Part II

Evolving budgetary surveillance

Summary

This part of the report describes the major innovations in the EU framework for fiscal policy and reviews notable developments in budgetary surveillance. It is divided in three sections. The first section illustrates the main features of the agreed lines for revising the Stability and Growth Pact. The second section deals with several topics of relevance in EU fiscal surveillance: the discrepancy between budgetary plans in stability and convergence programmes and outcomes; the determinants of debt dynamics; the role of national budgetary institutions in shaping budgetary results. The third section reviews the Commission methodology for assessing the long-term sustainability of public finances.

The debate on the reform of the Stability and Growth Pact

The European Council of 22/23 March 2005 endorsed the Council report 'Improving the implementation of the Stability and Growth Pact', agreed by the ECOFIN Ministers at their extraordinary meeting of 20 March. It updates and complements the Stability and Growth Pact. It also recommends measures for improving fiscal and statistical governance both at the national and the EU level. This agreement on the revision of the rules of the Pact is the result of a comprehensive review of the Stability and Growth Pact that followed the Commission Communication of September 2004. In conjunction with the renewed commitment from all Member States to stability-oriented budgetary policies and effective fiscal surveillance, the compromise agreement of March 2005 puts an end to the uncertainty that has surrounded the interpretation of the existing budgetary rules in the latest years. Following the agreement by the Council, the Commission has launched the legislative procedures for amendment of the existing regulations where necessary to implement the agreement. Final adoption of the revised set regulations lies with the Council.

In the agreement, the Treaty's reference values for government deficit and debt remain the anchors of the system. The preventive arm of the Pact has been strengthened by ensuring that due attention is given to the fundamentals of fiscal sustainability when setting medium-term budgetary objectives. In future, the medium-term objective of a country will be defined on the basis of its current debt ratio and potential growth. For Member States having adopted the euro and for those participating in the European Exchange Rate Mechanism, the agreed range of medium-term objectives is between -1% of GDP for countries with a combination of low debt and high potential growth, and balance or in surplus for countries with a combination of high debt and low potential growth. The preventive dimension of the Pact is further underpinned by the strengthened commitment of Member States to actively consolidate public finances under favourable economic conditions and the possibility for the Commission to act in form of issuing timely policy advice if this is not the case. The new agreement also includes incentives for Member States to embark upon structural reforms. In particular, major structural reforms that have direct long-term cost-saving effects and verifiably improve fiscal sustainability over the long-term will be considered. The main modifications in the corrective arm of the Pact concern the definition of 'excessive deficits', the possible extension of the existing deadline for the correction of an excessive deficit, and the introduction of the possibility of repeating steps in the implementation of the excessive deficit procedure (EDP). Considerations are also included related to the assessment of systemic pension reforms in the EDP; and the enhanced focus on surveillance on government debt.

In particular, the new rules allow expanding the one-year deadline for the correction of an excessive deficit by an additional year in case a correction in the year directly following the identification of an excessive deficit is not warranted on economic grounds. Moreover, under the strict provision that effective action has been taken by the country concerned, the Council can decide to repeat certain steps in the excessive deficit procedure, in case of an unexpected adverse economic event hitting a country in the course of correcting its excessive deficit. Finally, the new agreement specifies a

set of 'relevant factors' that the Commission and the Council can take into account when deciding on the existence of an excessive deficit and when determining the deadline for its correction. These factors include, *inter alia*, developments in potential growth and prevailing cyclical conditions, but also considerations with respect to debt sustainability, the implementation of policies geared towards meeting the objectives of the Lisbon agenda or the record of fiscal consolidation in 'good times' will be assessed.

These modifications will increase the room for judgement in the application of the excessive deficit procedure. However, a number of complementary elements built into the new agreement will effectively constrain the scope for discretion, preserving strong incentives for fiscal discipline in the EU on the basis of a rules-based EU framework. First of all, both the Commission, when considering whether an excessive deficit exists or may occur, and the Council, when deciding on the existence of an excessive deficit, will take into account any relevant factors only if the general government deficit remains close to the reference value and its excess over the reference value is temporary. Second, other relevant factors are always considered in an overall assessment, in which a large number of factors, including those that may call for a stricter interpretation of the deficit figures, are examined. No simple discounting of certain categories of public expenditure from the deficit calculations is foreseen. Third, Member States in excessive deficit are requested to achieve a minimum annual budgetary effort of 0.5% of GDP irrespective of relevant factors. Fourth, the Commission will always issue a report under 104(3), if the deficit of a Member State exceeds 3% or if it sees a risk of an excessive deficit. And, finally, the obligation of the Council to impose sanctions in case a Member State in excessive deficit repeatedly fails to act in compliance with the successive decisions of the Council remains unchanged as the ultimate threat against non-compliance.

The 2005 ECOFIN report recognises that modifications to the provisions of the Pact are not sufficient to ensure a meaningful improvement of their implementation. In order to solidly re-establish the credibility of the Pact and to strengthen the enforcement of budgetary discipline, the report contains a number of complementary elements designed to increase the ownership of the Pact provision, clarify the respective roles and responsibilities of the various actors involved as well as measures to improve the quality and timeliness of statistical data, both at the national and the EU level.

Issues in EU budgetary surveillance and sustainability analysis

Since the inception of the EU fiscal framework, budgetary surveillance in the EU has been evolving. This evolution was partly driven by the need to tackle specific issues that have been encountered in the practical application of the framework (e.g., measuring the countries' fiscal effort), partly in response to a changing economic and institutional landscape (e.g., ageing populations, EU enlargement), and partly as a result of efforts to upgrade the analytical toolkit used in EU budgetary surveillance though technical work carried out in working groups attached to the relevant Council committees (e.g., the agreed methodology for computing potential output and output gaps). The Public Finances in EMU Report regularly collects analytical work undertaken by the Commission services with the aim of improving the understating of public finance issues in the EU and upgrade budgetary surveillance. This year the focus is on the discrepancy between budgetary plans from stability and convergence programmes and results, the analysis of debt dynamics, the role of national budgetary institutions in shaping fiscal outcomes, and the assessment of public finances sustainability in the long term.

The process of fiscal surveillance has provided a wealth of data on budgetary plans, outcomes and assessments. This information is used in this report for two purposes: (i) comparing budgetary developments in the Member States relative to plans, and (ii) investigating how the Commission assessment of stability and convergence programmes evolved over time. On the first aspect, the data show that slippages between budgetary plans and outcomes have been common and sizeable in some years, even after controlling for growth surprises. Such slippages seem mainly associated with differences between planned and realised expenditure/GDP ratios, discrepancies in revenue ratios having played a minor role. As far as the Commission assessment of stability and convergence programmes is concerned, retrospective analysis shows that the Commission has responded to the discrepancy between budgetary plans and outcomes by focusing increasingly the assessment on the credibility of the adjustment path described in the programmes. Moreover, the scope in fiscal surveillance has broadened over time and Member States' fiscal policies are assessed in more comprehensive way.

In EU fiscal surveillance, increasing focus is put on debt developments. The dynamics of the debt-to-GDP ratio can be decomposed into three components: one related with the realized budget balance, one associated with nominal growth, and one, named the stock-flow adjustment, capturing the discrepancy between the change in the outstanding debt stock and the government budget balance as defined in the Protocol to the Maastricht Treaty. The usual analysis focuses on the first two elements, putting much less attention to the magnitude, characteristics and determinants of the stock-flow adjustment. However, this component of the debt dynamics could convey relevant information concerning the evolution of government assets and liabilities and the reconciliation between cash and 'Maastricht' deficit figures. Analysis contained in this

report aims at filling this gap, providing analysis on the determinants of the stock-flow adjustment for EU Member States. It is shown that the stock-flow adjustment in past years has been on average positive (adding therefore to the build-up of debt) and that in some countries the stock-flow adjustment is partly associated to cash deficits being systematically higher than Maastricht deficits.

There is growing agreement among economists and policy-makers that institutional aspects, related for instance to the procedures and practices for the preparation, approval and implementation of the budget law, or the existence of medium-term expenditure frameworks, are key determinants of budgetary outcomes. The relevance of national budgetary institutions in supporting the effectiveness of the EU fiscal framework has been recognised in the EU Treaty and the debate leading to the agreed lines for revising the SGP. A section in this part of the report reviews the existing economic literature on the role of budgetary institutions in shaping fiscal outcomes and provides analysis on EU Member States. Although there is evidence of a possible link between national budgetary institutions and budgetary outcomes, difficulties in interpreting the results should not be underestimated.

For instance, it has been argued that the very different degree of effectiveness of the EU fiscal framework in inducing budgetary discipline across EU countries could be explained by differences in the overall budgetary arrangements and institutions across Member States. According to this argument, countries which base the containment of deficits on a strong role of finance ministries ('delegation countries') are less likely to be strongly affected by fiscal rules at he EU level than countries whose fiscal governance is based instead on procedures and arrangements among different spending ministries and levels of government ('commitment countries'). However, given that delegation countries tend also to be large countries, it could be difficult to disentangle the role of institutions from sheer country size in determining budgetary outcomes: in larger countries the EU budgetary objectives may have received less weight than in smaller countries and there may have been a perception of larger costs of fiscal consolidation in larger countries.

At EU level, sustainability analysis is carried out since 2001 in the context of the assessment of the stability and convergence programmes. It is based on debt projections on the basis of budgetary data provided in stability and convergence programmes and estimates of age-related expenditures (mainly pension, health care and education) up to 2050. A set of indicators are constructed to provide a synthetic quantification of sustainability risks. Given the uncertainty surrounding the far future, judgement is a key aspect of sustainability analysis: robustness of budgetary projections, reliability of planned or implemented reforms, composition of the budget, risks associated with the medium term scenario are all elements to be considered when performing the sustainability analysis. In light of the general agreement on the need to increase the focus of EU budgetary surveillance on long-term public finance developments, this section describes the current Commission approach for carrying out sustainability analysis, discusses the robustness of debt projections and sustainability indicators with respect to the major assumptions underlying the analysis, and outlines suggestions for possible improvements. In particular, it is suggested that increased information exchange within the Ageing Working Group attached to the Economic Policy Committee for what concerns national projections on age-related expenditures, including on the models to carry out such projections, would increase transparency and contribute to upgrade the overall assessment of the long-term sustainability of public finances.

1. The debate on the EU fiscal framework

1.1 Introduction

On 22 March 2005, the EU Heads of State and Government endorsed the report of the ECOFIN Council entitled 'Improving the implementation of the Stability and Growth Pact'.[24] Two days before, at their extraordinary meeting of Sunday 20 March, Ministers of Finance had reached consensus on the reform of the Pact after several months of intense discussion.

The new set of rules introduces more economic rationale and flexibility in the application of the EU fiscal framework and encourages Member States to achieve the necessary budgetary consolidation when economic conditions are favourable. In conjunction with a renewed commitment from all Member States to stability-oriented budgetary policies and the surveillance procedures, the new agreement puts an end to the uncertainty that has surrounded the interpretation of the existing budgetary rules since November 2003 and can reinforce the credibility of the EU fiscal framework.

The 2005 Ecofin report updates and complements the Stability and Growth Pact. It recommends furthermore complementary measures for improving fiscal and statistical governance both at the national and the EU level.

The agreement on the revision of the rules of the Pact is the result of a comprehensive review of the Stability and Growth Pact. It was launched by the Commission with its September 2004 Communication against the background of past and prospective budgetary developments and challenges as well as in light of the experience with the implementation of the budgetary rules in the EU Member States.

Overall, the agreement reached by the Council reflects a broadly balanced compromise. On the one hand, more economic judgement will be introduced in the application of the rules in order to better reflect the economic realities in the enlarged EU. This will help fostering the acceptability and ownership of the budgetary rules in Member States. On the other hand, renewed commitment of Member States to sound budgetary policy throughout the economic cycle provides a solid basis for improved and economically sensible implementation of the Pact.

The fundamental rules remain unchanged. In particular, the ECOFIN report reconfirms the agreement that the Treaty's reference values for government deficit and debt will remain the anchor of the system. This is underpinned by the commitment of the Commission to make a report under Article 104(3), the initial step of the excessive deficit procedure, always if a deficit exceeds 3%. Any excess of the deficit that will not be small and temporary will be considered excessive, whatever the influence of 'other relevant factors'. An excessive deficit will still need to be corrected promptly, despite the new extension of the deadlines in the excessive deficit procedure. A new annual minimum budgetary effort has been introduced for countries in EDP.

The Commission will ensure a forceful implementation of the agreement and continue the impartial and equal application of the rules to all Member States. Following the agreement by the Council, the Commission has swiftly move on and presented to the Council for adoption the necessary legislative proposals for implementing the agreed changes.[25]

This section of the report describes and explains the main elements of the 2005 reform package. It provides furthermore a first and tentative assessment of the changes against a set of established criteria for optimal fiscal rules and informs the reader about the main stages of the debate. In order to put the changes into

[24] See Presidency conclusions of the Brussels European Council of 22 and 23 March 2005 (7619/05) and the (Ecofin) Council report to the European Council of 21 March 2004 (7423/05).

[25] The legislative procedure was still ongoing by the time the 2005 Public Finance Report went to press.

perspective, the chapter starts by briefly recapitulating the key features of the existing EU fiscal framework.

1.2 The architecture of the existing EU fiscal framework

When the project of the European Economic and Monetary Union (EMU) was launched there was widespread recognition that enhanced economic co-ordination mechanisms were needed among the countries sharing the single currency.

In order to ensure the benefits of union-wide financial stability, Member States in the 1990s reached consensus on the design of a supranational fiscal policy framework at the level of the EU. The rules were adapted to the institutional characteristics of EMU and designed with a view to encouraging Member States to pursue sound budgetary policies while allowing sufficient margins for national budgetary flexibility.

The EU fiscal framework provides a combination of numerical and procedural rules enshrined in the Treaty and the Stability and Growth Pact.[26]

The Maastricht Treaty of 1992 established the requirement for Member States to keep their public deficit below 3% of GDP and the general government debt level below 60% of GDP (or diminishing at a satisfactory pace towards this reference value) as well as disciplinary rules to be followed in case a Member State fails to meet these criteria. According to Art. 104(3), when assessing a Member States' compliance with these criteria, the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors. The Stability and Growth Pact, adopted in 1997, further complemented and specified the rules of the Treaty with a view to reinforcing the preventive elements of the framework and inducing Member States to correct excessive deficit positions speedily if they occur.

The 1997 SGP consists of two Council Regulations, which are politically underpinned by the Resolution of the 1997 Amsterdam European Council. The first regulation, No. 1966/97, 'on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies', constitutes the preventive arm of the Pact. The regulation lays down a monitoring and early warning system with a view to prevent government deficits from becoming excessive. It requires Member States to achieve and maintain budgetary positions of 'close to balance or in surplus'. This is meant to ensure that fiscal policy contributes to an environment in which monetary policy can effectively maintain price stability whilst being growth supportive. Moreover, by maintaining a budget position of 'close to balance or in surplus', Member States would have the necessary room for manoeuvre for cyclical stabilisation through the working of the automatic stabilisers without the 3% of GDP reference value for deficits being breached (see e.g. Buti and Sapir (2002)). In addition, it would lead to a rapid reduction of the government debt to GDP ratio, implying a lower interest burden and creating further scope for governments to pursue growth enhancing reforms.

In order to allow for a consistent monitoring of the budgetary developments, the Regulation requests Member States to submit Stability or Convergence Programmes.[27] They include the medium-term objective for their budgetary position and describe the adjustment path towards it. In addition, since 2001, the annual up-dates of the Stability and Convergence Programmes contain complementary information on the long-term sustainability of public finances.

The Council is at the core of the peer review mechanism established by the Treaty and specified by the Pact. Based on the assessment of the Commission, the Council examines the programmes and formulates an opinion for each Member State. If the Council identifies significant divergence of the budgetary position from the medium-term budgetary objective or the adjustment path towards it, it can decide to address a recommendation to the Member State concerned to take the necessary action.

The dissuasive dimension of the Pact is laid down in the Council Regulation No. 1467/97 on "speeding up and clarifying the implementation of the excessive deficit procedure."[28] The main purpose of the regulation is to speed up and clarify the excessive deficit procedure as defined in the Treaty Article 104. It introduces a rigorous timetable for the procedure designed to strengthening the dissuasive nature of the Treaty requirements and providing incentives to ensure a sufficient safety margin from the reference value of 3% of GDP for the government deficit.

