad Economic Policy Guidelines.

The need to curb the dynamics of spending in the health sector is explicitly included in the Guidelines. Overall, budgetary consolidation measures should secure a lasting improvement in the general government balance.

They should be geared towards an enhancement of the quality of public finances and a reinforcement of the growth potential of the economy.

Moreover, the French authorities shall submit by 15 December 2003 a report to the Commission outlining the announced decisions to respect the recommendations under Article 104(9). As regards 2004, the report shall announce the measures or reforms to be implemented and the time-horizon for their application. It shall contain estimates of the impact of such measures on the general government deficit, including all the relevant assumptions made for the quantification. As regards 2005, the report shall indicate as clearly as possible the measures or reforms envisaged by the government. This report will be examined by the Commission and the Council assess compliance by France with the Council decision.

The French authorities shall prepare four implementation reports over the next two years for allowing the Commission and the Council to monitor the progress of the French government in correcting the excessive deficit. Such reports should be submitted in April and in October of each year following the bi-annual Excessive Deficit Procedure notification of deficit and debt data. Each of these reports will be examined by the Commission and the Council to assess compliance by France with the Council decision.

Background

Based on the evidence that the government deficit in France amounted to 3.1 per cent of GDP in 2002 and on a report from the Commission made in accordance with Article 104(3), the Council decided on 3 June that an excessive deficit exists in France. At the same time, the Council adopted a recommendation according to Article 104(7) of the Treaty with the aim of bringing the situation of excessive deficit to an end in 2004 at the latest. The Council established the deadline of 3 October 2003 for the French government to take appropriate measures to this end. On 8 October 2003, in accordance with the provisions of Article 104(8) of the Treaty, the Commission recommended the Council to decide that no effective action has been taken in response to the recommendation addressed under Article 104(7).

Annex 3

Council Conclusions of 25 November 2003

14492/1/03 REV 1 (en) (Presse 320)
2546th Council meeting
- **ECONOMIC AND FINANCIAL AFFAIRS** -
Brussels, 25 November 2003

IMPLEMENTATION OF THE STABILITY AND GROWTH PACT

– France

The Council took a vote on a Commission Recommendation for a Council Decision under Article 104(8) of the Treaty in respect of France.

With Belgium, Denmark, Greece, Spain, Netherlands, Austria, Finland and Sweden voting in favour, the Presidency concluded that there was not a qualified majority for adopting the Decision. The Decision was therefore not adopted.

The Council also took a vote on a Commission Recommendation for a Council Decision under Article 104(9) of the Treaty in respect of France.

With Belgium, Greece, Spain, Netherlands, Austria and Finland voting in favour, the Presidency concluded that there was not a qualified majority for adopting the Decision. The Decision was therefore not adopted.

It is recalled that only countries which have adopted the euro are allowed to vote on Decisions on the Article 104(9) of the Treaty.

The Council, with Belgium, Germany, Greece, Ireland, Italy, Luxembourg and Portugal voting in favour, adopted the following conclusions regarding France (it is recalled that the same voting rules as for a Decision under Article 104(9) apply):

“Council conclusions on assessing the actions taken by France in response to recommendations of the Council according to Article 104(7) of the Treaty establishing the European Community and considering further measures for deficit reduction in order to remedy the situation of excessive deficit

1. In assessing the budgetary situation of France, the Council has taken several considerations into account, in particular:
 - a. By Council Decision 2003/487/EC², it was decided, in accordance with Article 104(6) of the Treaty, that an excessive deficit existed in France.
 - b. In accordance with Article 104(7) of the Treaty and Article 3(4) of Regulation (EC) No 1467/97, the Council sent a Recommendation to France on 3 June 2003 requesting it to take measures to bring the

