The future of the SGP and some lessons for other monetary unions

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Abstract

The Stability and Growth Pact (SGP) was originally introduced as a counter-balance to monetary policy at the EU level. The crisis surrounding the pact in 2004 and 2005 caused revisions to be made to the SGP, brokered through the euro subcommittee of the Ecofin council. Although the SGP has been criticized, and is widely acknowledged as being imperfect, there must be perceived advantages to having a fiscal pact in place in the EU, otherwise these renegotiations would not have occurred and the pact would have been scrapped. This paper explores the possible political and economic consequences of the pact on the basis of the likely further revisions that will be made to the SGP, and the likely direction that the EU will be taken in by the modified pact. Finally, some lessons are drawn for monetary unions elsewhere based on the experience of the EU in adopting and implementing the SGP.

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"Revising the SGP will not be easy. Taking the long view, however, the cost of sticking with a deeply flawed set of rules is bound to dominate the short-term reputation damage caused by any significant redesign of the rules." (Buiter, 2003, p. 98)

I. Introduction

The European Union (EU) has a unique institutional arrangement for macroeconomic policymaking - one that was only recently designed following the Maastricht Treaty in 1991 and then established in 1999 following the launch of the euro in 1999. In this policy configuration, monetary policy is handled at the European level by the European Central Bank (ECB), while fiscal policy is still made by national governments at the member state level. Such a novel configuration has obviously attracted a lot of attention from academics (mostly political scientists and economists), but also has been a catalyst for other regional integration projects around the world to consider and evaluate the feasibility of making the step from being solely trade blocs to more economically integrated areas, through similar policies (to those of the EU).

Although on the monetary side, the launch of the euro has been regarded as one of the great post World War II successes, there have already been signs of growing problems with how the single currency interacts or coordinates with the decentralized fiscal policies of the EU member states. The widely-reported arguments surrounding the Stability and Growth Pact (SGP), a pact that was originally put in place to exert some form of pan-EU fiscal policy discipline on member states from the EU level, has left some doubts as to whether the current arrangements are sustainable, if not in design, then most certainly in substance.

The purpose of this paper is three-fold. First we want to analyse the recent reforms to the SGP to evaluate whether the new version of this pact is more sustainable than the previous version. Second we wish to evaluate what would make most sense in terms of feasible arrangements for fiscal policy at an EU level within EMU. Third we then aim to draw out some lessons from the EU's experience so far with the SGP.

The paper is laid out as follows: in the following section we offer an evaluation of the institutional and political context for the SGP, which in part III is followed by a short review of the revisions to the pact. Sections IV to VI deal with potential consequences of the new SGP in the light of other EU priorities by constructing some illustrative scenarios for how the SGP might come to bear on the future evolution of the EU, and then in turn the consequent changes that this would induce to the SGP. In section VII some lessons for other monetary unions are discussed, and then finally in section VIII some conclusions are presented.

II. The institutional context for the SGP

One source of the biggest problems with the design of European Union (EU) integration has been the difficulties involved in re-visiting previously-made decisions. Although reappraisal and revision are hallmarks of constitutional agreements in many countries[1], the costs involved in the consensual nature of much EU decision-making fosters significant reluctance to revisit or redesign any existing agreement. In this paper we explain why in the case of the Stability and Growth Pact (SGP) the benefits from a significant redesign of the rules will eventually come to dominate the costs of sticking to a "deeply flawed set of rules".

The EU is an innovative experiment in non-federal integration, that involves a considerable pooling of national sovereignty at the supranational level. As such, relevant concerns over the dynamic interaction between actual and potential fiscal and monetary policies have stimulated a voluminous amount of research, both from economists and political scientists. With economic and monetary union (EMU), the European Central Bank (ECB) operates monetary policy for all euro-area participants, but within the euro area as a whole, fiscal policies are decided by individual member states. Although fiscal decisions are to a modest degree restrained by means of the prior commitment to the SGP at the supranational level, the SGP is only a crude counterpart for the ECB in the monetary sphere—at least in terms of the determination of a collective limit to the EMU fiscal-policy stance. In institutional terms, the EU's Council of Economics and Finance Ministers (Ecofin) and the euro subcommittee of Ecofin might then be viewed as an (embryonic) institutional embodiment of a tentative counterbalance to the ECB.

This institutional arrangement is both distinctive and unique, as noted in Crowley (2006a), but it is also deeply flawed. Despite the fact that the original purpose of the SGP remains unclear (Crowley 2002), its current purpose—as unambiguously stated by the ECB—is to ensure a sufficient degree of fiscal stability to serve as a perceived necessary condition for monetary stability in the euro area.

The formal arrangements for monetary and fiscal policies are couched in very different legal frameworks. The ECB is akin to a federal institution, while the SGP is, in large part, an intergovernmental agreement. The arrangements for monetary policy in the euro area are very distinctly identified in the Maastricht Treaty, while the further finessing of arrangements has also been made by the ECB and approved by its Governing Council—which, of course, ultimately determines monetary policy in the euro area. The current arrangements for fiscal policy, however, lie primarily

[1] Notably also in both Canada and the US.

outside the bounds of Treaty arrangements and are deeply embedded in national democratic traditions. Although the procedure associated with the declaration of an "excessive deficit" is mentioned in the Treaty, its mode of operation—which is part of the *raison d'etre* for the SGP—stems only from a series of directives made by the European Council.

It is in regard to this disparity or disconnection that the ECB also has a particular interest in the design and operation of the SGP[2]. In fact it is this disconnection between design and operation that has created such recent tensions in the euro area—tensions which economists have not been able to adequately address or resolve with any consensus. Some member states have flouted the rules using a rationale that the SGP is unduly restrictive given current economic conditions for member states or "stupid"[3], while others have fallen afoul of the rules and subsequently have made strenuous efforts to comply with the corrective actions specified in the operation of the pact. While temporary conditions may pose problems for national politicians given obvious concerns about re-election and promoting growth, the real question to be dealt with is whether the SGP is the most appropriate counterbalance to a monetary policy determined in a supranational forum.

The current economic context for implementation of the SGP has exposed its major weakness —namely, the fact that the "rules-based" approach taken by the designers of the pact has to make economic sense, be applicable to all, and yet there must still be sufficient flexibility to cover all appropriate circumstances given the integration "dynamic"[4]. Using exact limits on some economic measure—a measure that did not make much economic sense (budget deficits) but at the time seemed the logically admissible candidate to follow—was perceived to be the only way to make a rules-based approach work in the EU. Now the context and principal reasons for breaching those limits must be taken into consideration by those deciding on the implementation of the penalty-based elements of the pact.