[26] For a more detailed description of the EU fiscal rules see Buti and Sapir (1998) and Cabral (2001). On the optimal design of fiscal policy rules see Kopits and Symanski (1998).

[27] Member States having adopted the euro submit Stability Programmes, the other Member States Convergence Programmes. The main difference between the Stability and Convergence Programmes concerns the quality of the monitoring of implementation. In terms of content, Convergence Programmes have to provide additional information on the medium-term monetary policy objectives, price and exchange rate stability. [See European Commission, (2000)]

[28] Council Regulation 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure.

Box II.1. Why fiscal rules?

Unsustainable budgetary positions are a major threat to macroeconomic stability. The experience of lax fiscal policies in several European countries up to the early 1990s had given evidence of the adverse effects of high public deficits and rising debt levels on economic growth and stability. The existence of large deficits and debt levels tends to push up prices and interest rates, distorts the allocation of resources and constrains the economy's capacity to respond counter-cyclically in case of an economic downturn. Effective multilateral fiscal rules can play an important role in countering the frequent deficit bias of fiscal policies by providing an external anchor to domestic budgetary reforms.

The formation of the European Economic and Monetary Union created additional arguments for fiscal rules at the supranational level. The combination of a single currency and decentralised fiscal policies carried out by sovereign countries call for enhanced coordination of macroeconomic policies within EMU. With the adoption of a single currency the potential for economic spillover between the participating Member States, including through the conduct of budgetary policy, increases considerably. At the same time market discipline tends to diminish as the risk of exchange rate changes and the ability of national central banks to influence the national interest rate of a specific country disappears. Such constellations open the possibility for free riding and give rise to the risk of moral hazard behaviour. In the absence of fiscal rules, governments in Member States may have an incentive to run overly expansionary policies because the costs in form of higher interest rates is spread across all members and can be expected to remain muted for the (ir-)responsible country. As a result of such behaviour the aggregate deficit and debt in the eurozone could rise to levels well beyond what is sustainable and socially acceptable. There is also a risk of impairing the functional independence of the European Central Bank, if Member States were allowed to accumulate unsustainable levels of public debt. High-debt countries, in order to avoid a default with negative repercussion on the euro area wide financial market, could *de facto* force the ECB to either accept a higher level of inflation than warranted (inflationary bail-out) or to bail out the indebted country at the cost of the whole union, despite the no-bail rule enshrined in the Maastricht Treaty. (See for example Eichengreen and Wyplosz 1998)

Main elements of Regulation 1467/97 include:

- The definition of the existence of an excessive deficit, including the concepts of 'exceptional and temporary' excess over the reference value and 'severe economic downturn'. According to the regulation the excess of a deficit can be considered exceptional if it results (a) from an unusual event outside the control of the Member State or (b) from a severe economic downturn. In either case, and provided that the deficit remains close to the reference value, no excessive deficit would be identified.
- The deadlines for the correction of the excessive deficit. The regulation stipulates that within four months the Member State has to take effective action for the correction of an excessive deficit and that the correction of the excessive deficits should be completed in the year following its identification by the Council, unless there are 'special circumstances'.[29] The latter concept is not specified and leaves discretionary room for decision making in the Council.
- Rules for the monitoring and assessment of the results of corrective actions taken,
- Deadlines for the subsequent steps in the procedure, including the application of sanctions.

The regulation focuses on the budget deficit and does not explicitly specify the application of the debt criterion of the Treaty, as compliance with the deficit criterion was deemed sufficient to ensure a satisfactory rate of debt reduction.

The rules of the Pact are embedded in a wider framework of economic governance and coordination in the EU and complemented by a more comprehensive set of policy instruments and rules, both at the EU level (e.g. the Broad Economic Policy Guidelines) as well as at the national level. Moreover, statistical governance, both at the level of the EU and the Member States, including rules concerning the timely provision of correct and comparable budgetary data is another key element of the EU fiscal framework.

1.3 Improving the implementation of the SGP – the 2005 reform package

The Review of the Pact provisions took place against the background of deteriorating budgetary performance of many EU Member States as well as in light of the changes in economic circumstances of the enlarged EU. By and large in line with the ideas presented by the Commission in its Communication of 3 September 2004,[30] the 2005 Ecofin report identifies five areas where improvement is warranted, notably to:

(i) enhance the economic rationale of the budgetary rules to improve their credibility and ownership;

[29] See Council Regulation No. 1467/97, Art. 3(4).

[30] Communication of the Commission 'Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact' of 3 September 2004, COM(2004)581 final. See also Deroose and Langedijk (2005) for a concise presentation of the reasons for reform. An alternative view focussing on effective and full application of original SGP is presented by Annett, Decressin, and Deppler (2005).

(ii) improve "ownership" by national policy makers;

(iii) use more effectively periods when economies are growing above trend for budgetary consolidation in order to avoid pro-cyclical policies;

(iv) take better account in Council recommendations of periods when economies are growing below trend;

(v) give sufficient attention in the surveillance of budgetary positions to debt and sustainability.

While some of these objectives could only be achieved by reducing the degree of automaticity of the existing rules and allowing for more economic judgement, the achievement of others is facilitated by adequately strengthening the incentives for compliance and enforcement. Moreover, the Commission, being the guardian of the Treaty and responsible for equal treatment in the application of EU rules, was concerned to ensure that by improving the economic underpinning of the Pact its rules-based character would not be jeopardised. Overall, the agreement reached by the Council reflects a balanced compromise.

The 2005 Ecofin report, endorsed by the European Council, up-dates and complements the existing SGP. For the implementations of some of the agreed changes it is necessary to formally amend the Council Regulations which underpin the SGP. Beyond these legal changes, the Ecofin report provides guidance for the Member States, the Council and the Commission in the application and interpretation of the Pact provisions. In line with the commitment of the Council to limit legislative changes to a minimum, the Report actually suggests only minimal changes to the Regulations, [including in the preventive arm of the Pact (Regulation 1466/97), notably on how to take structural reforms into account in the context of budgetary surveillance, and in the corrective arm of the Pact (Regulation 1467/97), notably the new definition of a 'severe economic downturn'; the nature of 'other relevant factors' and the steps of the EDP in which they should be considered; and the extension of the deadlines for taking effective action and measures in the course of the excessive deficit procedure.]

Elements designed to improve the economic underpinning and to increase the ownership of the Pact provisions are introduced both in the preventive arm of the Pact as well as in the application of the rules of the excessive deficit procedure. Moreover, the agreed measures to improve economic, fiscal and statistical governance are cross-cutting by nature. Their main aim is it to strengthen the legitimacy and ownership of the Pact and thereby foster its preventive power.

In order to facilitate the comparability with both the existing Pact, the following three sub-sections review the major modifications of the Pact provisions, by looking in turn at the changes to the preventive and the corrective arm and the measures related to the dimension of fiscal and statistical governance.

1.3.1 Changes in the preventive arm

Both the Commission and the Council considered enhancing the preventive dimension of the Pact a central objective of the reform.[31] Experience in the run-up to the recent protracted economic slowdown had highlighted the importance of prudent and symmetric-over-the-cycle fiscal policies and in particular the need to achieve surpluses in economically good times. Moreover, in light of the increased economic diversification in the EU of 25 Member States there is a need to better differentiate the medium-term budgetary policy objective according to relevant country-specific features. For lack of economic rationale, uniform budgetary objectives for all countries appeared no longer appropriate.

In response these challenges, the new agreement includes four major innovations in the preventive arm: (i) the definition of country-specific medium-term objectives within a given range and the procedure to set and revise them; (ii) agreement on a minimum annual budgetary effort for countries that have not yet reached the medium-term objectives; (iii) policy advice by the Commission to encourage Member States to stick to their adjustment path and (iv) the treatment of structural reforms.

These reform elements are designed with a view to enhancing the economic underpinning of the EU's medium-term fiscal policies, by providing more room for country-specific considerations. They are intended to raise Member States' compliance with their MTO and strengthen the incentives for prudent fiscal policies over the cycle and the implementation of structural reforms. The main modifications in the preventive arm are described below.

i) Country-specific medium-term objectives

The new definition of the medium-terms budgetary objective (MTO) is designed to better take into account the diversity of economic and budgetary positions and risks across Member States. In future, the medium-term objective of a country will be defined on the basis of its current debt ratio and potential growth, while the overall objective of achieving over the medium-term budgetary position of close to balance or in surplus remains. For Member States having adopted the euro area and for those participating in the European Exchange Rate Mechanism (ERM II), the agreed range of MTOs is between -1% of GDP for countries with a combination of low debt and high potential growth and balance or in

[31] See Council Declaration on the Stability and Growth Pact of 18 June 2004 and the Commission Communication of 3 September 2004.

surplus for countries with a combination of high debt and low potential growth.

The aim of the new country-specific MTO is threefold. It is designed to provide a safety margin with respect to the 3% deficit limit, to ensure fiscal sustainability in the long-run, and to improve the scope for productive public investment.

By taking into account relevant economic fundamentals, the new provision on the MTO allows for a better differentiation among countries while preserving the simplicity and transparency of the rule. Sustainability risks associated with implicit liabilities are indirectly addressed by ensuring that debt converges towards and remains at prudent values. Member States are thus offered the choice of combining different degrees of structural reform and debt reduction according to national preferences. Incentives for structural reform are not compromised.

The Report invites the Commission to continue methodological work on measuring and assessing implicit liabilities and to provide a progress report by the end of 2006. Once criteria and modalities for the assessment of implicit liabilities are established and agreed by the Council, the definition of the MTO will be reviewed with a view to reflecting such implicit liabilities more explicitly in the medium-term objective. Like in the past, the MTO is defined in cyclically-adjusted terms, net of one-off and temporary measures. The MTO for every Member State will be reviewed every four years and revised in light of the respective developments in government debt, potential growth and fiscal sustainability.

ii) Minimum annual budgetary effort for countries that have not yet reached the medium-term objectives

Member States of the euro area and of the ERM-II that have not yet reached their MTO have agreed to achieve, as a benchmark, an annual adjustment of 0.5% of GDP.[32] All Member States that have not yet reached their MTO are expected to achieve it over the cycle, by implementing more ambitious fiscal adjustment during good times. The new agreement on a minimum budgetary effort underpins the medium-term orientation of the European fiscal rules. The 1997 Pact provisions contain no explicit reference to the appropriate adjustment path.

The 2005 Ecofin report contains furthermore a commitment of Member States for the conduct of more symmetric fiscal policies over the cycle. Governments agreed to pursue active consolidation of the budget when the economic conditions are favourable, i.e. in ‘good times’, and to use windfall revenues, as a rule, for the reduction of government deficit and debt. The Report defines ‘good times’ as periods during which actual GDP growth is above potential growth, ‘taking into account tax elasticities’. This implies that the magnitude of consolidation in good times will depend on the actual impact of growth on public revenues. The latter is largely determined by the composition of the sources of growth.

iii) Early warning system

With a view to strengthening the preventive character of the Pact, the 2005 Ecofin Report clarifies and expands the existing early warning mechanism. The Report expects the Commission to issue direct, i.e. without prior Council involvement, policy advice to encourage Member States to realise the agreed adjustment path. Accordingly, the Commission will address the Council in future not only if there is an acute risk of breaching the 3%-of-GDP reference value, but can do so also in cases of unjustified deviations from the adjustment path towards the MTO or the MTO itself, including in good times. The agreement pertains to the transition period until the new Constitution becomes effective. Once it is in force, the instrument of the ‘policy advice’ will be replaced by a Commission ‘opinion’ in line with the new Article III-184(5), directly addressed to the Member State concerned.

iv) Structural reforms

With a view to eliminating possible disincentives for structural reforms, the Council agreed that under certain conditions, certain structural reforms can justify a temporary deviation form the MTO and, for Member States that have not yet reached their MTO, temporary deviations from the adjustment path towards the MTO.

Provided that the respect of the 3%-of-GDP reference value is not jeopardised and the budgetary position is expected to return to the MTO within the four-year programme period, the Council, when assessing the MTO or the adjustment path towards it, shall take into account major structural reforms. Only major structural reforms that have direct long-term cost-saving effects and verifiably improve fiscal sustainability over the long-term will be considered. This rule pertains in particular to systemic reforms of the pension scheme of a Member State. Such reforms typically imply budgetary costs in the short-run to the benefit of lower ageing-related implicit liabilities in the long-run. Significant other supply side reforms that raise potential growth can also be considered. These modifications should be seen in the context of increasing the consistency of the various policy objectives and instruments at the EU level, in particular with the objectives of the Lisbon Strategy.

[32] Measured in cyclically adjusted terms, net of one-off and other temporary measures.

Table II.1. 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 (MTO) 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 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 zone 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. Difference s 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 case 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 of real GDP of at least 2% for the preparation of report under Art. 104(3) by the Commission, and in decisions under 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 Member States commit not to invoke the severe economic downturn when growth is above -0.75%.	An economic downturn may be considered '*severe*' in case of a negative growth rate or accumulated loss of output during a protracted period of very low growth relative to potential growth
'Other relevant factors' (ORF)	No specific definition of '*ORF*' and their role in the excessive deficit procedure.	• The Commission report under Art. 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. • '*ORF*' 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 ORF 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 a 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 104(6) – from 3 to 4 months after notification; • for taking effective action following 104(7) - from 4 to 6 months; • for moving to 104(9) – from 1 to 2 months; • for taking action following a notice under 104(9) – from 2 to 4 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 '*ORF*' and on the condition that minimum fiscal efforts have been taken.
Repetition of steps in the EDP	Not foreseen.	Deadlines for correcting the ED 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.

In order to allow the Commission and the Council to scrutinise the envisaged structural reforms and assess their impact on the MTO and the adjustment path towards it, Member States will be requested to provide detailed documentation of the expected cost-benefit effects of the envisaged reforms in the context of the annual up-dates of stability and convergence programmes. It is furthermore envisaged to give the Council three, instead of two, months for the examination of the programmes following their submission.

1.3.2 Changes in the corrective arm

The main modifications in the corrective arm of Pact concern (i) the definition of 'excessive deficits', including the revision of the concept of 'severe economic downturn' and the role of 'other relevant factors', (ii) the possible extension of the existing one-year deadline for the correction of an excessive deficit following its identification by one year and the introduction of repeatability of steps in the EDP; (iii) considerations related to the assessment of systemic pension reforms in the EDP and (iv) focus on debt and fiscal sustainability.

Many commentators have criticised the revisions in the excessive deficit procedure as a significant weakening of the dissuasive dimension of the Pact. It is argued that in particular the agreement on the application of other relevant factors *de facto* erodes the 3%-of-GDP reference value, and that the lack of constraint would give rise to growing deficits in the future.[33] However,

[33] See e.g. Feldstein (2005) and Deutsche Bundesbank, press release of 21 March 2005.

such an assessment overlooks key elements of the new 2005 reform.

In practice, the room for discretionary judgement in the excessive deficit procedure to better capture economic reality, including the consideration of the agreed wider set of 'other relevant factors' or the possibility to incur a repetition of procedural steps, is effectively constrained by complementary provisions of the new agreement, preserving the character of the rules-based system. First of all, both the Commission, when considering whether an excessive deficit exists or may occur, and the Council, when deciding on the existence of an excessive deficit, will take into account any relevant factors only if the general government deficit remains close to the reference value and its excess over the reference value is temporary.

Secondly, there will be no simple discounting of certain categories of public expenditure from the deficit calculations. Other relevant factors are always considered in an overall assessment, in which a large number of factors, including those that may call for a stricter interpretation of the deficit figures, are examined symmetrically to assess compliance with budgetary discipline.

Thirdly, Member States in excessive deficit are requested to achieve a minimum annual budgetary effort of 0.5% of GDP[34] irrespective of relevant factors.

Fourthly, the Commission will always issue a report under Art. 104(3), if the deficit of a Member State exceeds 3%, or if it sees a risk of an excessive deficit.