- existence of an excessive deficit to an end in 2004 at the latest. The Recommendation was made public.
- c. Several important economic and budgetary developments have taken place since spring 2003, which the Commission recommended be taken into account: (i) the worsening in cyclical developments was abrupt and unexpected and made the effort to bring the deficit below 3% of GDP in 2004 much greater than expected in June 2003; the Commission spring forecast foresaw a growth rate for France of 1,1% in 2003 and 2,3% in 2004; in autumn the forecast was revised to 0,1% in 2003 and 1,7% in 2004; (ii) the cumulated loss of real GDP growth over the period 2003-2004 compared to what was expected in the spring now amounts to about 1,5 percentage points; (iii) the budgetary plans for 2004 submitted to Parliament in September are targeted at a reduction in the cyclically-adjusted deficit of 0,7 percentage points of GDP, slightly more than the 0,5 recommended by the Council in June. Consideration was also given to the fact that the French Government committed to implementing in 2004 a structural reform of health insurance, with the aim of curbing the dynamic of health expenditure, which constituted a major problem in controlling general Government expenditure in recent years.
 - d. The argument stressed by the Commission, that too great a consolidation effort in a single year might prove economically costly, in particular in the light of the downward revision of growth forecasts, should be given the appropriate relevance. On the basis of this argument, the Commission considered that the deadline which was set in June for the elimination of the excessive deficit in France should be extended by one year, provided that effective measures are taken by the French authorities as from 2004.
 - e. It is paramount that France moves rapidly towards a situation in which government finances are close to balance or in surplus. Such an underlying budgetary position must be achieved to ensure a rapid reduction in the debt to GDP ratio below the 60% of GDP reference value of the Treaty.
2. The Council noted that, following the Council Recommendation of 3 June 2003, France has adopted a number of structural measures, having an impact on 2003 and in the following years. The budget law entails a reduction of the structural deficit in 2004 estimated at 0,7% of GDP.
 3. The Council welcomes the public commitment by France to implement all the necessary measures to ensure that the deficit will be below 3% of GDP in 2005 at the latest.
 4. In the light of the Commission Recommendation and the commitments made by France, the Council recommends France to:

- a. achieve in 2004 an annual reduction in the cyclically-adjusted deficit of 0,8 percent of GDP;
 - b. achieve in 2005 a reduction in the cyclically-adjusted deficit of at least 0,6 percent of GDP or a larger amount so as to ensure that the general government deficit is brought below 3 percent of GDP;
 - c. should the recovery in economic activity be stronger than currently expected, allocate any higher-than-expected revenue to deficit reduction and accelerate the reduction in the cyclically-adjusted deficit;
 - d. ensure that the budgetary consolidation continues in the years after 2005, namely through a steady reduction in the cyclically-adjusted budgetary deficit by at least 0.5 percentage points of GDP per year or more if necessary to achieve the medium term position of government finances close to balance or in surplus and bring back the debt ratio to a declining path;
 - e. outline a strategy consistent with these commitments and based on prudent macroeconomic assumptions in the Stability Programme to be updated by December 2003;
 - f. take into account the recommendations issued by the Council in the framework of the Broad Economic Policy Guidelines when implementing the measures to be taken in order to comply with the above commitments;
 - g. put an end to the present excessive deficit situation as rapidly as possible and at the latest by 2005.
5. In the light of the recommendations and the commitments by France set out above, the Council decided not to act, at this point in time, on the basis of the Commission Recommendation for a Council decision under Article 104(9).
 6. The Council agrees to hold the Excessive Deficit Procedure for France in abeyance for the time being. The Council stands ready to take a decision under Article 104(9), on the basis of the Commission Recommendation, should France fail to act in accordance with the commitments set out in these Conclusions as it would emerge from the assessment based on paragraph 7 below.
 7. The Council invites France to regularly report on the progress made in fulfilling the commitments set out above, in particular in the context of the biannual notifications. In assessing the progress achieved, the Council and the Commission will give due attention to the prevailing economic conditions and to the structural reforms being implemented in France with a view to strengthening growth and ensuring the long term sustainability of public finances.”

– *Germany*

The Council took a vote on a Commission Recommendation for a Council Decision under Article 104(8) of the Treaty in respect of Germany.

With Belgium, Denmark, Greece, Spain, Netherlands, Austria, Finland and Sweden voting in favour, the Presidency concluded that there was not a qualified majority for adopting the Decision. The Decision was therefore not adopted.

The Council also took a vote on a Commission Recommendation for a Council Decision under Article 104(9) of the Treaty in respect of Germany.