The political context for the implementation of the SGP is also greatly problematic, since the larger euro-area member states now appear to be more easily able to flout the rules and get away with this failure to comply (judging by recent events)—a situation that has clearly led to some resentment among the smaller member states, who have strenuously tried to avoid breaching the SGP limits on deficits while themselves seeking to impose harsh fiscal policies measures, even though such measures

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[2] De Grouwe (2006) suggests that the ECB is content with as little institutionalization of fiscal policy at the EU level as this allows it to absolve itself of any responsibility for anything other than inflation as there is no necessity to coordinate with an EU fiscal policy as none officially exists.

[3] Former Commission President Romano Prodi went as far as to call the SGP "stupid" in an interview with Le Monde (October 17th, 2002).

[4] One might argue that this is directly analogous to the "rules vs. discretion" debate over monetary policy in the economics literature. See Barro and Gordon (1983).

could well be detrimental to overall economic conditions (e.g., Portugal).

III. The Revised SGP – how does it differ from the original SGP?

The SGP did not attract much attention during its first few years in operation, and indeed, due to moderately strong economic growth and the fact that most political foci were primarily set on the successful completion of EMU and establishment of the ECB, there was little effort in academic circles to study and evaluate the SGP during this expansionary period. This benign neglect changed in recent years when fiscal policies in EMU became an extremely controversial topic after France and Germany were issued automatic warnings by the Commission in 2003, and when subsequently an acrimonious environment emerged, stimulated by the separate decisions (taken in 2004) for both of these major countries which resulted in the European Council effectively deciding to ignore these warnings by holding the SGP in abeyance. France, Germany, Italy and Greece all exceeded the SGP guidelines in 2004, and thus prompted legal manoeuvres by the Commission in order to try and retain some vestiges of credibility for the pact[5].

While EU member states appear to accept that some permanent form of fiscal pact is needed, the previous form of the pact became viewed as too restrictive in present economic circumstances (as identified with an environment exhibiting low rates of inflation and growth for the major euro-area economies). When the Commission's review of the SGP was completed in early 2005, agreement was reached at the European Council meeting of March 23/24th to delay the imposition of any fines and restrain corresponding actions on the part of the Commission for 5 years from the declaration of an "excessive deficit" and to recognize a longer list of "exceptional circumstances" that would justify deficits "slightly and temporarily" above 3 percent of national GDP. An agreement to modify the SGP was reached[6], so that in effect the main coercive elements of the pact (which were effectively suspended in early 2004) have now come back into operation with Italy becoming the first member state subject to the new procedures in May and June of 2005[7].

[5] In its decision, the European Court of Justice favoured the Commission's argument that indeed the Council should have acted rather than making solely a political declaration about the SGP following the decision to freeze the process by Ecofin, noting that the decisions of the Council in regard to the operation of the SGP are "intended to have legal effects". On the other hand the ECJ confirmed that "responsibility for making the member states observe budgetary discipline lies essentially" with the ministers of the European Council. See Dutzler and Hable (2005).

[6] The release on June 27th, 2005 by the Commission after the European Parliament's approval of the changes in relations. More information is available at: http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/05/798&format=HTML&aged=0&language=EN&guiLanguage=en

[7] On May 23rd 2005, Eurostat announced that Italy's budget deficit had been in deficit at 3.1% of GDP for both 2003 and 2004. Following a report issued by Ecofin, the Commission declared on July 12th, 2005 that Italy had an excessive deficit, but given the extenuating economic circumstances, that Italy had until 2005 to correct its deficit.

In fact, most of the changes to the pact appear to be fairly cosmetic and scarcely radical revisions to the previous controls—most notably, the changes are as follows:

i) some clarification of "sufficient" effort on the part of member state governments in terms of correction of excessive deficits—this correction is now set at a minimum level of 0.5% improvement in structural deficit per annum;

ii) delays in the implementation of the coercive procedures;

iii) a greater degree of emphasis on the cyclical (or structural) budget deficits rather than actual budget deficits, although it is still not clear what particular measure of cyclical budget deficits will be used here;

iv) a widening of the exceptional circumstances under which an excessive deficit would be exempt from the coercive procedures in the pact; and

v) a lower limit than the previous 1.5% fall in GDP or 0.75% fall in growth for member states to be exempt from the coercive elements of the SGP, with this lower limit now set at less than 1% growth in GDP;

The first change relates to the preventive arm of the SGP. As the Commission's review of the changes to the SGP (European Commission, 2005) makes clear, the concept of a budget that is "close to balance or in surplus" is replaced by a specific "medium-term budgetary objective" for each member state, an objective which is to be determined on the basis of the debt ratio and also potential growth. The revisions ii) and iii) were both recognized to be long term deficiencies. Practical concerns noted some substantial issues of implementation and timing—many changes in fiscal policies involve a common 'recognition lag' associated with policy implementation, while at certain times of year, parliaments of member states might have insufficient time to debate, pass enabling legislation, and provide detailed bureaucratic protocols to initiate the desired changes and to disseminate adequate knowledge of them to relevant economic agents. The third revision reflects the attention that must be given to the operation of the automatic stabilizers, an important factor in the effectiveness of fiscal policies which had been largely ignored in the original formulation of the SGP, although critics of these revisions have made clear that member states could allow their automatic stabilizers to operate by ensuring that budget balances over the cycle remain roughly in balance. Some calculations of cyclical deficits will now be provided, and also a wider consideration of recent GDP growth figures will be taken into account in the process of determining whether an excessive deficit exists. Both Germany and France suffered from anaemic growth during the 2002-04 period, and reactions to this historical experience prompted the forceful insistence that the fourth and fifth changes should be included in the revision of the SGP.

How will these revisions impact the coordination of monetary and fiscal policy in the EU? Obviously as occurs in all cases of substantial changes in economic circumstances and unanticipated or unavoidable shocks, there is considerable uncertainty as to what to expect. In particular, it is still uncertain as to how the new revisions will indeed be applied, and as to whether further iterations in terms of changes will be made to the SGP. Prediction is seriously hampered even in terms of qualitative criteria, but is seems likely that path-dependent modes of application for most rules will 'emerge' rather than be set out simply by bureaucratic edict, and that some further tinkering will be strongly encouraged by future changes in the ability or willing of national governments to deal with changes in economic circumstances. A table that summarizes the changes in more detail is provided in Appendix A.

In terms of the individual changes, various opinions appeared in the media and other official media outlets: they were mostly positive from the point of view of French and German politicians, as well as the Commission, with more negative viewpoints emanating from both the central banks and leading academic observers such as, for example, Feldstein (2003). As an example, the Bundesbank (2005, p. 21) indicated that:

> In the Bundesbank's view, the new rules severely weaken the SGP. They diminish both the incentives to pursue a sound budgetary policy and the binding impact of the rules and also send the wrong signals to those countries, which have not yet introduced the single currency.