And finally, the obligation of the Council to impose sanctions in case a Member State in excessive deficit repeatedly fails to act in compliance with the successive decisions of the Council remains unchanged as the ultimate threat against non-compliance. The various modifications in the corrective arm are presented in more detail below.

i) Definition of 'excessive deficits'

The identification of an excessive deficit is the cornerstone of the SGP's dissuasive arm. According to Article 104 (2a) of the Treaty (and the Protocol on the Excessive Deficit Procedure) a government deficit above 3% of GDP is considered to be excessive unless the excess over the 3% is only exceptional and temporary and the government deficit ratio remains close to the reference value.[35] The existing Council Regulation 1467/97 specifies in Art. 2 that the excess over 3% can be considered exceptional if it results (a) from an unusual event outside the control of the Member State (e.g. a natural disaster) or (b) from a severe economic downturn, which is defined as an annual fall of real GDP of at least 2% (Article 2(2)). In order for the excess to be considered temporary, the Commission's forecast must indicate that the deficit will fall back below the reference value following the end of the unusual event or the severe economic downturn. The Commission's usual forecasting period is two years.

'Severe economic downturn' redefined

In order to reformulate the exceptionality clause more in line with economic reality in the EU Member States, the Council agreed to make the condition of 'severe economic downturn' less demanding and suggested adapting paragraphs Article 2 (2) and (3). Accordingly, both the Commission and the Council, when assessing and deciding on the existence of an excessive deficit according to Treaty Article 104 (3-6) may consider as exceptional in the sense of Art. 104(2a) an excess over the reference value 'which results from a negative growth rate or from the output loss accumulated during a protracted period of very low growth relative to potential growth'. However, the overarching conditions of 'close to the reference value' and 'temporariness' continue to apply.

The role of 'other relevant factors' clarified

Moreover, with a view to ensure a balanced and comprehensive assessment of the budgetary developments in the context of the economic and fiscal conditions prevailing in a country, the 2005 Ecofin Report clarifies a set of 'other relevant factors' that the Commission and the Council will take into account when deciding on the existence of an excessive deficit and when determining the deadline for its correction.[36] In particular, the Commission when preparing the report under Article 104(3), which initialises the Excessive Deficit Procedure, 'should appropriately reflect developments in the medium-term economic position, (in particular, potential growth, prevailing cyclical conditions, the implementation of policies in the context of the Lisbon agenda and policies to foster research and development and innovation) and developments in the medium-term budgetary position (in particular, fiscal consolidation efforts in 'good times', debt sustainability, public investment and the overall quality of public finances)'.

Furthermore, the Commission shall give 'due consideration' 'to any other factor, which in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value'. Such factors may include 'budgetary efforts towards increasing, or maintaining at a high level, financial contributions to fostering international solidarity and to achieving European policy goals, notably the unification of Europe'.

[34] In cyclically-adjusted terms net of one-off and temporary measures.

[35] See Cabral (2001) for details.

[36] The Treaty provisions on the excessive deficit procedure (Article 104) include the concept of other relevant factors. However, in practice it did not play a significant role in the excessive deficit procedures in the past.

Once the Council has taken the decision that an excessive deficit exists, 'the other relevant factors will also be considered in the subsequent steps' of the procedure, including in the decision on the appropriate deadline for the correction of the excessive deficit and the assessment of effective action, but not 'in the decision of the Council whether a Member State has corrected its excessive deficit'.

The 2005 Ecofin Report stresses that other relevant factors are taken into account only under the condition that 'the excess over the reference value is temporary and the deficit remains close to the reference value'. In other words, if a deficit above 3% exceeds what is considered 'close to the reference value' or if there is no indication in the budgetary forecast provided by the Commission that the deficit will fall below the reference value, the presumption prevails that an excessive deficit exists despite all 'other relevant factors', and the Council shall decide accordingly.

ii) Deadlines and repeatability of steps in the excessive deficit procedure

The 1997 Pact provisions are characterised by a high degree of automatism both with respect to the timing and the sequence of the respective steps in the EDP. The 2005 Ecofin Report, while up-holding the principle that an excessive deficit should be corrected promptly, introduces more flexibility to respond to changes in economic circumstances. The new agreement sticks to the provision that, as a rule, an excessive deficit should be corrected the year after it is identified by the Council, i.e. usually the second year after it occurs. However, in cases where a correction in the consecutive year would be unwarranted for economic reasons, the Council may decide to set the deadline for the correction of the excessive deficit in the second year after its identification. When deciding on the appropriate deadline for the correction of the excessive deficit, the other relevant factors analysed by the Commission in its report under Art. 104(3) will be taken into account.

The increased flexibility with respect to setting the initial deadline for correction is counterbalanced by the Council agreement that, as a benchmark, countries in excessive deficit have to implement a minimum fiscal adjustment of at least 0.5 % of GDP[37] irrespective of the existence of other relevant factors. The Council, on the basis of a recommendation by the Commission, can intervene at any time, if it finds that the action implemented by the country concerned is inadequate to bring the excessive deficit to an end as recommended, and move to the next step in the procedure.

With a view to allowing both the Commission and the Council for an appropriate assessment of all aspects, the delay for adoption of a decision under Article 104(6) establishing the existence of an excessive deficit should be extended from three to four months after the notification deadline. By the same token, to facilitate the effective adoption of more comprehensive consolidation packages in the context of national budgetary processes, the delay for taking effective action will be extended from currently four to six months. For the same reasons, the one-month deadline for the Council to take a decision to move from Article 104(8) to Article 104(9) will be extended to two months, and the two-month deadline under Article 104(9) to 4 months. As a result, the overall maximum period of 10 months within which the Council is obliged to take a decision to impose sanctions in case a Member States participating to the eurozone fails to comply with the successive decisions of the Council[38] is effectively expanded to 16 months.

The 2005 Ecofin Report introduces also the possibility of repeating steps in the excessive deficit procedure, thereby correcting what has been seen as one of the main sources of rigidity of the current Pact.

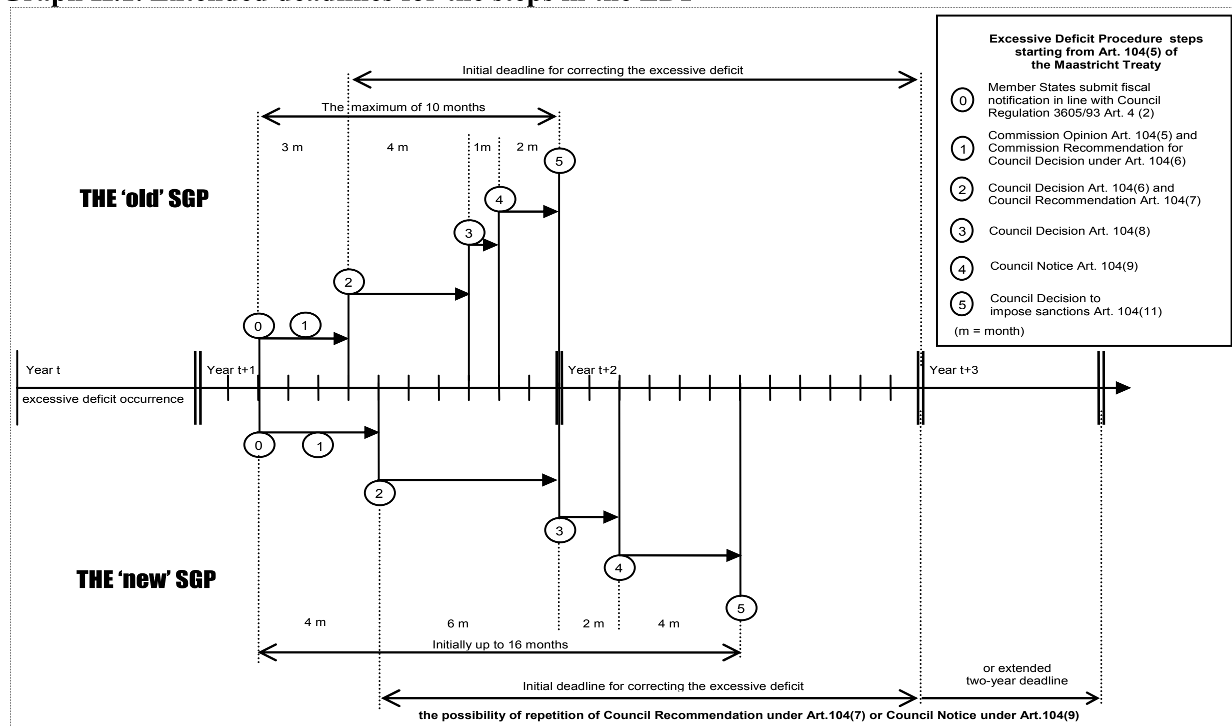
In case an unexpected adverse economic event with a considerable negative impact on the budget hits a country in the course of correcting its excessive deficit, the deadlines initially agreed by the Council following Art. 104(7) or Art. 107(9) can be revised and expanded.

However, a repetition of these steps can only be invoked under the provision that effective action has been taken by the country concerned in compliance with the initial recommendation or notice. This implies that as a minimum, measures in the magnitude of 0.5% of GDP in cyclically-adjusted terms, net of one-off and other temporary measures, must be in place.

[37] In cyclically-adjusted terms, and net of one-off and other temporary measures.

[38] Council Regulation 1467/99, Art. 7.

Graph II.1. Extended deadlines for the steps in the EDP



Source: Commission services.

iii) Taking into account systemic pension reforms

In line with the provisions concerning the treatment of so-called second-pillar pension reforms in the definition of the MTO, the 2005 Ecofin Report commits the Council and the Commission to 'consider carefully' in the context of the EDP an excess close to the reference value caused by the introduction of a multi-pillar pension system that includes a mandatory, fully funded pillar.

In particular, when assessing whether the excessive deficit has been corrected, the Commission and the Council will compare the developments of the nominal deficit figures under the EDP with the net costs related to the implementation of the second pillar.

Over the first five years after the implementation of such a reform, and following a regressive mode, the deficit figures can be corrected for the net costs of the pension reforms. The correction will be for 100% of the net costs in the first year, for 80% in the second year, and for 60%, 40%, and 20% in the third, fourth and fifth year. For Member States that have already implemented such reforms, the same five-year mechanism would apply, starting in 2005.

While these provisions are generally designed to provide further incentives for increasing the long-term sustainability of pension systems, they pertain particularly to a number of new Member States, which have recently started with the build-up of a fully funded second pillar. While most of these countries are currently in EDP, a certain proportion of the excessive deficit is attributable to the pension reform. Thus, the agreement reached by the Council on the treatment of second-pillar pension reforms in the EDP may have implications for the assessment of fiscal convergence in line with the deficit criteria laid down in the Treaty for deciding on membership in the euro zone.

iv) Focus on debt and fiscal sustainability

The Commission intends to apply in full the provisions of the Treaty. Under the current legal provisions, according to Article 104(2) of the Treaty, the Commission monitors whether the debt ratio exceeds the reference value and, if so, whether it is sufficiently diminishing and approaching the reference value at a satisfactory pace. The Commission has the possibility, where it is of the opinion that there is an excessive deficit for non-compliance with the debt criterion, to recommend to the Council to take a decision on the existence of an excessive deficit according to Article 104(6) of the Treaty.

The 2005 Ecofin Report recalls the Commission's obligation to examine compliance with budgetary discipline on the basis of both the deficit and the debt criterion and reaffirms the need to reduce government debt to below 60 % of GDP at a satisfactory pace. The Council calls in particular for a strengthening of the debt surveillance framework by applying the Treaty's concept of 'sufficiently diminishing and approaching the reference value at a satisfactory pace' for the debt ratio in qualitative terms. This implies that macroeconomic conditions, in particular the level of potential growth and the cyclical position, and debt dynamics should be taken into account, including the pursuit of appropriate levels of primary surpluses as well as other measures to

reduce gross debt, including the one-off and other temporary measures, and debt management strategies. Following such an approach avoids a mechanistic interpretation of gross debt figures.

In case the Council identifies a situation of non-compliance with the debt criterion, it will formulate a recommendation in the context of the Council opinions on the stability programme.

1.3.3 Improving governance

The 2005 Ecofin report recognises that modifications to the provisions of the Pact are not sufficient to ensure a meaningful improvement of their implementation. In order to solidly re-establish the credibility of the Pact and to strengthen the enforcement of budgetary discipline, it is important that complementary measures are taken to enhance the institutional conditions for fiscal and statistical governance. The report contains a number of elements designed to increase the ownership of the Pact provision, clarify the respective roles and responsibilities of the various actors involved as well as measures to improve the quality and timeliness of statistical data, both at the national and the EU level.

i) Fiscal governance

The 2005 Ecofin Report stresses that increasing the effectiveness of peer support and pressure is an integral part of a reformed Stability and Growth Pact. With a view to strengthening the central peer support functions of the Pact, the Council and the Commission commit to explain publicly their positions and decisions at all appropriate stages of the fiscal surveillance procedure established by the Treaty and the Pact.

The Report highlights furthermore the importance of national budgetary rules complementing Member States' commitments under the Stability and Growth Pact at the EU level. It suggests that national institutions could play a more prominent role in domestic budgetary surveillance, thereby underpinning and complementing the monitoring and surveillance procedures at EU level. A more effective mobilisation of the national public opinion is seen as a useful measure to strengthen national ownership and enhance enforcement.

Following the same rationale, it is foreseen that a new government taking office shows continuity with respect to the budgetary targets endorsed by the Council on the basis of the Member States' previous update of the stability/convergence programme. When the new government prepares its first up-date of the programmes, it is expected to present its budgetary strategy, outlining the means and instruments which it intends to emply to achieve the agreed targets.

With due respect to the subsidiarity principle, the Report suggests a greater involvement of national parliaments in the EU fiscal surveillance process. It invites Member State governments in particular to present to their national Parliaments their stability or convergence programme and the respective Council opinions thereupon, and to discuss with the national parliaments the follow-up to recommendations in the context of the early warning and the excessive deficit procedures.

In order to facilitate a better differentiation between forecasting and policy errors, Member States are requested in future to include more comprehensive sensitivity analysis and/or developing alternative scenarios in their respective stability and convergence programmes. This will enable the Commission and the Council to consider a wider range of possible fiscal outcomes.

In this context, the report points to the important contribution that Commission forecasts can provide for the coordination of economic and fiscal policies. It calls in particular on the Member States of the euro area and ERM II to use the 'common external assumptions' provided by the Commission in its forecasts. More generally, Member States are called upon to explain divergences between the national and the Commission forecasts in their stability or convergence programmes and their respective up-dates, also to assess possible forecast errors.

ii) Statistical governance

The 2005 Ecofin Report recognises that the credibility and implementation of the fiscal framework rely crucially on the availability of correct and reliable fiscal data. Transparent budgetary statistics are also seen as instrumental to enable financial markets to better assess and distinguish the creditworthiness of the different Member States, thus providing an important signalling function for policy errors.

The Report recalls in particular the need to have in place adequate practices, resources and capabilities to produce high quality statistics at the national and European level and to ensure the independence, integrity and accountability of both national statistical offices and Eurostat. With respect to Eurostat, the Report emphasises the importance of further developing its operational capacity, monitoring power, independence and accountability.

Given the crucial importance of reliable data for the functioning of the EDP and in order to avoid moral hazard behaviour, the report makes reference to the possibility of invoking sanctions, to be considered in case of an infringement of the obligations to duly report government data.

The Commission and the Council pursue the objective of improving the governance of the European statistical system in parallel with the reform of the SGP. In December 2004, the Commission presented three main lines of action towards a European governance strategy

for fiscal statistics.[39] They include the further elaboration of the legal framework related to the reporting of fiscal data; the development of European standards for the institutional set-up of statistical authorities; and finally the provision of additional resources to enable the relevant Commission services to enhance their activity level with respect to budgetary surveillance and the verification of the quality of budgetary statistics (See box on 'Strengthening the governance of budgetary statistics').

1.4 An assessment of the 2005 SGP Reform according to criteria for an optimal fiscal policy rule

Buti, Eijffinger and Franco (2003) assess the design and compliance mechanisms of the Stability and Growth Pact rules against the set of eight criteria for an ideal fiscal rule established by Kopits and Symanski (1998). They conclude that EU fiscal rules appeared to fare relatively well against the Kopits-Symanski criteria. The SGPs strongest point was its simplicity while its weakest aspects concerned enforceability and support of structural reforms. Buti et al. highlight the existing trade-offs between the various criteria, namely between simplicity and flexibility, between simplicity and adequacy, and between flexibility and enforceability. These trade-offs are influenced by the multinational setting in which the rules are applied. In particular, Buti et al. argued that a multiplicity of countries increases heterogeneity and dispersion of preferences with the consequence that a one-size-fits-all fiscal rule is likely to be sub-optimal.