With Belgium, Greece, Spain, Netherlands, Austria and Finland voting in favour, the Presidency concluded that there was not a qualified majority for adopting the Decision. The Decision was therefore not adopted.

It is recalled that only countries which have adopted the euro are allowed to vote on Decisions on the Article 104(9) of the Treaty.

The Council, with Belgium, Greece, France, Ireland, Italy, Luxembourg and Portugal voting in favour, adopted the following conclusions regarding Germany (it is recalled that the same voting rules as for a Decision under 104(9) apply):

“Council conclusions on assessing the actions taken by Germany in response to recommendations of the Council according to Article 104(7) of the Treaty establishing the European Community and considering further measures for deficit reduction in order to remedy the situation of excessive deficit

1. In assessing the budgetary situation of Germany, the Council has taken several considerations into account, in particular:
 - i. By Council Decision 2003/89/EC³ it was decided, in accordance with Article 104(6) of the Treaty, that an excessive deficit existed in Germany.
 - ii. In accordance with Article 104(7) of the Treaty and Article 3(4) of Regulation (EC) No 1467/97, the Council sent a Recommendation to Germany on 21 January 2003 establishing the deadline of 21 May 2003 for Germany to take measures to bring the existence of an excessive deficit to an end as rapidly as possible. The Recommendation was made public.
 - iii. On the basis of information available upon the expiry of the deadline of 21 May 2003, the policies announced by the German authorities satisfied the requirement of budget consolidation measures amounting to 1 % of GDP set out in the Recommendation of 21 January 2003.
 - iv. Several important economic and budgetary developments have taken place since the Spring: (i) the worsening in cyclical developments was

- abrupt and unexpected and made the effort to bring the deficit below 3% of GDP in 2004 much greater than expected in May 2003; the Commission spring forecast foresaw a growth rate for Germany of 0,4% in 2003 and 2,0% in 2004; in autumn the forecast was revised to 0,0% in 2003 and 1,6% in 2004; (ii) the cumulative loss of real GDP growth over the period 2003-2004 compared to what was expected in the spring now amounts to nearly 2 percentage points.
- v. The following arguments, which the Commission stressed, should be given the appropriate relevance: (i) too great a consolidation effort in one single year might prove economically costly in view of the prolonged stagnation in Germany over the last three years and the expected slow recovery; and (ii) government proposals for structural reforms would boost potential growth and reduce the deficit in the medium to long term.
 - vi. Taking into account these factors, and in order to provide the conditions for a balanced correction, the Commission considered that it appears that the deadline set in January 2003 for the elimination of the excessive deficit in Germany should be extended by one year, provided that effective measures are taken by the German authorities as from 2004.
 - vii. It is paramount that Germany moves rapidly towards a situation in which government finances are close to balance or in surplus. Such an underlying budgetary position must be achieved to ensure a rapid reduction in the debt-to-GDP ratio below the reference value of 60% referred to in the Treaty.
2. The Council noted that, following the Council Recommendation of 21 January 2003, Germany has made a substantive adjustment adopting several measures, which have a total impact on government finances in 2003 that is estimated by the Commission to be 1 percent of GDP.
 3. The Council welcomes the public commitment by Germany to implement all the necessary measures to ensure that the deficit will be below 3% of GDP in 2005 at the latest, on the basis of the Commission's GDP growth projections.
 4. In the light of the Commission Recommendation and the commitments made by Germany, the Council recommends Germany to:
 - a. achieve in 2004 an annual reduction in the cyclically-adjusted deficit of 0,6 percent of GDP;
 - b. achieve in 2005 a reduction in the cyclically-adjusted deficit of at least 0,5 percent of GDP or a larger amount so as to ensure that the general government deficit is brought below 3 percent of GDP;