In general, there was a fairly wide consensus among central bankers that a rules-based procedure was the appropriate framework in which to implement the SGP[8], but they seemed to view the proposed revisions, unless rigorously enforced, as likely to represent an undesired loosening of the fiscal requirements within the euro area.

These observations should be contrasted with a German politician's views, namely those of former Chancellor Schroeder, speaking before agreement on the revisions to the pact were decided (January 14, 2005):

> The stability pact will work better if intervention by European institutions in the budgetary sovereignty of national parliaments is only permitted under very limited conditions. Only if their competences are respected will the member states be willing to align their policies more consistently with the economic goals of the EU.

It was clear from the interesting treatments by Buti, Eijffinger and Franco (2003a, b), Flores, Giudice and Turrini (2005), and Deroose and Langedijk (2005), that the Commission was in favour of maintaining the current general framework, of making incremental changes to improve the implementation of the pact and to strengthen the surveillance of the fiscal policies of member states.

Their reasons were simple, namely, the pact appears to have maintained some degree of fiscal austerity after the inception of EMU. To quote Flores, Giudice and Turrini (2005, p. 17):

> In spite of recent difficulties, there has been no return to the profligate budget policies of the past. The SGP and multilateral surveillance have played a decisive, albeit sometimes difficult, role in containing the deficit levels during the economic slowdown.

After the revisions were made, the Commission (2005) was less certain that it considered the new arrangements to provide an improvement over the original SGP. Its evaluation of the new arrangements was made by appealing directly to the Kopits-Symansky criteria (Kopits and Symansky, 1998) for an "ideal" fiscal rule[9]. In particular, the Commission thought that although the new arrangements were less well-defined, less transparent and less simple, they still rated the new arrangements as more flexible, more adequate to goal, more credible, more consistent and more supportive of structural reforms[10]. The netting off of the five "positives" against the three "negatives" leaves the two "positives", which leads the Commission to state that:

> …it is important to keep in mind that the various qualitative scores…cannot be summed up. While the results suggest a broadly balanced set of rules, it cannot be concluded that the new rules are "better" or "worse" than the existing rules. (p. 97).

Nevertheless, one is left with the impression that the use of the "pseudo-objective" Kopits-Symansky criteria has been used to signal that the revisions yield an overall improvement to the design of the pact which the Commission can accept.

One of the main features of the new SGP was the increased emphasis on flexibility. The revisions to the SGP were seen as a shift from a rules-based policy to a more discretionary policy. Although an analogy with the earlier "rules vs. discretion" debate in monetary economics is a substantial stretch given the fact that member states still have a huge degree of discretion in terms of how they set fiscal policy, even under a strict rules-based SGP, there is little doubt that the list of "special circumstances" can now be much more broadly interpreted[11], and that as such, there is less likelihood that the coercive arm of the SGP will come into play.

In terms of the coercive arm itself, the Commission clearly expects the enforcement of the rules to improve again, stating that: "As in the old system, subjective political pressure on the

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[8] For example, see Papademos (2005).

[9] The Kopits-Symansky criteria are requirement for i) well-defined, ii) transparent, iii) simple, iv) flexible, v) adequate to goal, vi) enforceable: rules should be credible with impartial application, vii) consistent and viii) supportive of structural reforms.

[10] Reliance on such criteria to evaluate fiscal rules caused other economists to construct such criteria, see for example Buiter (2003).

[11] An example of a new "special circumstance" is where government spending can be related to fostering greater European integration.

enforcement can be expected to remain, which proves that the renewed SGP continues to bite."(p. 96)

However, this statement is quite alarming from another perspective. "Subjective political pressure" was essentially the cause of the SGP crisis in 2003/04, as pressure to override the "objective" rules in place for enforcement won the day at the European Council. In an instructive sense, the statement is a tacit admission by the European Commission that the events which led to the demise of the previous version of the SGP are quite likely to occur again. But there is also something even more sinister lurking in this seemingly innocent statement: an admission by the Commission, the body which is the custodian of the SGP, that there are no "objective" rules for fiscal policy that would not attract political pressure from member states to bend these rules to suit the particular fiscal stance of a (collection of) member state(s)[12]. The statement thus implies that the Commission likely anticipates another crisis surrounding the SGP in the future – this supports the major assumption that gives rise to this paper – that this current iteration of the SGP is not a "steady state" situation: further iterations will undoubtedly be forthcoming. This prospect is the working assumption that we use in the rest of the paper.

IV. What does the future hold? Providing the context for the revised SGP

a. The Approach

After the events of late 2003 and 2004, culminating in the overhaul of the SGP on March 22nd in 2005 after the review by the Commission, there are still very few signs of a real consensus among academic economists about whether the pact is really necessary or about what changes should and could have been introduced to make the pact more suitable to those affected by it. Clearly (given our own academic backgrounds) this lack of consensus should be seen as problematic, especially if such economists aim to offer any effective guidance to those policymakers who have to abide by the consequences of the pact on a day-to-day basis. Given this awkward but understandable lack of consensus, we need to make a start by setting up an initial framework for dealing with the practical concerns to be raised and the potential resolutions that eventually might be forthcoming to deal with them. Our approach is as follows:

a) define the economic and political factors that might impinge upon the EU, and clarify the context for the SGP;

[12] This is in direct contrast to the evaluation of the entry criteria into EMU (the "Maastricht" criteria), where there has been no political pressure to "bend the rules" – instead member states attempted to manipulate their own budget balances so as to fit within the rules. See Brück and Stephan (2006). Whatever one might think of the criteria they have been applied, to date, in a strict and objective manner.

b) look at the economic options for reform that would make practical sense, given the current design of the pact; and
c) analyse the political acceptability of the options for reform of the pact, and define scenarios for what might happen to the SGP, given circumstances within the EU.

If one recalls the main events that led to the revision in the SGP in early 2005, this hesitant approach is analogous to what happened in a real-time context. First, some problems were recognized with the operation of the SGP—problems which presumably were put to one side until politicians were forced to look at revisions in light of some form of crisis that dictated that current rules were not going to be followed. Second, this opportunity was provided by the freezing of the procedures by the Ecofin in 2004 for Germany and France, which then prompted the European Council to request that the Commission prepare new proposals for overhaul of the SGP. Thus economic circumstances provided the opportunity for the politicians to revise the SGP. Third, the newly-revised SGP was then decided upon by the European Council (with input from Ecofin and the Commission) and was subsequently ratified by the European Parliament.