Against this background, the 2005 reform of the SGP, as reflected in the Ecofin report, can be tentatively assessed. Overall, the analysis suggests that the changes result in a broadly balanced set of new rules. Table II.2 shows that the Kopits-Symanski (KS) score deteriorated on the criteria on which the SGP scored high in the assessment of Buti et al. In particular, it appears that in comparison to the original Pact, the new provisions are less well-defined, contain a higher risk of interpretative ambiguity, and are less transparent and more complex. On the other five criteria, where the ratings had been less positive, its score improved.

KS-1 - A ***well-defined*** fiscal rule, in terms of the indicator to be constrained, institutional coverage and escape clauses, is paramount for effective enforcement. Whereas the Treaty criteria remain well-defined as to the policy variables subject to constraints (i.e. budget balance and gross public debt) and the institutional coverage (i.e. general government), the escape clauses specified by the SGP are widened and subject to some more ambiguity. The concept of closeness and temporariness are activated, but not fully specified; overall judgement of 'other relevant factors', as well as of 'cumulative loss of output' to identify a severe economic downturn, is introduced in the decision on the existence of an excessive deficit; room for judgment is introduced in setting the deadline for correction of the excessive deficit. On the other hand, the SGP medium-term objectives, which remained vague under the 1997 SGP, are specified. Moreover, the required fiscal adjustment both in the excessive deficit procedure and towards the medium-term objective is specified, while additional judgement is introduced by allowing for considering structural reforms. The SGP remains silent on how to apply the Excessive Deficit Procedure in the case of violation of the public debt criterion of the Treaty which requires the debt ratio to be on a declining trend as long as it is above the 60% of GDP reference value. Overall, the adjustments of the SGP which introduced more room for judgement have resulted in a deterioration against the KS criteria of a well-defined system.

KS-2 - Transparency has several dimensions. For fiscal rules to score high on transparency, they need to include provisions on accounting conventions, forecasting exercises, reporting practices, and interpretation of data. The Treaty and the SGP continue to be based on ESA-95 accounting. The Commission forecasts are the reference point for assessing the risk of an excessive deficit or for detecting a "significant divergence" from the set of budgetary targets. The respective roles of Commission and national forecasts in the assessment of Stability and Convergence Programmes and in the EDP (repetition of steps) have been partly clarified. However, increased use of non-measurable indicators in the assessment in order to allow for a richer judgement of the economic and budgetary circumstances, reduce transparency. The 2005 reform of the SGP formalises the practice of the previous years to increasingly use cyclically-adjusted measures, indicators of implicit and contingent liabilities and estimates of potential growth which are all subject to uncertainty. In addition the assessment of structural reforms for which no conventions or reporting practices exists reduces transparency of the fiscal rules. The reform of the statistical governance, on the other hand, addresses moral hazard problems and incentives for creative accounting by enhancing statistical surveillance. Overall, the more complex and richer framework with increasing importance of non-measurable and uncertain indicators, in addition to the data based on ESA-95 accounting, will reduce transparency.

[39] See Commission Communication 'Towards a European governance strategy for fiscal statistics' of 22 December 2004, COM(2004)832.

Box II.2. Strengthening the governance of budgetary statistics

Main elements of the governance of budgetary statistics. The main elements of the governance of budgetary statistics in the EU were described in Chapter II-4 of the 2003 edition of the report *Public Finance in EMU*. They consist in (i) a consistent set of accounting rules; (ii) the Commission authority in providing the data for budgetary surveillance, though statistics are compiled from basic sources by the national authorities in compliance with the principle of subsidiarity; (iii) well-defined deadlines for the transmission of the main government figures – i.e. deficit and debt – as well as for the transmission of the complete underlying accounts, (iv) the role of Eurostat in the assessment of the quality of data reported by Member States, and (v) multilateral discussion of methodological issues within the Committee on Monetary, Financial and Balance of Payment Statistics (CMFB). The 2003 report also described developments such as the adoption by the ECOFIN Council, on 18 February 2003, of a Code of Best Practice and a number of steps towards the compilation of government accounts with quarterly frequency.

Some progress… In the meantime, there has been progress notably concerning the timeliness, completeness and consistency of government accounts. There were also important decisions concerning the accounting of innovative and complex transactions – e.g. private-public partnerships – and the government delimitation, for example in relation to the reform of pension systems. A major achievement was the remarkably smooth integration of new Member States in the transmission and validation of fiscal statistics. As regards the compilation of quarterly accounts and their use in budgetary surveillance – which was characterised in the 2003 report as a medium-term project and a major challenge for the future – there has also been some steps forward. Quarterly government revenue and expenditure accounts are already available for the euro-area, ([1]) though data per country are under embargo until the end of 2005; the quarterly government debt is available for most countries.

… but evidence of data quality problems. However, evidence of substandard quality in the budgetary statistics of some Member States – which materialised notably in the exceptionally large revision in the Greek government accounts in 2004 ([2]) –, the discrepancies in the accounts of some Member States ([3]) and the ensuing suspicions about the quality of budgetary data has led the Council and the Commission to propose strengthening the governance of these statistics.

The Council calls for action. On 2 June 2004, the ECOFIN Council noted that "*reliable fiscal statistics are essential for the credibility of the excessive deficit procedure (EDP). The EDP notification of March 2004 showed rather good compliance with the Code of Best Practice as regards the reporting deadlines. There was also a considerable improvement in the availability of detailed data on the government sub-sectors* (…)." However, "*on several occasions, fiscal statistics have been revised after a new government took office. The Council considers that the compilation and reporting of statistics for the EDP must not be vulnerable to political and electoral cycles.*" Therefore, "*the Council invites the Commission to strengthen the monitoring of the quality of reported fiscal data and report back to the Council before the end of the year 2004*".

From a more general perspective, the Council also concluded that "*high-quality statistics are fundamental for European policies. The Council considers that integrity, independence and accountability of data compilers, and the transparency of the compilation methods, underpinned by the appropriate institutional arrangements, are crucial to ensure such high-quality statistics. It would therefore be recommendable to develop minimum European standards for the institutional set-up of statistical authorities. The Council invites the Commission to make, by June 2005, a proposal for such standards, which reinforce the independence, integrity and accountability of Member States' national statistical institutes. These standards should also help to address the specific concerns on the quality of fiscal statistics*". The importance given by policymakers to the quality of budgetary statistics is illustrated by the fact that this topic was also in the agendas of the 10 September, 7 December 2004 and 17 February 2005 ECOFIN Council meetings.

The Commission proposes three lines of action. The Commission response to the ECOFIN Council conclusions was outlined in the Communication "*Towards a European governance strategy for fiscal statistics*" ([4]) adopted on 22 December 2004. The Commission strategy involves three lines of action: (i) building-up the legislative framework; (ii) the development of the operational capacity of the Commission; (iii) the preparation of European standards on the independence of statistical institutes. The rest of this box elaborates on the first and third items of this strategy. The second line of action consists mainly in increasing the resources devoted to budgetary surveillance and to checking the quality of budgetary statistics in the relevant Commission services (Eurostat and DG ECFIN).

Completing the legal framework. On 2 March 2005, the Commission adopted a proposal for a Council Regulation which is intended to strengthen the quality of the statistical data for the excessive deficit procedure.([5]) The proposal consists in amending Council Regulation (EC) N° 3605/93, which is the legal act governing the reporting of fiscal data for EDP. The amended regulation will enter into force after formal adoption, by qualified majority, by the ECOFIN Council. The European Parliament and the ECB also participate in the adoption of this regulation as they are required to prepare non-binding opinions.

Regulation (EC) N° 3605/93 currently has two sections on (1) definitions and (2) rules and coverage of reporting. According to the Commission proposal, these two sections will be kept basically unchanged. However, section 2 will be completed with two new articles establishing the Member States' obligation to report and properly documenting revisions in data, and clarifying that the tables transmitted by Member States are public.

The Commission proposes to add three new sections (3, 4 and 5) to the regulation. Section 3 establishes a number of processes to check that data compiled and reported by national authorities comply with the accounting rules and are reliable, complete and consistent. In a number of respects, the proposal enshrines existing practices, such as the preparation and publication by the national authorities of statistical inventories for government accounts, ([6]) the regular dialogue between Eurostat and the Member States' statistical authorities, and a procedure involving the CMFB when there is a need to complete and clarify the accounting rules. However, the proposal goes farther than existing practice by establishing further visits, during which Eurostat will look at the detailed economic data which justify the reported figures. The association of experts from other Member States to these visits

will broaden the expertise. Moreover, transparency will be ensured by making public the conclusion of the quality assessment. ([7])

Section 4 clarifies the provision in the Treaty Protocol, according to which the statistical data for EDP are provided by the Commission. The provision of data is done by Eurostat, by publishing the data three weeks after the deadlines for the transmission of data by the Member States. The new section makes clear that the Eurostat task is not simply to reiterate Member States' figures; it can publicly raise reservations to the data transmitted by Member States in case there is enough evidence that data compiled by the national authorities are of substandard quality, or even unilaterally amend these data in case reported figures do not comply with the rules and there is sufficient information to provide alternative estimates.

Section 5 answers specifically to concerns on the vulnerability of fiscal statistics to political cycles. It establishes that the compilation of fiscal statistics data is done in accordance with a number of principles, most notably impartiality ([8]) and that the officials responsible for the compilation of government accounts should abide by these principles.

European standards for the statistical institutes. The third line of action – which covers all economic statistics and not simply fiscal data – concerns the development of European standards for the institutional set-up of statistical authorities. Such standards should reinforce the independence, integrity and accountability of statistical institutes, which should improve trust and confidence in statistical authorities and the credibility and quality of their statistics. On 24 February 2005, the Statistics Programme Committee (SPC), which gathers the director generals of the national statistical institutes and of Eurostat, unanimously adopted a European Statistics Code of Practice. This code of practice includes fifteen principles ranging from professional independence of data compilers, statistical confidentiality, impartiality and objectivity, accuracy, reliability and timeliness of data to adequacy of resources of statistical institutes. On 25 May 2005, the Commission endorsed this code, recommending that Member States recognise it as a common set of standards at the European level for statistical authorities and intends to set up a reporting system to monitor adherence within the European Statistical System.([9])

([1]) See Table 6.4 of the ECB Monthly Bulletins (Euro area statistics).
([2]) See Box I.1 on the revisions of the Greek accounts.
([3]) See Part 2 Section 2.2 of this report for a detailed discussion on the stock-flow adjustments in the EU Member States.
([4]) COM (2004) 832.
([5]) COM (2005) 71.
([6]) Statistical inventories are documents prepared by the national statistical authorities, describing the methods, procedures and sources for the compilation of statistics. Rather than a description of the accounting rules, the inventories should detail how Member States apply the rules, which services provide which data, the estimation procedures to deal with missing data, etc.
([7]) In the Communication of 1 December 2004 (COM (2004) 784), the Commission acknowledged that discussions on the quality of fiscal statistics often took place within a restricted circle of statisticians and were not effectively communicated to the political level and to the public.
([8]) According to Council Regulation (EC) N°322/97 on Community Statistics, statistics shall be compiled according to the principles of impartiality, reliability, relevance, cost-effectiveness, statistical confidentiality and transparency. Specifically, impartiality means that data are compiled "*in an objective and independent manner, free from any pressure from political or other interest groups*".
([9]) Communication from the Commission to the European Parliament and to the Council and Recommendation on the independence, integrity and accountability of the national and Community statistical authorities (COM (2005) 217).

KS-3 - The EU fiscal rules were ***simple*** and easily understandable. Some of the simplicity has been lost by introducing room for judgement in the decision on the existence of an excessive deficit and in the adjustment path. The large range of possible relevant factors which need to be assessed renders the system more sophisticated and complex. In addition, the factors mentioned under KS1 and KS2, affecting transparency and the concept of a well-defined framework also affect simplicity. On the other hand, the agreement that the Commission shall always prepare a report under article 104(3) if the EDP deficit exceeds the 3% of GDP reference value is straightforward. It enhances simplicity and clarifies accountability in the decision making. Overall, the increased room for judgement and the wider range – and more uncertain nature - of indicators that are assessed implies increased complexity of the rules.

KS-4 A number of factors have been adjusted allowing more ***flexibility*** in different stages and parts of the fiscal framework. The tight specification of the escape clauses of the 'severe economic downturn' has been widened, allowing judgement by the Commission and Council. Also the consideration of other relevant factors in the decision on the existence of an excessive deficit increases flexibility, though within the margins of 'temporariness' and 'closeness to the reference value'. The Council also has the flexibility to grant at the start an additional year for the correction of an excessive deficit if 'special circumstances' occur. As to deviation from the medium-term objective and the adjustment path to it, certain structural reforms may be considered. Overall, the flexibility is clearly enhanced - though within constraints - to better capture economic reality and allow sound policy advice.

KS-5 - Adequacy of the rules has to be assessed in relation to their final goal. Rules should be neither too broad nor too narrow. The goal of the EU fiscal rules is ensuring budgetary prudence. The concept of budgetary prudence has widened over the years (see sub-section II.3 on increased focus on sustainability and growth). The deficit limit guaranteed fiscal discipline on a yearly basis, but was no longer adequate for long-term sustainability. Increased focus on debt and future debt developments as well as catering for structural reforms enhances the adequacy to this long-term objective.

Table II.2. Trade-offs according to good fiscal policy rule criteria

Kopits and Symanski criteria.	Buti et al. (2003) assessment of the SGP	Impact of the 2005 reform on fulfilment of the criteria
Well-defined: no ambiguous definitions, competence divisions or escape clauses	+ +	(-)
Transparent: data reporting and data analysis according to the same rules / procedures; no interpretation problems	+ +	(-)
Simple: rules being easily understandable and observable	+ + +	(-)
Flexible: allow for capturing of the impact of important influences not captured in the framework, making its application less mechanistic	+ +	(+)
Adequate to goal: rules should be not too broad nor too narrow; legal instruments should be capable of obtaining the goal	+ +	(+)
Enforceable / credible: rules should be credible; application impartial; susceptible to subjective pressures	+	(+)*
Consistent - internally and with other policy objectives	+ +	(+)
Supportive of structural reforms: rules should take due account of importance of structural reforms for the economy.	+	(+)

** The (+) assessment of the enforceability/credibility of the rules is compared to the situation existing after November 2003.*
Legend: - Buti, Eijffinger and Franco (2003) assessment: +++ very good, ++ good, + fair
- Assessment of the 2005 Reform of the SGP: (+) improvement, (-) deterioration

Moreover, differentiation of the medium-term objective according to risks to sustainable debt developments (initially on the basis of debt levels and potential growth; in the future possibly also on the basis of implicit liabilities) allows better catering for adequate policies in all countries, including in particular in peripheral countries that are characterised by large public investment needs, low debt level and high growth potential. While the goal remains budgetary prudence, a more sophisticated approach is taken to minimise short-term policies which are excessively pro-cyclical and inconsistent with budgetary stabilisation over the cycle. To this end, the economic situation and developments are considered in the deadlines for correcting excessive deficits and early warnings or early policy advice will be applied to avoid pro-cyclical policy in good times. Overall, the adequacy of the rules to their goal has improved.

KS-6 - The narrow specification in the SGP of the timetable of the Excessive Deficit Procedure and the application of sanctions were set to improve ***enforceability***. Experience has shown that the narrow specification did not contribute to the enforceability in the existing institutional setting. Instead, it led to raising tensions and a loss of credibility after the events of November 2003. Against this background, the renewed commitment and consensus among the 25 Member States as reflected in the 2005 Ecofin Report constitutes a solid fundament for restoring the dented credibility of the framework. Agreement to enhance fiscal governance, through development and increased involvement of national institutions and parliaments could also contribute to enhancing peer pressure and increasing reputational costs to discipline national authorities. As in the old system, subjective political pressure on the enforcement can be expected to remain, which proves that the renewed SGP continues to bite.