- c. should the recovery in economic activity be stronger than currently expected, allocate any higher-than-expected revenue to deficit reduction and accelerate the reduction in the cyclically-adjusted deficit;
 - d. ensure that the budgetary consolidation continues in the years after 2005, namely through a steady reduction in the cyclically-adjusted budgetary deficit by at least 0,5 percentage points of GDP per year or more if necessary to achieve the medium term position of government finances close to balance or in surplus and bring back the debt ratio to a declining path;
 - e. outline a strategy consistent with these commitments and based on prudent macroeconomic assumptions in the Stability Programme to be updated by December 2003;
 - f. take into account the recommendations issued by the Council in the framework of the Broad Economic Policy Guidelines when implementing the measures to be taken in order to comply with the above commitments;
 - g. put an end to the present excessive deficit situation as rapidly as possible and at the latest by 2005.
5. In the light of the recommendations and the commitments by Germany set out above, the Council decided not to act, at this point in time, on the basis of the Commission Recommendation for a Council decision under Article 104(9).
 6. The Council agrees to hold the Excessive Deficit Procedure for Germany in abeyance for the time being. The Council stands ready to take a decision under Article 104(9), on the basis of the Commission Recommendation, should Germany fail to act in accordance with the commitments set out in these conclusions as it would emerge from the assessment based on paragraph 7 below.
 7. The Council invites Germany to report regularly on the progress made in fulfilling the commitments set out above, in particular in the context of the biannual notifications. In assessing the progress achieved, the Council and the Commission will give due attention to the prevailing economic conditions and to the structural reforms being implemented in Germany with a view to strengthening growth and ensuring long term sustainability of public finances.”

The Council unanimously adopted the following conclusion:

“The Council:

- confirms its strong commitment to sound public finances as a basis for strong economic growth and increased employment, in accordance with the conclusions of the European Council meeting of spring 2003;

- recalls the central role played by the Stability and Growth Pact in ensuring an improvement in the overall budgetary situation in the EU, and encouraging the development by the Member States of sound and sustainable budgetary policies;
- reaffirms its commitment to the Stability and Growth Pact as the framework for the coordination of budgetary policies in the European Union with the particular
- objectives of achieving budgetary positions of close to balance or in surplus over the business cycle and public finances that are sustainable in the long term;
- will, to achieve these objectives, strengthen the monitoring of budgetary developments in the Member States in accordance with the surveillance procedures laid down by the Treaty and the Pact;
- reaffirms the determination to implement the provisions of the Stability and Growth Pact by ensuring equality of treatment across Member States and the role of the Commission in this area;
- will pay particular attention within the surveillance framework to the full and timely implementation of the firm commitments given by those Member States whose budgetary positions require significant improvement in order to meet the Pact's medium term objective;
- undertakes to strengthen the implementation of the Pact by reinforcing budgetary discipline over the cycle and fostering structural reforms aimed at increasing growth potential.”

The Commission entered in the Council minutes the following statement:

“The Commission takes note of the rejection by the Council of the Commission recommendation under Article 104(8) for France and Germany, without giving the adequate explanation as laid down in the European Council Resolution on the Stability and Growth Pact. The Commission therefore considers that the Council recommendations based on Article 104(7) remain in force.

The Commission deeply regrets that the Council has not followed the spirit and the rules of the Treaty and the Stability and Growth Pact that were agreed unanimously by all Member States. Only a rule-based system can guarantee that commitments are enforced and that all Member States are treated equally.

The Commission will continue to apply the Treaty and reserves the right to examine the implications of these Council conclusions and decide on possible subsequent actions.”

Annex 4

Council Recommendation in the Context of the Excessive Deficit Procedure for Germany

COUNCIL RECOMMENDATION TO GERMANY

of 21 January 2003

with a view to bringing an end to the situation of an excessive government deficit - Application of Article 104(7) of the Treaty

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(7) thereof,

Having regard to the recommendation from the Commission under Article 104(7) and Article 104(13),

Whereas in stage three of Economic and Monetary Union (EMU), Member States according to Article 104 of the Treaty shall avoid excessive government deficits.

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.

Whereas the Amsterdam Resolution of the European Council on the Stability and Growth Pact of 17 June 1997 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.

Whereas the Council has decided, in accordance with Article 104 (6), that an excessive deficit exists in Germany.