In what follows, our maintained hypothesis is that the current revisions to the SGP will not be sufficient to avoid another crisis occurring, particularly if the SGP is applied as intended and political pressure continues to be exerted in the European Council. Even if political pressure does not halt the SGP processes, political pressure that leads to a lax implementation of the SGP might also precipitate a crisis of confidence in the framework for the SGP, so either way it is likely, in our assessment, that further reforms to the SGP will be forthcoming at some undefined point in the future.

b. Factors impinging on the evolution of the EU

To begin, what are the main economic and political factors that are likely to impact on the development of the EU during the medium and longer term? These we list below, in rough order of perceived importance:

i) the dynamic for geographical and other enlargements (political and economic);
ii) the operation of EMU (economic);
iii) the Lisbon agenda and internal structural reforms (economic);
iv) institutional stability and development (political);
v) business-cycle synchronisation and the coordination of policies (economic);
vi) further integration within the EU (economic and political); and
vii) external considerations and intrusions (political and economic).

Obviously the enlargement dynamic is extremely important for the political future of the EU. Although the new member states are now integrated into the institutional structure of the EU, they surely need to move towards the average EU standard of living (usually measured as GDP per capita), and the policies of such states must be clearly geared more towards investment, whether by private or public sector, or through the attraction of FDI so as to foster growth. In political terms the existing member states do not want the new member states to start strategic voting *en bloc*, as this might challenge, even destabilise, the coalitions that have already formed around certain issues (such as the CAP) within the European Council's members. Clearly too, any new expansion in membership in the EU partially depends on the continuing success in integrating the recently new member states into the existing framework[13].

Looking forward, the continuing success of EMU is of great concern to the member states of the euro area, as it is the most advanced stage of integration that the EU has accomplished to date. With the SGP constraining fiscal policy and the loss of the exchange rate instrument, the stance of monetary policy should certainly be appropriate as envisaged by a large majority of the members most of the time. If monetary policy is deemed inadequate, there is a chance that the EMU could unravel or the desirability of joining EMU could substantially decrease. The latter development would jeopardise future integration projects[14].

Internal structural reforms are also considered vital for continued increases in productivity. Blanchard (2004) analyses some of the issues that face the EU in terms of productivity and reforms to institutional rigidities in member states. He argues that in fact the productivity problem is not so much a problem as a matter of choice. In terms of structural reforms though, Blanchard makes the point that, in his opinion, the public sectors of EU member states are lagging in terms of necessary reforms when compared to those experienced by the corresponding private sectors. Although this statement is possibly true for all countries, the dispersion of evidence in the EU context is likely large, with the lag in Scandinavian countries perhaps being much less significant than the lag for those of southern Europe. The opinion also ignores such problems such as those associated with the well-known weaknesses of any quantified measurements of productivity in service industries.

Institutional development is also important to the EU, as frequently expressed in a host of commentaries over the last decade on structural and institutional aspects of performance, innovation and growth. If the current institutions of the EU are to develop in line with the increasing number of

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[13] During late 2005, there was a tacit agreement to slow accession of new member states, mostly to appease French concerns, where alarm about the implications of EU policies on French national policies caused a political backlash against the EU.

[14] De Grauwe (2006) recently went further than this, reversing this to state that "the long run success of the eurozone depends on the continuing process of political unification." (p23)

members, the growing ambitions of member states, the stresses of multi-level governance, and the pressing demands of competition in a globalized and clustered world economy, a greater clarification of responsibilities will be clearly needed as many institutions appear, grow and mature. Deciding on standard matters by recourse to unanimity at the highest levels of governance usually worked well with 12 or 15 member states, but with at least 25 members, a search for unanimity is unlikely to be able to achieve similar results. A derogation for one or two member states was possible in earlier times when controversial developments occurred, but permitting derogations for say 10 member states would just render the majority decision effectively meaningless[15] in any useful sense.

Business cycle synchronisation and the attendant demands for the coordination of policies is an important issue. With member states of the euro area, the synchronicity of business cycles may help to ensure that general ECB policies are jointly suitable for most member states, but heterogeneity in the form of cyclicality is a major obstacle to joint interests. Business cycle synchronicity, if it occurs, can also ensure (in the opinion of some observers) that the SGP operates more effectively. In general, some feel that more synchronous business cycles and less diverse growth rates across the EU, perhaps because the EU is closer to the vision of a single market, might encourage some resources not to flow from one part of the EU to another, so that income gains might be more evenly distributed across the continent.

Further integration in the EU is also an important issue. The EU has gone from a customs union to a single market and to a single currency area with common policies in a variety of areas. Further integration in defence, foreign policy and in other areas is clearly possible. Various means of achieving these ends has been pursued, such as the exchange rate mechanism of the European Monetary System, and directives in a variety of areas to standardize products and services seeking to foster greater efficiency[16]. External considerations also impact the EU. These would include, for example, the gradual assimilation of novel standards according to the Kyoto accord, the multiplicity of effects that stem both directly and indirectly from the invasion of Iraq, the instability that this invasion induced, and the severe price shocks associated with both actual and potential oil-supply dislocations as well as other characteristics found in the evolution of exchange rates, the international monetary system, and payment systems.

Table 1 exhibits some tentative guesses concerning the potential interaction between the considerations listed above and the SGP. The table reveals how the SGP may enhance developments in the factors identified above, and it indicates some tentative scenarios as to how the SGP could

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15 This is particularly the case in relation to European defense and foreign policies.

16 Crowley (2006) offers an analysis of future integration of the EU beyond the current state of affairs.

become the centre of attention once again in the EU, thus limiting fiscal policy in the face of some non-systematic or systematic asymmetry, misinterpretation, or other event.

The table does not include some other events which might cause the SGP to once again become the focus of attention in the EU. A scenario which involved the election of a fiscally profligate anti-EU government in a member state could also trigger a crisis since such a government might choose to ignore the SGP, and refuse to pay the fines levied as part of the excessive deficit procedure (a situation that we identify within the "rogue" member state scenario in what follows).

V. How might the SGP be reformed to make more economic and political sense?

Many suggestions have been made as to how the SGP might be reformed beyond the limited reform that took place in 2005, some rather exotic—for example, involving a "traded-deficits" market (Casella, 2002). In this section though we consider what reforms might have a better political and economic rationale in the EU context, and what these reforms could imply in terms of Treaty changes. Below we focus on just four options for reform.[17] These options should all be considered "end points" in their own right – or to use the language of economists, a "steady state" solution (that is, one that does not entail further iterations). These options are listed below and then summarized in table 2:

a) Scrap the pact.

The pact is scrapped, but the Maastricht convergence criteria are still maintained as a means of ensuring a certain degree of economic and monetary convergence for new EMU members. The no-bailout clause in Maastricht would still remain in force, and financial markets would be encouraged to properly price the public debts of member states according to perceived risks of default and the apparent degree of fiscal prudence by allowing as much transparency in public sector accounting as possible. The ECB would have to make it clear that it will not automatically accept the additional debt of individual member states as collateral, and that debt levels in excess of 60 percent of GDP would likely be the cutoff point[19]. This option would likely involve a Treaty amendment, unless the excessive deficit procedure could be "reinterpreted" as only being relevant for the transition period for assimilation into EMU of newly joining member states.