KS-7 Consistent - internally and with other policy objectives A good fiscal rule has to be internally *consistent* and consistent with other policies. The SGP implies that countries attain broadly balanced budgets in cyclically-adjusted terms and then let automatic stabilisers play freely. Empirical evidence shows that this would be consistent with attaining a relatively high cyclical smoothing while safeguarding the 3% deficit ceiling. Such behaviour would imply a neutral fiscal stance at the euro area level and be consistent with a monetary policy entrusted with maintaining price stability. This could be considered an internally consistent framework in its steady state, if all countries have achieved their medium-term objectives. However, as long as the medium-term objectives had not been achieved, excessively pro-cyclical policies were required in economic downturns, which could be considered inconsistent with the objectives of (automatic) fiscal stabilisation. Allowing for considering the economic situation and developments of a country in EDP addresses this inconsistency between policy objectives. It should be noted however, that this also reduces the possible deterrent effect of high economic (and political) costs of an EDP which provided Member States with an incentive to pursue ambitious consolidation towards the medium-term objective. In addition to the consideration to avoid excessively pro-cyclical policies in bad times, the 2005 reform allows taking into account structural reforms, thus addressing a

major criticism and potential external inconsistency between the policy objectives of the budgetary framework and structural reforms (see also KS-8).

KS-8 Fiscal rules should be ***supportive of structural reforms.*** The reformed framework explicitly takes better account of structural reforms, in particular those that enhance long- term sustainability, both in the preventive arm (deviation from the MTO or adjustment path) and the corrective arm (other relevant factors, special circumstances, possible early abrogation for specific second pillar pension reforms).

Overall, the comparative assessment of the new rules against the established set of criteria for ideal fiscal rules provides a useful indication of the quality and direction of the various changes. The interpretation of the results, however, must be taken with care. Some of the criteria partly overlap and some are highly interlinked. Moreover, it is important to keep in mind that the various qualitative scores in table II.1 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.

After six years of accumulated experience with the existing rules of the Pact, the 2005 report reflects Member States' shifted preferences along the trade-offs towards greater flexibility, in order to better respond to the changing economic conditions, such as related to enlargement, demographic ageing and the low growth conditions. There are basically two distinct options to allow for greater flexibility in the application of fiscal rules. Either the sophistication of the provisions themselves is increased by adding more contingencies to the rules while their implementation is kept straightforward. Or the rules are kept simple, but a more flexible application is introduced, thus exerting more economic judgement of the individual case.[40]

Following the intention to preserve the rules-based character of the EU fiscal framework, the Commission initially favoured responding to the increased preference for flexibility with the development of a significantly more sophisticated set of rules. While this would have been at the expense of simplicity and transparency, it would have minimised the room for discretionary judgement and facilitated equal treatment. In light of these considerations, the agreement finally reached by the Council constitutes a compromise.

Whereas the legal content of the rules remains by and large unchanged, the new agreement introduces more room for economic judgement in their application. However, given the limits of enforcement power in a supranational setting, in order to contain deficits from becoming excessive, the new procedural flexibility is effectively restricted to relatively small fiscal slippages by holding on to simple and transparent conditions, including the deficit and debt reference values and the principles of closeness and temporariness, and by requesting an annul minimum fiscal effort.

The increase scope for judgement raises furthermore the responsibility for both the Commission when assessing budgetary developments in Member States and the Council when deciding on the appropriate steps in the surveillance procedure. It also elevates the need to ensure transparency and accountability in the decision making by the various actors.

1.5 The road to the 2005 SGP reform

The agreement on the 2005 Reform marks the end of a longer drawn review and discussion process at the level of the EU about the further development of the EU fiscal rules. The interpretation and application of the rules have evolved over time and discussions about reinforcing the fiscal co-ordination has practically been ongoing since the start of EMU.[41]

1.5.1 Early stages of the reform debate

Following the conclusions of the 2002 Barcelona European Council on the need to reinforce existing fiscal policy co-ordination mechanisms, the Commission adopted on 27 November 2002 five proposals to improve the interpretation of the SGP.[42] Against the background of mixed budgetary performance since 1999 and emerging difficulties in the implementation of the rules, the Commission proposed (i) to establish medium-term budgetary objectives that take account of the economic cycle, i.e. measured in cyclically-adjusted terms and net of one-off measures; (ii) for countries that have not yet realised a budgetary position of 'close to balance or in surplus' to achieve an annual improvement of the underlying budget position of at least 0.5% of GDP; (iii) to avoid pro-cyclical policies in economically good times; (iv) to ensure the consistency between the Pact rules and the goals of the Lisbon strategy, by allowing for small and temporary deviations from the underlying budgetary position of 'close to balance or in surplus' or the adjustment path to it; and (v) to attach greater weight to the sustainability of public finances, including by making the Treaty's debt criterion operational. Moreover, the Commission pointed to need to take complementary measures in order to foster the overall fiscal and statistical governance, including through more transparent communication so a to enhance external incentives for Member States to run

[40] Beetsma and Debrun (2003) also make this point.

[41] Previous editions of 'Public finances in EMU' provide ample evidence. See also Deroose and Langedijk (2005) for a concise overview of the experiences with the Stability and Growth Pact in the first 6 years and a description of the Commission's approach for improving the Stability and Growth Pact.

[42] See Commission Communication on 'Strenghtening the co-ordination of budgetary policies' of 27 November 2002, COM(2002)668 final and European Commission (2003a).

sound fiscal policies and improvements concerning the quality and timeliness of government finance statistics.

In March 2003, the Ecofin Council endorsed in its report to the Spring European Council[43] most of the Commission proposals to improve the effective application of the SGP, yet agreed that there was no need for legal chances to the current EU fiscal rules.[44]

In parallel, the debate on the coordination of budgetary policies in the framework of EMU continued in the Convention on the Future of Europe. The new Treaty establishing a Constitution for Europe, which was signed in Rome on 29 October 2004 and currently subject of the ratification procedures in the 25 Member States, strengthens the role of the Commission in the excessive deficit procedure. Notably it establishes the right for the Commission to address an early warning directly to the Member State if it considers that an excessive deficit in a Member State exists or may occur. Furthermore, the Council's decision on the existence of an excessive deficit will in future be based on a 'proposal' from the Commission, which is more difficult for the Council to overrule than a Commission 'recommendation', which is the current basis for the Council decision.

Tensions in the application of the SGP continued to accumulate, creating considerable institutional uncertainty. They culminated in the legal dispute between the Commission and the Council concerning the excessive procedure for France and Germany.[45] These tensions gave further evidence of diminished ownership of the rules in several Member States and undermined the credibility of the framework as a whole.

Even though the budgetary framework set by the Maastricht Treaty and the Stability and Growth Pact helped to deliver overall macroeconomic stability in the EU and to keep budgetary positions at prudent levels in most EU countries, it became clear that the fiscal rules need to be adapted in light of changing economic circumstances in order to remain relevant and acceptable to Member States. A further stretching of the Pact provisions by simply modifying their interpretation would have jeopardised the rules-based character of the system. Against this background, the Commission launched a major review of the Stability and Growth Pact, by examining both its performance in the past as well as its potential to adequately respond to the prospective challenges, notably those associated with the increased economic heterogeneity in the enlarged EU and the demographic changes ahead.

On 18 June 2004, when agreeing on the Draft Treaty Establishing a Constitution for Europe, the European Council adopted a Declaration on the Stability and Growth Pact (SGP). It stressed that raising growth potential and securing sound budgetary positions are the two pillars of the economic and fiscal policy of the Union and the Member States. The European Council also invited the Commission to come forward with proposals towards a further development of the SPG.

1.5.2 The launch of the review

The Commission with the adoption of its Communication on 'Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact' on 3 September 2004 launched a major review process of the SGP and provided further orientation for the future set-up of the SGP. Building on the Communication of November 2002, it proposed four main areas for reform, notably (i) to place more focus on debt and sustainability in the surveillance of budgetary positions; (ii) to introduce the concept of country-specific medium-term objectives; (iii) to increase the economic underpinning of the excessive deficit procedure; and (iv) to ensure earlier action to correct inadequate budgetary developments. In addition, the Communication contained a number of ideas to improve the fiscal governance, enforcement and ownership of the EU fiscal rules. Particular proposals included measures to improve the consistency between national and EU processes, including through more involvement of national institutions in budgetary surveillance, and to increase the transparency and accountability of the various actors in the surveillance process.

On 10 September 2004, the Council, in its Ecofin formation, stated that the Commission Communication provided a good basis for discussion. There was consensus not to envisage any changes to the Treaty provisions and to keep legal modifications of the regulations underlying the SGP to a minimum.

On the basis of the Communication, the Council's further guidance, and drawing from abundant input from academics and policy makers, the Commission services further analysed and developed the options for strengthening the Stability and Growth Pact, expanding the main ideas into a practical coherent framework. A set of technical issues papers addressing the key elements of the fiscal framework was prepared by the Commission services for discussion in the Economic and Finance Committee. Together with contributions from Member States, they provided the basis for in-depth discussions with the Member States from September 2004 through March 2005.

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[43] Ecofin Council report on 'strengthening the coordination of budgetary policies', 7 March 2003, 6877/03 (Press 61).

[44] See European Commission (2003a), pp. 78/79.

[45] See Box II.3 on the decision of the European Court of Justice of 13 July 2004.

Box II.3. The European Court of Justice's decision on the EDP for France and Germany of 13 July 2004

On recommendation by the Commission, the Council decided in the first half of 2003 that an excessive deficit existed in Germany and France and adopted recommendations with a view to bringing this situation to an end by 2004. In autumn 2003 the Commission recommended that the Council should establish that the actions implemented by Germany and France were not adequate and should give them notice to take measures to remedy the situation. In light of the weaker than expected economic situation, the Commission recommended that the deadline for correcting the deficit should be extended to 2005. On 25 November 2003 the Council voted on the recommended decisions but did not achieve a majority. (See Public finances of EMU 2003, Box II.1). Instead, the Council adopted conclusions addressing recommendations to Germany and France for the correction of the excessive deficit by 2005 and stating that in light of the commitments by the two Member States the excessive deficit procedure was held in abeyance. The Commission challenged certain elements of the Council conclusions of 25 November before the Court of Justice.

In its judgement of 13 July 2004 (See Case C-27/04 Commission of the European Communities against the Council of the European Union), the Court annulled the Council conclusions in so far as they aimed at formally suspending the procedure and modifying the existing recommendations. The Court, recalling the Commission's right of initiative in the excessive deficit procedure, argued that the Council went beyond its competence by de facto modifying the recommendations decided by the Council under Article 104(7) EC. While it acknowledged the Council's right for discretion, the judgement clarified that '…the Council cannot break free from the rules laid down in Article 104 EC and those which it set for itself in Regulation 1467/97…'

The Court's judgement created unique circumstances in relation to the excessive deficit procedure concerning Germany and France. In substance, the annulled Council conclusions went along the same lines as the recommendations of the Commission for remedying the situation, notably that the deadline for the correction of the excessive deficit should be extended to 2005. Moreover, the actions of the Council in November 2003 had a factual effect on the path of fiscal adjustment in the countries concerned. In its Communication concerning 'the situation of Germany and France in relation to their obligations under the excessive deficit procedure following the judgement of the Court of Justice of 14 December 2004 (COM(2004)813) the Commission took the position that a satisfactory resolution of the budgetary problems of Germany and France within the framework of the Stability and Growth Pact demands the assessment of the actions taken to correct the excessive deficit should refer to 2005 as the relevant deadline.

On 16 November, Ecofin Ministers had an exchange of views on substance on a number of the issues at stake. The discussion followed by and large the proposals made by the Commission. Ministers agreed to explore a limited number of practical options, so as to be able to agree on concrete proposals to the Heads of State or Government at the Spring European Council in March 2005. The main focus of the debate was in particular on ways to better use periods of economic recovery to consolidate public finances, how to take into account sustainability of public finances in defining medium-term targets, how to increase the focus on debt and sustainability, how to take into account economic circumstances in the excessive deficit procedure, and about whether and, if so, how to take into account structural reforms and investment needs in the budgetary framework. The agenda was widened in the course of the subsequent meetings of Ministers notably to address aspects of fiscal and statistical governance.

The negotiations revealed differing views among Member States on how much judgement was deemed necessary to sufficiently capture economic reality and pursue economically sound policies. While mainly the larger countries tended to be in favour of ensuring more room for case-specific judgement, the Commission and most of the smaller countries expressed a high preference for the predictability of the Pact as a rules-based system.

At the Ministerial level, discussions in the Ecofin Council, including all 25 Member States, were usually preceded by an exchange of views within the Eurogroup. The capacity of the Luxembourg Presidency, starting in January 2004, to mediate a compromise was boosted by the unique triple function of Luxembourg's Prime Minister and Minister of Finance, Jean Claude Juncker, being simultaneously President of both the eurogroup and the Ecofin Council as well as presiding over the European Council.

1.5.3 The 2005 Council agreement on the reform of the SGP and follow-up

Following the failure of the Ecofin-meeting of 8 March to reach agreement on the reform package on the occasion of their meeting of 8 March, Jean-Claude Juncker convened an extraordinary meeting on Sunday 20 March, thus two days preceding the start of the 2005 Spring European Council. Ministers met first in the formation of the euro group, succeeded by the meeting of the Ecofin in the afternoon. Ministers were keen to conclude their review of the SGP in time for the Spring European Council in order to avoid a reopening of the debate by the Heads of States and Government. The specification of 'other relevant factors' and the treatment of second-pillar pension reforms in the excessive deficit procedure were the main issues of debate until the last moment. Agreement was finally reached later in the day. The Ecofin Council adopted the report to the European Council on 'Improving the implementation of the Stability and Growth Pact'.

The European Council endorsed the report on 22 March, stating that is up-dates and complements the Stability and Growth Pact. It furthermore invited the Commission

to adopt the necessary legislative proposals to adapt the existing regulations 1466/97 and 1467/97 in accordance with the new agreement.

On 20 April, the Commission adopted the draft proposals for amending Council Regulations 1466/97 and 1467/97, which were subsequently submitted to the Council.

The Council is the decisive body for the adoption of the Commission draft proposals. The two regulations are based on different legal bases, requiring distinct legislative procedures. Inter alia, they foresee a different degree of consultation of the European Parliament and the European Central Bank. By the time the 2005 report on Public finances in EMU went to press, the procedure for the adoption of the legislative package was still ongoing. On parallel track, work has started to amend and up-date the Code of Conduct in light of the 2005 Pact reform.

2. Developments in EU budgetary surveillance

2.1 The stability and convergence programmes: a retrospective overview of plans, outcomes and assessments 1998-2005

2.1.1 Introduction

Over the years, the process of fiscal surveillance of stability and convergence programmes has provided a wealth of data on budgetary plans, outcomes and assessments. The aim of this section is to make a first use of these data over the 1998-2005 period to analyse: (i) the magnitude, main features and determinants of the discrepancy between budgetary plans in stability and convergence programmes and actual outcomes; (ii) the way in which stability and convergence programmes have been assessed by the Commission services.

The analysis permits to highlight the following points:

- slippages between budgetary plans and outcomes have been common and in some years quite sizable;
- the difference between the budgetary plans in stability and convergence programmes and actual data are mainly associated with slippages on the expenditure side, discrepancies in revenues having played a relatively minor role;
- growth different than expected contributes to explain part of the difference between data on stability and convergence programmes and actual outcomes;
- the scope of the assessment of stability and convergence programmes by the Commission services has broadened over time.

Section 2.1.2 analyses the main features of the recorded slippages between budgetary plans in stability and convergence programmes and results. A short overview of the topics considered in the Commission assessment of stability and convergence programmes is presented in section 2.1.3. Section 2.1.4 concludes.

2.1.2 The stability and convergence programmes: plans and outcomes

The role of the stability and convergence programmes in EU fiscal surveillance

In the run-up to the introduction of stage III in EMU in 1999, all EU Member States committed to regularly submitting programmes, convergence programmes for non-euro countries and stability programmes for euro countries.[46] The programmes are a requirement under the Stability and Growth Pact, and since 1998 all EU Member States have submitted updates yearly.

From the outset, the content of the programmes have varied, in terms of the variables included, the length of the forecasting period and the focus and degree of thoroughness of the qualitative analyses. Since 1998 the content of the programmes has been governed by a Code of Conduct endorsed by the Council. The Code of Conduct stressed the importance of the information being suitable and allowing for comparison across Member States, while also acknowledging that the programmes are the responsibility of national authorities and that the possibilities and practices differ across countries. The Code of Conduct was upgraded in 2001 to increase the streamlining and thus facilitate the assessments and improve the comparability of the

[46] The first convergence programmes were delivered in 1991. The submission of these programmes was not compulsory, but took place at the initiative of the Member States. Updates and revisions of the programmes were since presented with varying time spans.

programmes. The changes include both the status of the Code of Conduct and the variables specified. The Code of Conduct of 1998 'does not suggest that the guidelines be made obligatory, but any departure would have to be justified by the Member States concerned'. In 2001, the wording is slightly stricter, asking 'that the guidelines be followed as far as possible, and any departure would have to be justified by the Member States concerned'. The 2001 Code of Conduct also specifies more variables including a standardised set of tables that should be presented. The required time horizon has remained the same throughout the EMU period, demanding annual forecasts for at least the preceding, the current and the three following years.