Whereas having decided on the existence of an excessive deficit in Germany, the Council, in accordance with Article 104(7) of the Treaty and Article 3(4) of Regulation EC 1467/97, shall adopt a Recommendation establishing a deadline of four months at the most for effective action to be taken by Germany to correct the excessive deficit position; whereas the Council takes note of the budgetary measures announced in November 2002, which aim at reducing the deficit level to 2 ¾% of GDP in 2003, as well as those planned for 2004; whereas the Council welcomes the measures announced by the German authorities but shall establish a deadline of 21 May 2003 at the latest for the German government to take measures to bring the existence of an excessive deficit to an end within the deadline established by this Council Recommendation.

Whereas Article 3(4) of Regulation EC 1467/97 requires that the Recommendation adopted by the Council in accordance with Article 104(7) also establishes a deadline for the correction of the excessive deficit, which should be completed in the year following its identification.

Whereas the German government adopted a federal budget aiming at a general government deficit of 2 ¾% for 2003; whereas on 18 December, the German government adopted an updated Stability Programme aiming at a balanced budget in 2006 in a central scenario.

Whereas, in accordance with Article 104(12) of the Treaty, a Council decision under Article 104(6) on the existence of an excessive deficit will only be abrogated if the excessive deficit, in the view of the Council, has been corrected; whereas the Council will take into account compliance with the recommendation made under Article 104(7) when taking decisions in accordance with Article 104(12),

HEREBY RECOMMENDS:

- the German government to put an end to the present excessive deficit situation as rapidly as possible in accordance with Article 3(4) of Council Regulation (EC) No 1467/97;
- the German authorities to implement with resolve their budgetary plans for 2003 which, on the basis of GDP growth projections of 1 ½% in 2003, aim at reducing the general government deficit in 2003 to 2 ¾% of GDP; in particular, the German authorities should ensure a rigorous budgetary execution and a thorough implementation of the measures announced for 2003 amounting to 1% of GDP. The Council establishes a deadline of 21 May 2003 at the latest for the German government to take such measures. If some of these measures are not implemented, the German government should adopt and implement compensatory measures to ensure a reduction of the government deficit in 2003 as planned. In addition, the Council recommends the German authorities to ensure that the rise in the debt ratio is brought to a halt in 2003 and reversed thereafter.

In addition, the Council notes the commitments of the German authorities:

- to implement structural reforms which should vigorously address the need to raise the growth potential of the German economy and, in this way, also be conducive to the achievement of a medium-term budgetary position of close to balance or in surplus, and to a debt ratio brought back to a declining path;
- to ensure that the momentum of budgetary consolidation is maintained throughout the period covered by the December 2002 update of the Stability Programme, namely through a reduction in the underlying budgetary deficit

by more than 0.5% of GDP per year, with the exception of 2005 due to the introduction of tax reforms, which in turn requires the introduction of structural reforms;

- to reinforce the co-ordination mechanisms of budgetary policy in Germany and to secure the process of budgetary consolidation. In this regard, the Council notes with satisfaction the approval and implementation of the new §51a Haushaltsgrundsätzegesetz ('law on budgetary procedures') aimed at strengthening budgetary co-ordination and fiscal discipline among the constituent sectors of general government, thereby assisting in the management of fiscal policy; the Council welcomes the efforts that are being made by the German government to reduce the government deficit on a permanent basis and encourages the German government to implement these policies with determination.

Annex 5

Council Recommendation in the Context of the Excessive Deficit Procedure for France*

COUNCIL RECOMMENDATION TO FRANCE with a view to bringing an end to the situation of an excessive government deficit - Application of Article 104(7) of the Treaty

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(7) thereof,

Having regard to the recommendation from the Commission under Article 104(7) and Article 104(13),

Whereas:

- (1) In stage three of Economic and Monetary Union (EMU), Member States according to Article 104 of the Treaty shall avoid excessive government deficits.
- (2) 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) The Amsterdam Resolution of the European Council on the Stability and Growth Pact of 17 June 1997 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.
- (4) The Council has decided, in accordance with Article 104 (6), that an excessive deficit exists in France.
- (5) Having decided on the existence of an excessive deficit in France, the Council, in accordance with Article 104(7) of the Treaty and Article 3(4) of Regulation (EC) 1467/97, shall adopt a Recommendation establishing a deadline of four months at the most for effective action to be taken by France to correct the excessive deficit position; whereas the Council shall establish a deadline of 3 October 2003 at the latest for the French government to take measures to bring the existence of an excessive deficit

* 3 June 2003.

to an end within the deadline established by this Council Recommendation.