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[17] See Crowley (2005) for a summary of the various proposals that have been made, plus other proposals that are considered here that have not yet appeared in the mainstream literature.

[19] This clearly would require the "no-discrimination" debt policy of the ECB to be rescinded, but would at the same time remove the adverse selection problem from the ECB's use of sovereign debt in monetary policy operations.

b) Member state budget legislation

Rules require appropriate incentives and penalties, and if there are insufficient incentives then the potential penalties must be such that personal reputation and liability is at stake. Any rule that originates at the EU level is liable to political manipulation, favorable interpretation, and in any event as established above, is not fully enforceable. Member states should adopt balanced budget amendments (or specific levels of “permitted deficit” amendments) which are enforceable by law, while at the same time "rainy day" funds should be permitted for smoothing of the business cycle at the level of member states (Inman, 1996). This is the general means of ensuring fiscal prudence at the state level in the US (and in some Canadian provinces), and although states are prone to put fewer funds into "rainy day" funds than might be considered prudent by some observers, the laws do provide additional accountability, transparency, and some scope for automatic stabilizers to work. From a legal perspective, any auditor for a state government that does not balance its books in any given year is personally liable for any shortfall, so that the incentive to allow a shortfall is usually resisted and there is a general understanding that hard decisions sometimes have to be made. In three US states, the balanced budget rules can be over-ridden by a 75 percent vote of the legislature, but such an event has rarely occurred. This option would clearly have to be enforced at the EU level, in the same way that the independence of central banks was also enforced, and it would likely require a Treaty amendment as all EMU member states would be expected to comply. Member states that did not comply and removed their budget laws would automatically be suspended from EMU.

c) Conditional SGP

Given that the SGP is already in place, one option would be to modify the pact so that it contains a better economic rationale. It is clear that the main focus in the pact should be on debt, not on budget deficits as is currently still the case. Rather than shifting the focus entirely over to debt without the "soft" elements of the clause in the Maastricht Treaty dictating that member states with gross levels of debt converging to 60% of GDP satisfy this constraint, use the debt criteria as a conditional rule to trigger the excessive deficit procedure. Thus, any member state having a debt level lower than 60% of GDP would not be subject to the excessive deficit procedure and the fines inherent in the SGP. However, in contrast, member states with debt levels higher than 60% would be subject to the excessive deficit procedure with the usual caveats. In this way, a real rules-based economic rationale for the SGP would apply, while most transgressions of the 3% budget deficit limit would be monitored but they would not be subject to the excessive deficit procedure's sanctions and fines. This option would not require a Treaty amendment, as this conditionality could be part of a further "clarification" of the excessive deficit procedure within a new resolution.

d) Fiscal Union

As with the previous policies constraining EU member state governments (such as the ERM of the EMS), there could be a commitment to using the SGP as a stepping stone to fiscal union at the EU level. The proposal would imply giving the European Parliament fiscal powers, and would be the last step in the EU integration process. This option would make economic sense of the SGP as a rule to protect the "no bailout" clause of the Maastricht Treaty, and would be directly in line with the free-rider explanation for rules, in that at some point the debt of member states would become common debt for the whole of the European fiscal union (even though, as in the US, some of the debt might still have to be held at the member state level). This option would also clearly require a Treaty amendment.

Although the four "end points" for revision of the SGP that are identified here clearly do not represent an exhaustive list of possibilities, they are illustrative of "steady states" such that there is no incentive to further change the arrangements for EU fiscal policy. In addition, they may make sense to some observers at least from an economic and/or political standpoint, a consideration that may be quite important in terms of consistency, both internally and in relation to other EU competencies and policies.

VI. Evaluating some scenarios for reform of the SGP

In this section we now combine elements of the previous two sections to specify scenarios where reform of the SGP might occur, and thus evaluate the likely nature of the reform to the SGP. Here we select an event and then evaluate which "end point" in terms of the four "steady states" described in the previous section best fit with the likely negotiations and bargaining that would likely take place. Each scenario is discussed in turn below.

1. EU enlargement.

This scenario largely follows the context described as the enlargement dynamic and is labeled as i) in table 1 and combines this with reform c) in table 2. In this scenario, the new EU CEEC member states, or a subset of this group, join the euro as early as possible (which has been slated for 2007), and then find that public investment considerations imply that a collection of these member states are then subject to the excessive deficit procedure. As Hughes-Hallett and Lewis (2004) make clear, the member states that are mostly likely to be subject to such constraints are the central European new member states (which they label as the "Hapsburgs"), since these states already have fairly large gross public debt. The Baltic member states (which Hughes-Hallett and Lewis label as the "Hansas" after the Hanseatic League connection) gained independence from the former USSR with no debt, so although their deficits may be quite large in their growth stage, it is unlikely that they would come under the same level of scrutiny as the "Hapsburgs". Most scholars studying the CEEC accession countries accept that indeed there would be a fairly lengthy period of "catch-up" required for these member states to move effectively towards the average GDP per capita within the EU. Buiter and Grafe (2004) also consider the SGP to be a limitation on CEEC growth and advocate a more complex evaluation of discounted future debt as the criteria that should constrain member state fiscal policies.

In this scenario there would be a crisis of confidence with the SGP in terms of it being able to accommodate new member states with relatively low GDP per capita within the framework of the other integration projects of the EU, and thus would precipitate further revisions to the SGP. The most likely revision would be to make the excessive deficit procedure conditional upon the level of debt that a member state had already accumulated. This action would safeguard monetary stability and therefore would likely be acceptable to the ECB, and might also largely solve the problem of the growth limitations that the SGP would impose upon rapidly growing new member states within the EU.

This scenario could lead to a more coherent basis for fiscal coordination in the EU, as the emphasis of the SGP would now be placed firmly on public debt rather than budget deficits. In political terms, it would likely make EMU more attractive to new less-developed members as it would not lead to any constraints on fiscal policy as long as levels of public debt remained below some threshold value, here assumed to be 60% of GDP.

2 EMU non-endogenous OCA

In this scenario, operation of EMU which is labeled ii) in table 1 and business cycle acyclicality which is labeled v) in table 1 are combined with scrapping the pact, labeled as a) in table 2 or member state budget legislation, labeled as b) in table 2. Here, the EMU is found not to be an endogenous optimal currency area (OCA), meaning that business cycles do not become synchronous, so that some member states do not find ECB monetary policy appropriate and require greater latitude in fiscal policy than is granted by the SGP[20]. A move by some member states or even by a single member state to leave EMU might precipitate such a crisis, and would then cause consideration of revision of the SGP.

[20] See Crowley (2006b) for some evidence on whether the growth cycles in new accession states can be classified as similar to those of the existing euro area member states.