The 1998 Code of Conduct refers to discussions in the Monetary Committee promoting the use of a common set of macro-economic projections, but recognizing the practical difficulties involved. It is mentioned, however, that significant differences from the Commission's projections should be justified. By 2001 Member States are asked to present at least one set of projections based on common basic assumptions for the main extra-EU variables, the assumptions being provided by the Commission after consultation with national experts. For intra-EU variables, the wording is the same as in 1998, requiring justifications of significant differences from the Commission's projections.

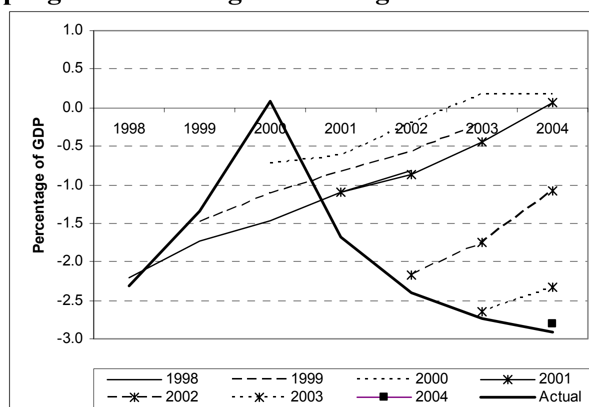
This analysis focuses on the euro area countries. The ten recently acceded Member States have only had the time to produce two programmes, and including all Member States in the averages for the last years would thus make the figures less comparable over time. The analysis below is limited to the EMU period, i.e. programmes under the Code of Conduct of 1998 or 2001. The figures for this period are more complete and comparable than in earlier programmes, but even for this period, challenges remain. Some countries present two or more scenarios. Unless the programmes clearly state which scenario policy forecasts are based on, this analysis considers the more cautious one. Some other discrepancies also remain, including missing data. For total revenues and total expenditures a large number of data are missing for early years, when their provision was not clearly specified in the Code of Conduct, while data for the budget balance and GDP growth are much more complete. This underlines the indicative nature of the results, especially regarding the breakdown on revenue and expenditure discrepancies for the first part of the analysed period.

Since the introduction of the 2001 Code of Conduct, the data used in this analysis are almost always available. Still, both for the euro area and for the whole EU, less than half of the Member States were in full compliance with the Code of Conduct in the 2004 updates. Most of these broadly complied, but one euro-country and three other Member States only partly complied, cf. Section I.3.

Budget balances

Graph II.2 displays the development of actual general government budget balances in EU-12 for the 1998-2004 period and compares this to the estimates given in the stability and convergence programmes over the same period. The graph shows that actual balances were higher than expected in 1999 and 2000, but lower in the last four years. It also shows that the programmes have consistently forecasted improved budget balances, while in reality deficits increased in most of the period.

Graph II.2. General government budget balances. Projections from different programmes. Weighted averages EU-12[1]



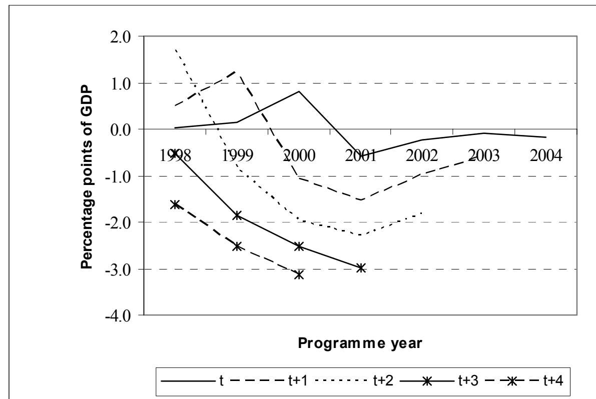
Sources: National stability and convergence programmes and the European Commission.

[1] In the 1998 programmes averages three observations are missing for 2002. In the 1999 programmes averages three observations are missing for 2003. In the 2000 programmes average one observation is missing for 2002 and 2003 and two observations are missing for 2004.

Graph II.3 presents the same information in a different way. This graph presents the budget balance slippages, i.e. the actual outcome less the budget balance envisaged in the relevant programme. Negative figures thus mean that the actual outcome was lower than expected. In this graph the slippages are presented according to time horizon. The line marked *t* thus represents projections for the year the programme was published, the line *t+1* represents projections for the year ahead, and so on. When all the lines are below zero for 2001, this means that for all years the projections made in (the average of) the 2001 programmes were above the actual outcomes. This is also the case for the programmes from 2002, 2003 and 2004. Not surprisingly, the graph shows that the discrepancies between plans and actual outcomes are larger for long time horizons than for short ones.

Significant deteriorations of the budget balance in some large Member States heavily influence the EU-12 weighted averages. However, even though the exact numbers change and the budgetary developments appear less dramatic, the qualitative picture remains the same if one instead looks at unweighted averages. The above description thus seems broadly to fit many Member States.

Graph II.3. Budget balance slippages. Various time horizons. Weighted averages EU-12[1]



Sources: National stability and convergence programmes and the European Commission.

[1] In the 1998 programmes averages three observations are missing for 2002. In the 1999 programmes averages three observations are missing for 2003. In the 2000 programmes averages one observation is missing for 2002 and 2003 and two observations are missing for 2004.

Expenditures and revenues

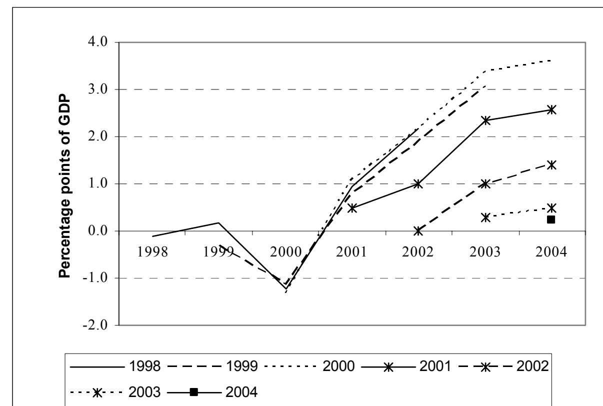
A key issue in the public finance debate is the composition of fiscal consolidations. For all years since 1998, most Member States have projected expenditure-based consolidations. However, while the average expenditure share fell between 1998 and 2000, it has mostly increased since. At the same time, the average revenue share has fallen, and the failure to implement the planned expenditure cuts has resulted in a worsening of the average budgetary balance, as opposed to the planned budgetary consolidation. Overall, while actual expenditures have been higher, and partly substantially so, than planned, most forecasts for revenues have been much closer to the actual outcomes, cf. Graph II.4 and Graph II.5.

Growth corrections

Deficits are influenced by many factors difficult to foresee and are unlikely to exactly replicate the budget plans made in advance. An important distinction can be drawn between deviations from plans mainly within and mainly outside the control of the government. One central factor is unexpected changes in economic growth. Economic growth directly affects budgets through automatic stabilisers. If growth is low, labour and capital incomes grow more slowly than normal, thus lowering the level of tax revenues compared to a high growth situation. On the expenditure side, social expenditures, especially unemployment benefits, increase when the cycle is weak. As Graph II.6 shows, there were positive growth surprises in 1999 and 2000, and negative growth surprises in the years after. Slippages caused by growth surprises can to a considerable degree be contributed to factors outside government control. However, it should also be noted that producing realistic estimates of growth is an important task and a necessary basis for responsible economic policy formulation, cf. Section 2.3.7.

A first rough evaluation of whether failure to forecast growth correctly explains the budget balance slippages can be obtained by (i) multiplying the growth errors with the sensitivity of budget balances to the effects of the cycle, and (ii) correcting the slippages for this factor.

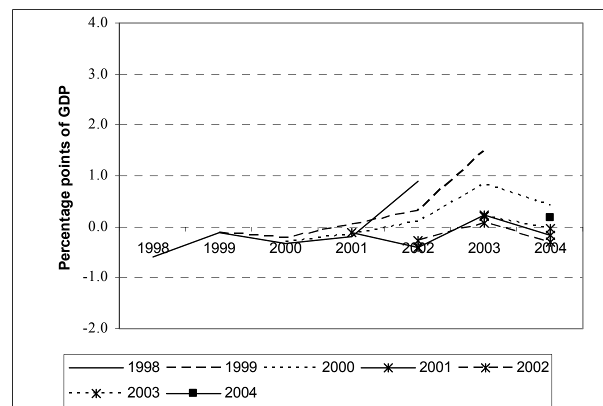
Graph II.4. Expenditure slippages. Projections from different programmes. Weighted averages EU-12[1]



Sources: National stability and convergence programmes and the European Commission.

[1] In the 1998 programmes averages five observations are missing for 1998 and 1999 and six observations are missing for 2000, 2001 and 2002. In the 1999 programmes averages two observations are missing for 1999, 2000, 2001 and 2002 and three observations are missing for 2003. In the 2000 programmes averages two observations are missing for 2000 and 2001 and four observations are missing for 2002, 2003 and 2004. In the 2001 programmes averages one observation is missing for 2003 and 2004.

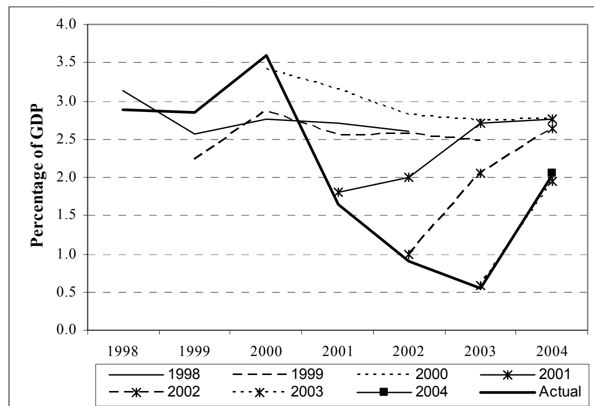
Graph II.5. Revenue slippages. Projections from different programmes. Weighted averages EU-12[1]



Sources: National stability and convergence programmes and the European Commission

[1] In the 1998 programmes averages seven observations are missing for 1998 and 2002 and six observations are missing for 1999, 2000 and 2001. In the 1999 programmes averages four observations are missing for 1999, 2000, 2001 and 2002 and five observations are missing for 2003. In the 2000 programmes averages three observations are missing for 2000 and 2001 and five observations are missing for 2002, 2003 and 2004. In the 2001 programmes averages one observation is missing for 2003 and 2004.

Graph II.6. Growth rates forecasts from Stability and Convergence Programmes. Projections from different programmes. Weighted averages EU-12[1]



Sources: National stability and convergence programmes and the European Commission.

[1] In the 1998 programmes averages one observation is missing for 1998 and three observations are missing for 2002. In the 1999 programmes averages three observations are missing for 2003. In the 2000 programmes averages two observations are missing for 2004.

This correction shrinks the differences between plans and actual outcomes, but does not remove them. On average across programmes and forecast horizons, growth surprises seem to explain about two thirds of the budget balance overruns. This still leaves important leeway for national authorities in the endeavour for improving budget balance control.

2.1.3 Evolving budgetary surveillance: the Commission assessment of stability and convergence programmes

The purpose of this section is to analyse the evolution of the Commission assessments of the stability and convergence programmes. Information about the evolution of fiscal surveillance over time can be obtained by systematically comparing the contents of the Commission assessments in different years. Table II.3 compares the assessments of 2005 with those of early 2000.[47]

The first column summarises the main topics that could be included in the assessments of Member States' medium-term fiscal strategies. Typically, the following topics are covered in the assessments: (i) the underlying assumptions, e.g. are growth projections on which the programmes are based realistic?; (ii) the risks to the adjustment path, e.g. are budgetary measures taken of temporary or structural nature?; does the budget balance leave sufficient margin for not breaking the 3% GDP reference value in the event of an economic downturn?; (iii) the analysis of debt and sustainability, e.g. are debt levels declining at a satisfactory pace of reduction in countries with a debt ratio above 60% of GDP, how will ageing populations affect the long-term budgetary outlook?; (iv) a range of issues related to structural reforms and the quality of public finances, including the composition of public expenditure (e.g. protecting productive expenditure such as education, R&D or public investment), the budgetary impact of structural reforms and national budgetary institutions that are conducive to fiscal discipline such as medium-term expenditure frameworks for controlling public expenditure.

The last three columns of Table II.3 report the percentage of programmes in which a clear independent and normative assessment by the Commission was made. [48] For example, a score of 100 for 'underlying assumptions' implies that all of the Commission assessments included a clear assessment of the underlying assumptions of the medium-term budgetary strategy.[49]

The content of Table II.3 can be summarised as follows:

- assessments of the underlying assumptions are a key part of fiscal surveillance, both in 2000 and 2005;
- In 2000, assessing compliance with the numerical rules of the EU Treaty was the key topic in fiscal surveillance: does the adjustment path leave enough room for normal cyclical variations of the budget without surpassing the 3% GDP reference value? On the basis of this condition, the assessments concluded whether a country did or did not comply with the medium-term objective of the SGP. Instead, by 2005 the overall assessment has become more refined. The question of whether the adjustment path leaves enough room for normal cyclical variations is still assessed, but complemented with a *separate* assessment of compliance with the medium-term objective of close-to-balance or in surplus. In addition, and more important, an overall judgement has been added on the question of whether the proposed adjustment path is credible. This reflects the experience of systematic underperformance of budgetary policies with respect to plans (see previous section).

[47] Stability and convergence programmes and Commission assessments are published on the website of DG ECFIN: See http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

[48] Hence, the criterion in doing the survey was not whether a topic has been mentioned in the assessment. Instead, phrases such as 'too optimistic', 'more ambition is needed' etc. indicate a clear assessment.

[49] In a large number of cases, the judgement pointed to too optimistic growth assumptions.

Table II.3. Assessments of stability and convergence programmes: 2000 versus 2005

Broad topic	Specific topic	EU-15 2000	EU-15 2005[1]	NMS 2005
		Percentage of programmes including an assessment		
Adjustment path: underlying assumptions	Underlying assumptions (growth)	100	100	100
Adjustment path towards 3% GDP or close to balance or in surplus	Sufficient margin for not breaking 3% GDP?	100	100	60
	Compliance with CTB?	n.a.[2]	93	50
	Credibility measures expenditure side (one-off?)/ revenue side	67	100	100
	Overall assessment credibility adjustment path	47	93	100
	Sensitivity analysis?	40	100	20
Debt	Decomposition of debt developments	60	100	100
	Overall assessment of debt development/'satisfactory rate of reduction'	33	100	70
Sustainability	Quantitative assessment of long-run sustainability	0	100	100
	Qualitative assessment of long-run sustainability	0	100	100
	Analysis of contingent liabilities	0	0	30
	Overall assessment sustainability	0	100	100
Quality of public finances	Composition of adjustment (revenue/expenditure side)	13	14	0
	Composition of expenditure (redirecting towards productive items)	27	21	0
	Composition of revenue, including tax burden on labour	20	0	0
	Impact of structural reforms on budgetary position	7	36	50
	Impact structural reforms on potential growth and employment	0	14	0
Fiscal governance	Role expenditure rules and expenditure control	13	43	20
	Federalism/national stability pacts	13	21	0
	Efficiency of public sector	0	14	0

Source: findings of the authors on the basis of the Commission assessments of the Stability and Convergence programmes.
[1]The assessment for Portugal was not yet available when this report was finalised.
[2]In 2000, if a country had established a sufficient safety margin for not breaking the 3% GDP reference value, then the assessments concluded that the country complied with the medium term objective of a budgetary position of close-to balance or in surplus (CTBOIS). By 2005, compliance with CTBOIS was subject to a separate assessment, based on the cyclically-adjusted balance (when available).