- (6) Article 3(4) of Regulation (EC) 1467/97 requires that the Recommendation adopted by the Council in accordance with Article 104(7) also establishes a deadline for the correction of the excessive deficit, which should be completed in the year following its identification.
- (7) In accordance with Article 104(12) of the Treaty, a Council decision under Article 104(6) on the existence of an excessive deficit will only be abrogated if the excessive deficit, in the view of the Council, has been corrected; whereas the Council will take into account compliance with the recommendation made under Article 104(7) when taking decisions in accordance with Article 104(12).
- (8) In January 2003, the Council adopted a recommendation sending an early warning to France in order to avoid the occurrence of an excessive deficit in 2003, in accordance with Article 99(4) of the Treaty and Article 6(2) of the Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies. In this recommendation, the Council stated that — the French government should take all the appropriate measures in order to ensure that the general government deficit does not breach the 3% of GDP threshold in 2003⁸; and that —adopting measures apt to improve the cyclically-adjusted budgetary position by at least 0,5 percentage point of GDP would not only reduce the risk for the general government deficit to breach the 3% of GDP threshold in 2003, but also contribute to resuming a budgetary consolidation path towards a close to balance position as from 2003⁸.
- (9) In February 2003, the French authorities decided, in order to control State expenditure in 2003, to put in reserve 4 billion (0.25% of GDP) on the State budget, of which 1,44 billion (0.1% of GDP) were cancelled in March; besides, the French authorities decided, in order to control health expenditure, several measures, such as a reduction in the reimbursement rate of some drugs of limited medical utility. When presenting their new official forecast in March 2003, the French authorities projected real GDP growth in 2003 at 1.3% and an improvement in the cyclically-adjusted general government balance by 0.1 percentage point of GDP in 2003; whereas, in the same forecast, the general government deficit in France for 2003 was projected to reach 3.4 per cent of GDP.

⁸ OJ L 34, 11.2.2003.

- (10) In the view of the Council, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy,

HEREBY RECOMMENDS:

1. the French authorities to put an end to the present excessive deficit situation as rapidly as possible and by 2004 at the latest, in accordance with Article 3(4) of Council Regulation (EC) No 1467/97. The Council establishes the deadline of 3 October 2003 for the French government to take appropriate measures to this end;
2. the French authorities to achieve a significantly larger improvement in the cyclically-adjusted deficit in 2003 than that currently planned;
3. the French authorities to implement measures ensuring that the cyclically-adjusted deficit is reduced in 2004 by 0.5% of GDP, or by a larger amount, so as to ensure that the cumulative improvement in 2003-2004 is enough to bring the nominal deficit below 3% in 2004 at the latest;
4. that France limits the increase in the general government gross debt to GDP ratio in 2003.

In addition, the Council:

- œ notes the commitment of the French authorities to ensure that the budgetary consolidation continues in the years after 2004 as reflected by the December 2002 update of the Stability Programme, namely through a reduction in the cyclically-adjusted budgetary deficit by at least 0.5 percentage point of GDP per year, in order to move decisively towards the medium term position of government finances close to balance or in surplus and bring back the debt ratio to a declining path;
- œ notes the commitment of the French authorities to ensure a tighter control of expenditures in 2003;
- œ and welcomes the commitment of the French government to achieve the pension reform already in process to secure the long-term sustainability of public finances.

Annex 6

Wording of Question and Possible Responses in German Public Opinion Poll on Fiscal Policy

Query: "In case the federal government and the Bundesrat (the German federal chamber) agree to implement the third step of the tax reform to next year, what effect will the tax reform have on your personal spending?"

Responses	Total	
	%	%
I will immediately increase my purchases.	2	2
I will increase my purchases only once the tax reform enters into force.	15	10
I will not spend more even after the tax reform has come into force.	78	81
No answer	5	8
	<i>July 2003</i>	<i>November 2003</i>

Source: Exclusive telephone survey for the German Press Agency by Polis, Munich (45/2003), translation by author.

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