What might determine whether the SGP is scrapped or whether member state budget legislation is adopted instead? This choice largely depends on both the nature of asynchronization and the existing levels of public debts for member states. If a collection of member states is highly asynchronous compared to another grouping but the geographical distribution is somewhat random, then it would make most sense to adopt differentiated measures for limits on budget deficits based on the relative degree of business cycle asynchronicity. These measures could perhaps be negotiated through the Commission and agreed on before national legislation is passed, with a review of the limits to be timetabled every 5 years or so. If a collection of member states is highly asynchronous compared to another grouping, but this pattern is more systematic (for example, a geographical core-periphery configuration in which the periphery member states are not synchronous *viz à viz* the core member states), then it might make more sense to adopt a selective two-tier approach, with some higher deficit limits specified for peripheral member states if ECB monetary policy is more appropriate for larger core member states[21]. On the other hand, at some point in the future if such a scenario were to be realized, and if overall public debt levels were fairly modest, then there might be a move to scrap the pact since breaching of the deficit limits could no longer pose a major threat to monetary stability within the euro area.

In economic terms, this situation would lead to adoption of a far superior SGP design, as fiscal policy could be differentiated on the basis of suitability to EMU, which would then "tune" fiscal policy to make allowance for the differential impacts of monetary policy on member states. From an EU political perspective as well, this situation would likely be superior to the current SGP, as fiscal policy would have to be monitored and enforced through the national legal systems rather than through the more “remote” Commission’s edicts. A better political environment might emerge within the EU, with the governments of member states responsible for the policies that they were elected to be responsible for, rather than leaving them to the auspices of an unelected body.

3 Lax implementation of the SGP

The third scenario involves lax implementation of the SGP, and might lead to escalated levels for deficits and public debt, thus producing a loss of credibility in the SGP. This scenario can be aligned with the implementation of the Lisbon agenda and structural reforms (factor iii) in table 1), and could manifest itself either in different interpretations of the “exceptional circumstances” clauses of the SGP or in ambiguous implementation of the SGP such that member states have a reason to disagree with the

[21] Crowley and Lee (2005) show that within the euro area more peripheral member states appear to have lower dynamic correlations with EU GDP than the larger core member states.

way in which the SGP is being implemented by the Commission. This scenario results in a refusal to abide by the penalties or fines levied on a member states as per table 1. If a member state refuses to abide by the fines, it could also result in an erosion of credibility in the SGP and as these fines would be difficult to collect, a crisis of confidence in the pact would likely ensue[22].

In terms of what might happen to the pact, here the outcome is non-specific. Once the SGP loses credibility it is uncertain what the resulting outcome would be. Perhaps a decision is taken to scrap the pact (option a) in table 2) to reduce debilitating conflict among member states and between individual members and the Commission or perhaps a decision might be taken to make the pact more dependent on the debt criteria, implying a revision of the SGP along the lines of a conditional SGP along the lines of option c) in table 2.

4 Fiscal Union

In this scenario, a more sanguine assessment of the future of the SGP is realized. The scenario is in line with factor vi) in table 1 (further integration within the EU) and aligns with option d) in table 2 (fiscal union). Here, the SGP acts as a stepping stone to fiscal union by ensuring that euro-denominated debt does not increase disproportionately with the growth of GDP in the euro area.
This is an interesting scenario for two reasons. First, it envisages a role for the SGP that is somewhat akin to the ERM of the EMS in its role as a precursor to EMU. Second, the scenario possibly implies a "two-speed" or "three-speed" EU. The reasoning in the latter case is that it would be difficult to envisage a fiscal union incorporating those member states that are outside the euro area, and some current member states of the euro area might not wish to participate in a fiscal union, leaving three separate groups of member states in the EU. Also obtaining fiscal union before monetary union would also be difficult to envision since no other federation has maintained this form of integration configuration. [See Crowley (2006a) on this point.]

In terms of the political consequences of the scenario, this situation could lead to a consideration of further integration in the EU, but the drawback is likely to be the probable "variable geometry" aspect of this configuration. In terms of institutional development, this development may be advantageous to EU institutions since it would confer on them additional responsibilities.

VII. The lessons for other monetary unions

After the successful launch of the euro, other projects for regional integration around the world

[22] This scenario therefore encompasses the "rogue" member state scenario referred to above.

have also considered adopting a single currency[23]. As such, these single currency projects will all have to face the issue of how to manage the interaction between fiscal and monetary policies in a supranational context. Given the above analysis of the likely future factors that will impinge on the SGP and a description of the aspects of the SGP that make it "deeply flawed", what are the lessons that other monetary unions can take away from the European experience with the SGP?

a) Any supranational fiscal agreements/rules should have clear objectives

The introduction of supranational fiscal agreements/rules in the EU substitute them for what the financial markets usually do, that is, monitor and rate or evaluate the evolution of fiscal policies in member states. The imposition of greater risk premia for countries that are more fiscally profligate is the usual means whereby major financial markets assess the relatively solvency of sovereign states (or parts thereof) and thus penalize accordingly. Any agreements relating to fiscal policy at the supranational level, therefore, should be justified on the basis of i) evidence of market failure or ii) the evidence of sizeable externalities[24] -- considerations that would then usually clarify objectives for the agreement/rule agenda.

b) The rules/agreements should be consistent with the objectives

The focus in any sensible fiscal policy must ultimately be on the appropriate economic variable to ensure government solvency – this should be clearly be represented by levels of government debt, not simply those for annual government deficits. To ensure both monetary and macroeconomic stability, the level of public debt is paramount, not the level of the budget deficit in any given year. Overall debt helps determine interest rates and the solvency of a country, not the budget deficit, which has a more modest signaling role. A fiscal crisis has never occurred because of a large budget deficit *per se*, but always because of what a budget deficit does to the underlying level of public debt.

c) Ensure that the rules/agreements are enforceable

One of the major problems with the SGP is that there are no effective mechanisms for enforcement with regard to the punitive aspects of the pact. The sanctions and penalties included in the pact are toothless and essentially meaningless if there is no clearly defined process for collecting the penalties that are indicated.