- the analysis of the long-run fiscal sustainability, completely absent in 2000, has become an important part of every individual assessment in 2005.
- In 2000 a high percentage of assessments contained a decomposition of debt developments, separating the impact of relevant factors (i.e. the budget balance, interest rate developments, growth developments and so-called 'stock-flow operations', i.e. operations that influence the stock of gross debt but not the deficit). However, an overall assessment of compliance with the debt criterion of the Treaty was included only in about one third of the cases. In contrast, by 2005, both the decomposition of debt developments and the assessment of compliance with the debt criterion has become a standard part of the analysis.
- Regarding the assessment of structural reforms and also the quality of public finances, there is a clear trend towards concentrating the assessment on the budgetary impact of structural reforms and on institutional issues (expenditure control, fiscal rules for lower levels of government). Given the further increase in the attention for the budgetary impact of structural reforms (see Part III in this report), the degree of assessment could be expected to increase further on this topic. Similarly, the role of domestic budgetary institutions in ensuring compliance with

budgetary discipline is now widely recognised, so that also this is an important aspect of fiscal surveillance that could be developed further in the years to come (see also section II.2.3 on the role of national budgetary institutions in this report).

In sum, the analysis shows that the scope of fiscal surveillance has broadened significantly in recent years. Fiscal policies are assessed on the basis of a range of fiscal indicators that account for different aspects of fiscal policy behaviour. Fiscal surveillance thus complements the simple and transparent reference values of the EU fiscal framework and serves as a basis for using the room for economic judgement that is given by the EU Treaty to the European Commission in operating the system.

2.1.4 Conclusions

The stability and convergence programmes provide a valuable source for comparing budgetary developments in the Member States relative to plans. Lessons drawn from such comparisons are central to evaluate the realism in future budget plans. To improve comparability, the progress made over the last year in streamlining the content of the programmes is important. Still, some areas remain.

The analysis carried out in this section of the report has pointed to frequent and sometimes sizable slippages in budgetary balances relative to medium-term plans. In order to improve adherence to planned budgetary developments, it is important to understand why slippages occur and how they can be avoided. Better estimation of growth is no doubt important. Still, the analysis has shown that discretionary measures have also played a central role during the last seven years. As a consequence, there is clearly room for better adherence to expenditure plans in the endeavour for improving budget balance control.

The way the assessment of the stability programmes is done by the Commission services has been evolving over the past years. This has partly reflected improvements in the analytical toolbox in budgetary surveillance (e.g., the use of budget balance measures adjusted for the cycle, the development of sustainability indicators,…), and has partly been driven by the experience accumulated with the operation of the EU fiscal framework. Overall, the scope of the assessment has broadened: the number of factors taken into account in assessing fiscal plans has expanded. This tendency is likely to continue in the coming years, as a result of the increased focus on long-term public finance developments (e.g., the impact of pension reforms) and on factors related to fiscal governance (e.g., the working of national budgetary institutions) which is present in the revised SGP.

2.2 The dynamics of government debt: decomposing the stock-flow adjustment

2.2.1 Introduction

The government deficit and debt are closely interrelated concepts. Deficits imply debt issuance while surpluses lead to debt repayments. However, given the specific definitions of deficit and debt applied for the EU budgetary surveillance,[50] the change in the debt level in any given year can be larger or smaller than the deficit.

The difference between the change in the outstanding debt *stock* and the yearly deficit *flow* is known as the *stock-flow adjustment* (SFA), or less frequently as deficit-debt adjustment. A positive (negative) SFA means that factors other than the government deficit increase (reduce) the government debt. In some cases, the nominal debt level can even fall while there is a deficit, or can increase in the presence of a surplus.[51] As will be shown below, while the SFA is typically set to zero in the theoretical analysis of debt dynamics, in real life such an assumption is unwarranted.

The reconciliation of deficit and debt figures requires a number of intermediate steps involving the breakdown of the SFA in several categories. The analysis of SFA is all the more important as the EU budgetary surveillance – which so far has focused attention on the deficit – may have provided incentives for shifting items from the deficit to the SFA, that is, from above to below the line. A careful analysis of the SFA is, therefore, important to countercheck the reliability and plausibility of the deficit figures.

This chapter is organised as follows: Section 2 provides an overview of the available SFA data and spells out concerns associated to the high and persistent levels of SFA in some Member States. Section 3 breaks down the SFA in three main components, which correspond to differences in the definitions of deficit and debt. Each component is also split into sub-categories. Section 4 concludes.

2.2.2 SFAs: main data and concerns

The main data. Graph II.7 shows annual data on the SFA for EU Member States from 2000 to 2004.52 The data show that the SFA is rarely zero or close to zero. In other words, the change in the debt level rarely corresponds to the deficit. SFA in the vicinity of zero (in the interval –0.2% / +0.2% of GDP) are even relatively rare. Moreover, SFAs tend to be positive and not to cancel out over time; for most countries, in most years, the government debt has increased by more than the deficit. For EU-15, the weighted average SFA over the last ten years or so has been +0.4% of GDP. In cumulative terms, this means that the government debt ratio for EU15 is now 4.1% points higher than it could be expected if the SFA was set to zero since 1994.

Concerns. Large SFAs are often presented as a source of concern, as a suggestion of inconsistent and low-quality statistics. In fact, high positive SFAs even over a protracted period are not necessarily an indication of any fundamental error in statistics. As it will be shown below, high and positive SFAs are even the normal outcome for low-debt governments in surplus. However, the high and persistent SFAs in some Member States, in particular, in those which are in deficit and have large debts, need to be closely scrutinised and explained, or the consistency of government accounts and truthfulness of deficit statistics will be put in question.

2.2.3 The main components of the SFA

The SFA exists because of differences in the basic accounting principles according to which the government deficit and debt are defined and compiled. Accordingly, the SFA can be split into three components along with these differences:

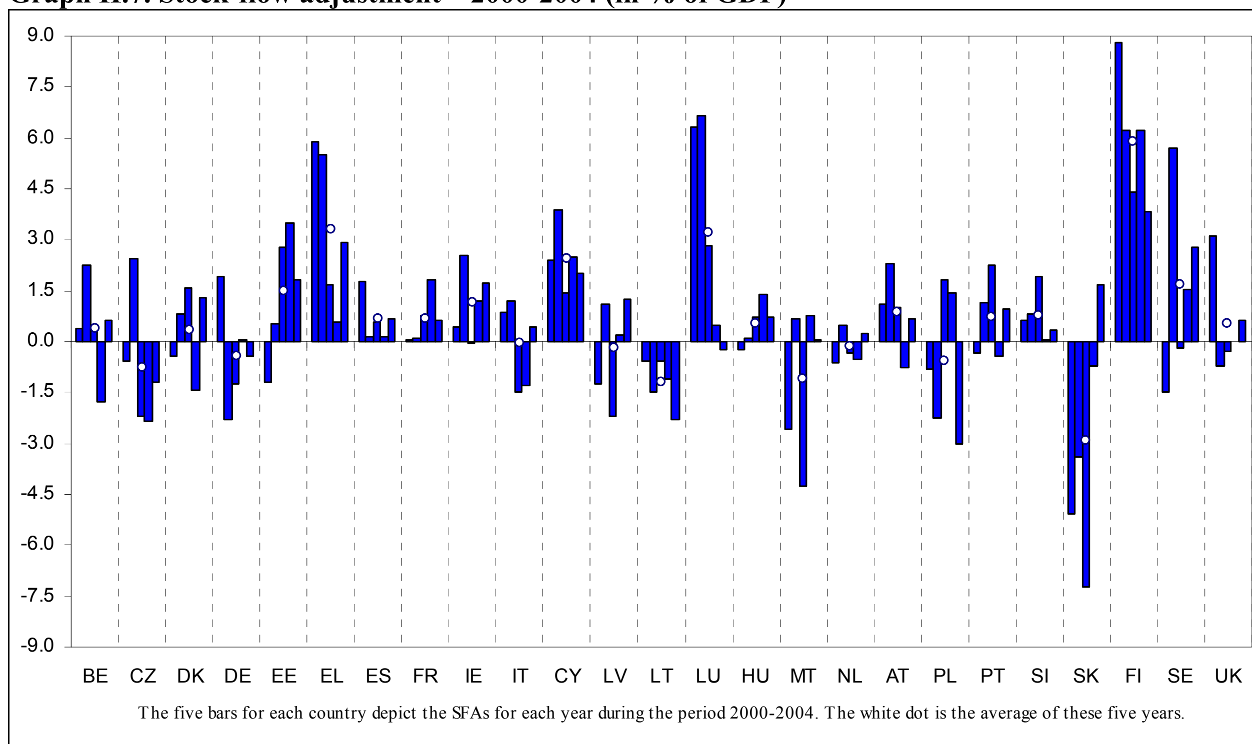
- differences between the accrual and cash bases of recording transactions;
- differences in the gross and net recording of transactions with financial assets;
- valuation effects and remaining statistical adjustments.

[50] The deficit and debt definitions that are relevant for the EU budgetary surveillance procedures have been established by the Treaty Protocol on the excessive deficit procedure and specified in Council Regulation (EC) No 3605/93. The deficit and debt are defined through cross references to the European System of Accounts (nowadays ESA95).

[51] The developments in the debt-to-GDP ratio also depend on the GDP growth rate, as can be seen in the usual equation: $\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{NB_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} \cdot \frac{y_t}{1+y_t} + \frac{SFA_t}{Y_t}$; where t denotes a time subscript, D is the government debt level, NB is the government deficit (net borrowing with a plus sign), Y represents GDP at current market prices and y the nominal GDP growth rate.

[52] Longer time series on the SFA per Member State (though not on its components) are available in the database Ameco.

Graph II.7. Stock-flow adjustment – 2000-2004 (in % of GDP)



The five bars for each country depict the SFAs for each year during the period 2000-2004. The white dot is the average of these five years.

Source: Commission services.

2.2.4 Cash vs. accruals: the time of recording of transactions in the deficit and the debt

Deficit on an accrual basis. Expenditure and revenue are recorded in the government accounts at the time of the underlying transaction – that is '*when economic value is created, transformed or extinguished, or when claims and obligations arise, are transformed or are cancelled*' – irrespective of effective cash payments and receipts. For example, interest is recorded as accruing continuously during the lifetime of a bond or a loan, and not when lenders receive the corresponding cash payments. For conventional bonds and loans that pay interest every year, the difference between interest accrued and effective cash payments in each year is very small if any. However, the *difference between interest accrued and paid* can be quite considerable in the case of zero-coupon bonds or other financial instruments which do not regularly pay interest, as well as in other circumstances when the issuance price is significantly different from the redemption price.

Lags between the underlying transactions and the related cash payments are also very frequent for other expenditure categories. If government takes delivery of some equipment in year *t*, expenditure must be recorded in year *t* even if the payment is deferred to a later period. Likewise, expenditure of year *t* must be recorded as expenditure in that year, even if, for any reason, the effective payment is postponed to *t*+1. The transactions that have already been recorded as expenditure, but for which the effective cash payment has not yet taken place, are called *accounts payable*.[53]

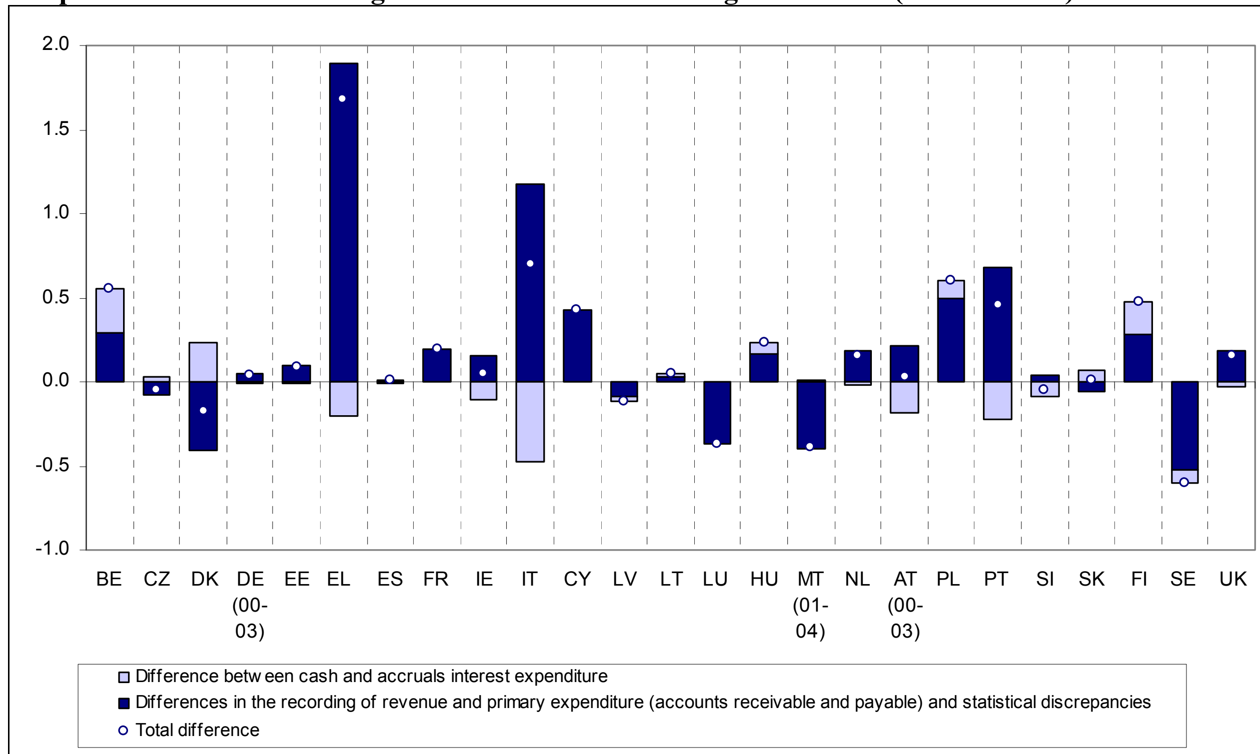
There are also lags between accrual accounting and cash accounting for revenue. For example, in many countries, taxes and social contributions collected in very first months of year *t* are allocated to the government accounts of *t*–1, as the obligation of paying the tax was generated by transactions that took place in year *t*–1. In the case of revenue, the difference between accruals and cash accounting gives rise to *accounts receivable*. There are also accounts payable in relation to revenue (e.g. taxes to be reimbursed), and accounts receivable in relation to expenditure (e.g. cash payments in advance of deliveries).

The government debt is a cash concept. Debt is recorded when financial instruments have been effectively issued. Moreover, the government debt is defined at *face value*. This means that interest which has accrued but has not yet been effectively paid to bondholders – for example in the case of saving certificates or of bonds with a grace period – is not included in the government debt.[54]

[53] In this note, the term 'accounts payable' does not include lags in relation to interest expenditure, which are considered separately.

[54] When the face value of a bond, for example a zero-coupon bond, is higher than the issuance price, the debt increases at issuance of the bond by more than the financing received from financial markets. This means that the cumulated interests of zero-coupon bonds, that is the difference between the face value and the issuance price, is treated in the debt definition as if they were paid at issuance.

Graph II.8. Time of recording: cash and accruals – average 2000-2004 (in % of GDP)



Source: Commission services.

Furthermore, the debt definition that is relevant for the budgetary surveillance in the EU does not include accounts payable.[55] Therefore, the debt does not increase when government commits a payment, but only when government has to obtain resources from financial markets to finance effective cash outflows.

Data on the difference between cash and accruals. The different accounting bases of the government deficit and debt imply that the net accumulation of accounts receivable and payable, and the difference between interest accrued and paid contribute to the SFAs.[56]

It is crucial to note that the difference between cash accounting and accrual accounting is only a matter of timing. In principle, the differences between effective cash payments and the underlying expenditure, between interest accrued and interest paid, and between the effective cash receipts and the underlying revenue cancel each other in the medium-term[57]. Large and protracted differences between accrual and cash data may suggest data quality problems.

Accrual data are considerably more difficult to estimate than cash figures and compilation errors are not rare. As a result, unexplained discrepancies between the accrual- and cash-based data, and between deficit and debt figures are relatively frequent, though they are not macroeconomically relevant in most countries. In this chapter, statistical discrepancies – i.e. the differences that statisticians cannot allocate to any specific SFA category – are deemed to come mainly from the differences between accrual and cash accounting and included in this first component of the SFA.