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[23] African and South American regional integration projects have both discussed this possibility

[24] Neither market failure nor significant externalities have been shown to be evident in the case of the EU. See Eichengreen and Wyplosz (1998).

d) Rule-based penalties should not exacerbate the situation

Penalties should not exacerbate an already adverse situation. At present, imposing a financial sanction which at some point in the future is turned into a standard fine does not make any economic sense, as it will just make the situation for fiscal policy even worse. A more sensible proposal would possibly be to deny the member state its voting rights on either the ECB governing council or the European Council if the situation is not rectified.

e) Rules should be applied at the same level as policy decisions

Fiscal policy remains in the hands of national politicians in member states in the EU. Thus if rules are deemed necessary, it seems sensible that such rules should be agreed upon by the politicians at that level of governance and then passed into "local" law so that those who decide on fiscal policy are made responsible for their actions in full democratic and legal senses. Laws for balanced budgets in the US appear to work because of the possibilities that politicians may not be re-elected (and may indeed be sued by constituents) if the political decision-makers gain an image of irresponsibility in the eyes of electors. It is very difficult to determine an appropriate form of democratic legitimacy for any supranational rule applied at a national level of government, and this adverse situation has little attraction, legally, politically or otherwise.

f) Decisions on national government transgressions of fiscal policy rules should be made by bureaucrats not politicians

There is one reason often granted as to why central bank independence has become almost universally accepted by academic economists: it stems from the feeling of those economists that the primary thoughts of many politicians become myopic immediately prior to an election so that much economic policy is distorted by an unfortunate bias towards "short-termism" and its pursuit does not usually lead to any optimal "long-run" outcomes. Central bankers may not always make the right decisions with the path of monetary policy but, in the views of many observers, it is probably better that this monetary policy be placed in the hands of informed bureaucrats or experts with longer term perspectives, rather than opportunistic politicians with very short-term agendas. Of course, it is not difficult to extend this particular proposition to the assessment of national fiscal policy whereby, for policy based on rules decided at the supranational level, we might be better served by relying more on those bureaucrats or experts who are in a much better position to make consistent decisions as to whether the governments in the individual member states are transgressing benchmarks or rules for fiscal policy instead of depending on the short attention spans of politicians at other levels.

g) If politicians are involved, the most recent iteration may not be the last!

With regard to any inter-governmental agreement made by politicians, there are inevitable political pressures that press for alterations in that agreement when adverse economic conditions subsequently occur or when an election is approaching. There is always an incentive to tinker with an apparently flawed agreement to maintain a sense of unanimity rather than abandon the agreed arrangement and start with a clean slate, even if there are legitimate concerns. It might of course be much better to start with the appropriate rules, enforcement mechanisms and agreements already in place, but most politicians are usually reluctant to comprehensively scrap anything that is currently already in place.

VIII. Conclusions

In this paper we have tentatively attempted to look to the future and determine whether the current SGP will persist as the final word on fiscal policy in the EU. Because the original pact is flawed and perhaps makes little economic sense, the relatively minor revisions introduced to the pact in 2005 are very unlikely to be the final "iteration", implying that further problems with the pact must lie ahead. Rather than attempting the impossible task of accurately forecasting precisely what form these further problems will take or when they will be substantially responded to, the approach taken here involves the construction of a few instructive scenarios where we define issues that might cause further review of the SGP, and we seek to anticipate the potential end result of this review, either immediate or iteratively.

The first task was to outline the changes to the SGP following the recent 2005 revisions to the pact, and it was recognized that these revisions were fairly modest. Then an assessment of the likely future issues that the EU will face was made, and we considered how these issues will interact with the SGP and its workings. After evaluating some options for reform of the SGP, which ranged from scrapping the pact to adoption of some form of fiscal union in the EU, four scenarios addressing how the current SGP design might impact the economic and political development of the EU were identified. In terms of these alternative scenarios, the most likely one to be realized at some point in the future is the first scenario, which relates to the necessary infrastructure for the new member states and the relationship of these requirements with the strictures of the SGP. Perhaps the least likely, given recent events, is the last scenario that involves a fiscal union. Although each scenario appears rather unlikely in current circumstances, in the medium and longer term it is possible that any one of these scenarios will materialize. One caveat needs to be made here-our maintained hypothesis might be wrong: the SGP might be successful in its current design. Although this persistence seems an unlikely outcome of current and foreseeable difficulties, this possibility might still confer greater credibility on the SGP and allow Ecofin to develop into a more powerful body within the EU institutional architecture.

Finally, given our evaluation of the likely triggers for changes to the SGP and the consequent future evolution of the pact, we next asked whether this evaluation gave rise to any simple lessons which could be learned from the European experience with the SGP. We determined that there were seven simple lessons which emerged from our brief reflections: a) that all schemes for supranational fiscal agreements/rules should have clear objectives; b) that the agreements/rules should be consistent with those objectives; c) that the agreements/rules should be enforceable to a substantial degree; d) that any rule-based penalties or sanctions should not exacerbate the fiscal policy situation; e) that effective rules should be applied at the same level as the decisions made on fiscal policy; f) that significant decisions on the transgressions by national government in respect of agreed-upon rules for fiscal policy might be better made by informed bureaucrats rather than by opportunistic politicians driven by short term imperatives; and g) that if politicians are involved, the most recent iteration of the details of the agreement/pact may not be the last.

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<u>**Table 1**</u>

Context for the SGP

Factor	Enhancement/ contribution?	Possible interaction with SGP?	Possible consequence?
i) enlargement dynamic	Unlikely – limits on public deficits might impinge on infrastructure development	Public investment requirements for infrastructure development in CEECs	Collective refusal to follow fiscal austerity measures in SGP – difficult to justify penalties
ii) operation of EMU	Possible – if properly implemented could reduce debt levels in highly indebted member states	Tight monetary policy requires substantial fiscal stimulus to maintain growth	Member state refuses to abide by excessive deficit procedure – largely rectified by current revision of SGP
iii) Lisbon agenda and structural reforms	Allowance in current revision of SGP makes clear that member states will not be penalized for reforms	Lisbon agenda reform enacted and disagreement on inclusion as an exceptional measure	Member state refuses to abide by excessive deficit procedure – non-collection of penalties
iv) institutional stability and development	Possible development of Ecofin into a more formalized fiscal monitoring body	None	
v) business cycle acylicality and coordination of policies	Permanent adjustment of fiscal position so that automatic stabilizers fully allowed to act	ECB monetary policy not appropriate for member state	Member state growth rate variation is exacerbated by ECB policy and SGP excessive deficit breached once per cycle
vi) further integration within the EU	Greater coordination of fiscal policies achieved through SGP could lead to institution of fiscal sovereignty for EU	Initiative to use SGP as a stepping stone to a fiscal union	Inclusion of the SGP into a future Treaty revision
vii) external considerations	Greater euro stability?	Exceptional event causes rapid and large increase in government spending in all member states	Excessive deficit procedure put into abeyance

Table 2

Options for reform of the SGP

Option description	Economic rationale	Political rationale	Treaty amendment?	Reference
a. Scrap the Pact	No threat to Maastricht "no bailout" clause, financial markets price debt efficiently	Principle of subsidiarity	Yes (No)	De Grauwe (2003)
b. Member state budget legislation	Fiscal consolidation desirable in all member states. Solves coordination problem for the ECB.	Fiscal sovereignty of member state governments respected	Yes	Inman (1996)
c. Conditional SGP	Fiscal consolidation desirable in highly indebted member states, others allowed latitude.	Leaves the SGP largely intact, while removing the current constraints on member states such as Germany and France. Path of least resistance.	No	
d. Fiscal Union	Internalizes the externality, and justifies current SGP as a "stepping stone"	Furthers the integration dynamic of the EU.	Yes	Crowley (2002) Collignon (2003)

Table 3

Scenarios for the SGP

Scenario	Description	Table 1 context	Table 2 reform	Result	Notes
1. EU enlargement	"Catch up" growth necessitates public infrastructure investment, which causes excessive deficits in CEEC member states	i)	c)	Better economic incentives, focus on public debt rather than deficits. Better political arrangement as Commission only involved in excessive deficit procedure if debt higher than specified limits.	Hughes-Hallett and Lewis (2004), Buiter and Grafe (2004)
2. EMU = non-endogenous OCA	Asynchronicity of business cycles leads to non-endogenous OCA characteristic of EMU. Perhaps core/periphery configuration where smaller peripheral member states need more fiscal latitude.	ii) and v)	a) and b)	Better economic incentives, as mediated either through financial markets [a)], or through national legal system. In either case, differentiated deficit limits could be set based on degree of business cycle synchronization, and better political arrangement in relation to EU and Commission.	Crowley and Lee (2005)
3. Lax/unclear implementation of SGP	Lax implementation erodes credibility of SGP, disagreement about inclusions under exceptional items in SGP, or threat to leave EMU.	iii), "rogue" member state	Unclear	Unclear	
4. Fiscal Union	Decisions for some core EMU member states to proceed to a fiscal union, thereby using the SGP as a "stepping stone".	v)	d)	Limited fiscal sovereignty achieved at EU level. 2- or 3-speed EU, with some supranational institutional development.	Crowley (2002) Collignon (2003)

APPENDIX

Main changes to the Stability and Growth Pact following the Council agreement of 20 March 2005

	Original	Revised
1. Changes in the preventive arm		
Medium-term objective (MTO)	All Member States (MS) have a medium-term budgetary objective of 'close to balance or in surplus'.	• Country-specific differentiation of MTOs according to stock of public debt and potential growth. • MTOs for euro-area and ERM II MS are set between – 1 % of GDP and balance or in surplus (in cyclically adjusted terms and net of one-offs). • Implicit liabilities to be taken into account at a later stage, when modalities for doing so are agreed by the Council.
Adjustment path towards the MTO	No specific provisions.	• MS to take active steps to achieve the MTO. • Annual minimum adjustment for MS of the euro area or of ERM II of 0.5 % of GDP. • The effort should be higher in 'good times'. • 'Good times' are identified as periods where output exceeds its potential level, 'taking into account tax elasticities'.
Early policy advice	Early warnings are adopted/addressed by the Council, upon recommendation of the Commission.	In addition, the Commission can issue direct 'early policy advice' to encourage MS to stick to their adjustment path. To be replaced by 'early warnings' in accordance with the Constitution once applicable.
Structural reforms	No specific provision.	Reforms will be taken into account when defining the adjustment path to the MTO and may allow a deviation from it under the following conditions: • only major reforms (direct/indirect impact on sustainability); • safety margin to the 3 % reference value is guaranteed; • the deficit returns to the MTO within the programme period; • detailed information is provided in the stability/ convergence programmes. Special attention to systemic pension reforms.
2. Changes in the corrective arm		
Preparing a report under Article 104(3)	No obligation for the Commission to prepare a report if a deficit exceeds 3 %.	• The Commission will always prepare a report in cases where there is a deficit above 3 %. • The report will examine whether the exceptions in Article 104(2) apply. • It will take into account whether the deficit exceeds government investment expenditure and all 'other relevant factors'.
Severe economic downturn	'Severe economic downturn' if there is an annual fall in real GDP of at least 2 % for the preparation of the report under Article 104(3) by the Commission, and in decisions under Article 104(6) by the Council, if observations by the Member State concerned show that the downturn is exceptional in light of evidence of the abruptness of the downturn and the accumulated loss of output with respect to past trends. The MS commit not to invoke the severe economic downturn when growth is above – 0.75 %.	An economic downturn may be considered 'severe' in cases of a negative growth rate or accumulated loss of output during a protracted period of very low growth relative to potential growth.

	Original	Revised
'Other relevant factors' (ORFs)	No specific definition of 'ORFs' and their role in the excessive deficit procedure.	• The Commission report under Article 104(3) will take into account: – developments in the medium-term economic position (potential growth, cyclical conditions, implementation of policies); – developments in the medium-term budgetary position (public investment, quality of public finances, as well as fiscal consolidation in 'good times', debt sustainability); – any other factors, which, in the opinion of the MS, are relevant in order to assess the excess over the reference value. • ORFs will be considered in the steps from Article 104(4) to (6) only if the excess over the reference value is temporary and the deficit remains close to the reference value. Any deficit above 3 % that is neither close to the reference value nor temporary will be considered excessive. • If the Council has decided that an excessive deficit exists, the ORFs will also be considered in the subsequent procedural steps of Article 104 (except in Article 104(12), i.e. abrogation, and when deciding to repeat steps in the EDP).
Systemic pension reforms	No specific provision.	• These are treated like an ORF, but under strict conditions also with a role in abrogation. • Consideration to the net cost of the reform will be given regressively for the initial five years after an MS has introduced the reform (or five years after 2004).
Increasing the focus on debt and sustainability	No specific provision.	• The debt criterion, and in particular the concept of a debt ratio 'sufficiently diminishing and approaching the reference value at a satisfactory pace', will be applied in qualitative terms. • The Council will formulate recommendations on the debt dynamics in its opinions on the stability and convergence programmes.
Extending deadlines for taking effective action and measures		• Deadlines are extended: for a decision under Article 104(6) — from three to four months after notification; • for taking effective action following Article 104(7) — from four to six months; • for moving to Article 104(9) — from one to two months; • for taking action following a notice under Article 104(9) — from two to four months.
Minimum fiscal effort	No specific provision.	Countries in excessive deficit are required to achieve a minimum fiscal effort of at least 0.5 % of GDP as a benchmark.
Initial deadline for correcting the excessive deficit	The excessive deficit has to be corrected in the year following its identification, unless there are 'special circumstances'.	The rule remains; possible extension by one year based on ORFs and on the condition that minimum fiscal efforts have been taken.
Repetition of steps in the EDP	Not foreseen.	Deadlines for correcting the excessive deficit can be extended if: • effective action has been taken by the MS concerned in compliance with the initial recommendation or notice, and • unexpected adverse economic events with major unfavourable budgetary effects occur during the correction phase.

Source: Commission services.