Graph II.8 shows the component of SFA that is due to the difference between cash and accruals in each of the EU Member States. Given the volatility of data, the graph shows the average for the last five years, rather than annual data. For most countries, the difference between accrual and cash interest (the light coloured bar in the graph) is very small. The most significant difference (a negative SFA) exists for Italy, given the weight of bonds that do not regularly pay interest to bondholders (notably postal bonds) in its debt structure. It corresponds to interest that accrued during the period considered and was properly recorded as deficit-

[55] The exclusion of accounts payable from the government debt was decided mainly for pragmatic reasons, in relation to the difficulty in collecting reliable data and the little macroeconomic relevance of these liabilities. In several EU Member States, a relatively frequent example of accounts payable is healthcare-related payment arrears (delays in payments by social security to pharmacists or to hospitals).

[56] The issuance of zero-coupon bonds, the reimbursement of bonds that do not regularly pay coupons, the accumulation of revenue arrears, the settlement of payment arrears and the payment of expenditure in advance, etc. result in positive SFAs. Symmetrically, interest accrued by zero-coupon bonds, or by other bonds that do not regularly pay coupons, the accumulation of payment arrears, the collection of revenue in arrears, etc. lead to negative SFAs.

[57] Differences may persist in two cases: exceptional transactions with particularly long lags for effective cash disbursements or because of nominal growth (for example, it is normal that VAT revenue on an accrual basis is persistently higher that effective VAT collection in cash basis).

increasing expenditure, but that has not yet been paid to the bondholders.

Cash-accruals differences in the recording of revenue and primary expenditure (the darker bar in the graph) are also small for most countries, and figures would be even smaller if the average was extended over longer periods. However, Greece, Italy and Portugal are outliers and their data have given reason for concern.[58]

2.2.5 Net vs. gross: accounting for financial assets in the deficit and the debt

The government deficit (surplus) is a net concept. The government deficit is defined in the Protocol on the excessive deficit procedure as *net* borrowing. This means that, when compiling the government deficit (surplus), one should consider the government *net* financial transactions. In practice, the government deficit is mainly compiled on the basis of the government non-financial expenditure and revenue (salaries earned by civil servants, purchases of goods and services, transfers paid, taxes and contributions collected, etc.), and not the financial transactions. However, by accounting identity, the balance of financial transactions must be the same as the balance of non-financial operations. Seen from this perspective, the government deficit (surplus) is the difference between revenue and expenditure excluding financial transactions.

The government debt is valued in gross terms. The government debt is *gross.* This implies that the government debt changes when government accumulates financial assets and therefore needs to finance this acquisition. Moreover, the debt is *consolidated* between and within the government sub-sectors. If a government sector (say social security) sells private bonds and buys securities issued by central government, the consolidated gross debt falls and there is a negative SFA. If social security buys private bonds and sells central government securities, the SFA is positive and the consolidated gross debt of the government as a whole increases.

Data on the accumulation of financial assets. The accumulation of financial assets by government is quantitatively the most significant component of SFA. An accumulation of financial assets leads to a positive SFA; a reduction in financial assets implies a negative SFA. Graph II.9 shows the accumulation of financial assets by the EU Member States over the period 2000 to 2004.

(Note that the scale of this graph is not comparable to Graph II.8 and Graph II.10 on the other components of SFA.) The accumulation of financial assets is broken down in four sub-groups: liquidities (i.e. currency and deposits with banks), securities other than shares (i.e. bonds issued by non-government units), loans and shares. It should be noted that 'shares' include equity in public enterprises as well as in privately controlled companies, and covers both quoted and non-quoted shares. It also includes privatisation proceeds, with a minus sign.

The Member States that have registered the largest accumulation of financial assets are those that have been in surplus and have relatively small debts, such as Denmark, Estonia, Luxembourg, Finland and Sweden. These governments prefer to invest their surpluses in financial assets, rather than reimbursing government debt. For some of them – such as Estonia and Luxembourg – the government debt is so low that the accumulation of assets is the only option, as there is virtually no debt to redeem. In some countries – e.g. Sweden – data on the accumulation of financial assets depends heavily on changes in the investment strategy of social security, shifting investment from government paper to private bonds and shares.

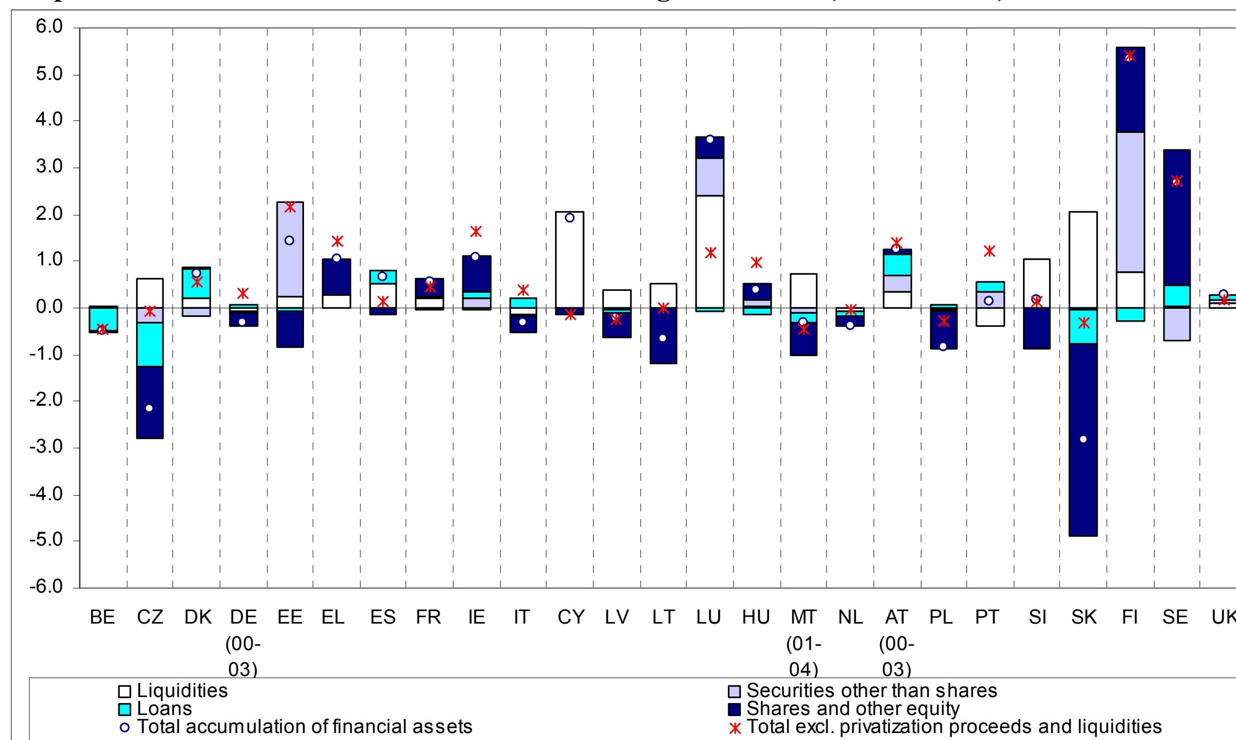
A number of countries with relatively high deficits and high debts, such as Greece, Cyprus and Austria,[59] have also accumulated a considerable stock of financial assets over the last five years. Moreover, the accumulation of financial assets is also significant for countries such as Portugal and Hungary if privatisation proceeds and liquidities are accounted separately. The countries showing a larger reduction in their financial assets are the Czech Rep. and Slovakia given their privatisation programmes.

In many cases, the accumulation of financial assets does correspond to an accumulation of wealth, and the government behaviour when accumulating financial assets is not much different from the behaviour of a private profit-driven agent. However, in some cases, financial assets accumulated by government might include a disguised subsidisation of certain economic activities.

[58] In the case of Italy, the difference comes notably from lags in the payment of social contributions, the settlement of healthcare-related arrears, the reimbursement of taxes, the recording of transactions with the EU budget and exceptionally large statistical discrepancies. In Greece, most of the difference concerns statistical discrepancies, which are, by their own nature, not explained, though accounts receivable (presumably on taxes) and an inconsistent recording in structural funds revenue also play a role. It should be noted that the difference between cash- and accrual-accounting in Greece is now much smaller (in particular for the most recent years) than it was before the revision of the deficit and debt time series in 2004. In the case of Portugal, the difference between cash and accrual data has been clarified. It is explained by the large stock of spending arrears at the beginning of 2000 and their settlement in the following years, notably in 2002.

[59] In the case of Cyprus, most financial assets accumulated by government are reported as deposits with the central bank). In Greece, most financial assets are social security investment in shares. In the case of Austria, most financial assets are loans granted by central government to other sectors.

Graph II.9. Accumulation of financial assets – average 2004-2004 (in % of GDP)



Source: Commission services.

The following questions are relevant when considering the accumulation of financial assets by government: Will loans granted by government to public enterprises or to developing countries be reimbursed at market conditions? Are shares in public enterprises worth the money that government paid for them? In case of negative answers, the logic is that the purchase of these 'assets' is recorded as capital expenditure thus increasing the government deficit.

For an effective budgetary surveillance, the Commission services (in particular Eurostat) regularly requests detailed data on the accumulation of financial assets from Member States, for example on the financial situation and outlook of the public enterprises receiving capital injections. In several cases, Eurostat requested Member States to reclassify capital injection into public enterprises, from below to above the line, thus revising the government deficit upwards. The rules on the accounting classification of capital injections into public enterprises are now relatively strict', but their implementation has been particularly difficult. These strict rules might have to widen to all kinds of financial assets, for example loans granted to public and private enterprises and to developing countries.

2.2.6 Valuation effects and residual adjustments

The third component of SFA corresponds to valuation effects with an impact on the government debt and a number of residual adjustments. These cases are depicted in Graph II.10.

Foreign exchange. The government debt denominated in foreign currencies is valued according to the market exchange rates. Therefore, movements in the exchange markets lead to changes in the value of government debt, though the debt face value was kept constant. These increases or reductions in the debt value do not have any direct impact[60] on the government deficit and are therefore booked as SFAs.[61]

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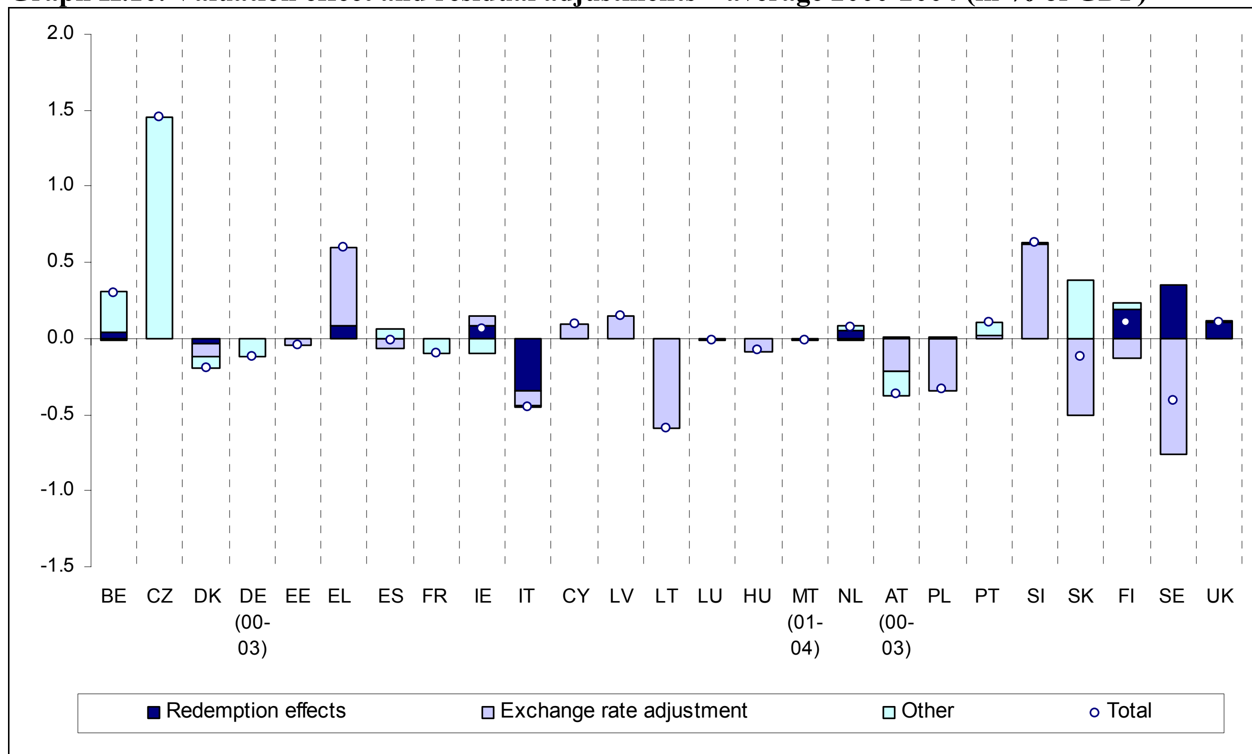
[60] There is an indirect impact in the sense that exchange rate movements may increase or reduce interest expenditure on foreign debt.

[61] A depreciation of the national currency vis-à-vis the currencies represented in the government debt leads to a positive SFA, while an appreciation imply a negative SFA. It should be noted that the change in the value of foreign currency-denominated debt is treated as capital gains and losses, which are always recorded below the line and have no direct impact on the deficit. Member States may have an incentive in issuing debt in low-yield currencies, as this would reduce their interest spending, even if it would increase their risk exposure.

Graph II.10. Valuation effect and residual adjustments – average 2000-2004 (in % of GDP)



Source: Commission services.

The valuation of foreign currency-denominated debt used to be a significant component of SFA in a number of Member States until some years ago. It is now almost irrelevant in those which are part of the euro area. If one considers the average from 2000 to 2004, the Member States where the exchange rate developments have contributed most to the SFA are Greece[62] and Slovenia (positive SFAs) and Lithuania, Slovakia and Sweden (negative SFAs).

Early reimbursements. There is also a need to register an entry in the SFA when the government reimburses debt at a price other than its face value, in particular in the case or early redemptions in secondary markets.[63] These transactions and the respective SFA are very frequent, though with relatively small macroeconomic relevance. The cases of Italy and Sweden are worth notice. In Italy, at the end 2002, the government replaced low-interest rate bonds with bonds at market rate and correspondingly lower face value. This operation led to a negative SFA and a reduction in the debt level by almost 2% of GDP. In the case of Sweden, the 2000-2004 average is heavily influenced by a large reimbursement of high-interest bonds with new bonds in 2000.

*Other adjustments***.**[64] Finally, there are other residual and relatively exceptional adjustments, which might lead to increases or reductions in the government debt and to positive and negative SFAs. An interesting case is when some units are reclassified from non-government sectors to government and vice-versa. In these cases, the government debt may increase or decrease because the debts of the reclassifying units are included in, or excluded from, the government debt. The consolidating financial assets of the unit being reclassified also need to be taken into account, therefore a reclassification of a unit into government might increase or reduce the debt. The most remarkable cases in the latest number of years concern the reclassification as government of the Czech Banking Consolidation Agency in 2002 or of a Belgian unit that used to be involved mortgage loans in 2001. Another kind of other adjustments was the loss of the legal-tender status of the coins denominated in the

[62] In Greece, the exchange rate effects were quite significant until joining the monetary union in 2001; it reached annual adjustments of almost 3% of GDP in 1999 and 2000. However, such an effect is now negligible.

[63] Including here are the cases where a government subsector other than the debt issuer buys the government liability in the secondary market.

[64] It should be stressed that the statistical discrepancies are not classified under this heading, but as timing differences, as most statistical discrepancies originate in the complexities of the accrual accounting.

former national currencies in 2002.[65] Some rare debt assumptions in the context of liquidation of public enterprises also imply an entry under other adjustments.

2.2.7 Conclusions

The high level of the SFA in some countries, i.e. the large discrepancies between the deficit and debt developments, have raised concerns about the quality of the government finance statistics, and even about the appropriateness of the existing deficit and debt definitions. The fact that the deficit is not the only determinant in the evolution of the debt level is not an indication of any fundamental error in the accounts of Member States. A large SFA is not, by itself, a source of concern. High positive SFAs are even the normal outcome for low-debt governments in surplus. The issue is more worrying when there are protracted high positive SFA components in high-debt countries in deficit.

All Member States transmit data on the SFA to the Commission on the occasion of the EDP reportings. Data on SFA transmitted by Member States are available both for general government as whole and for each of the government sub sectors. These figures are now publicly available, as the Commission publishes the complete tables transmitted by Member States in the context of the EDP notification.[66] Some Member States also took the initiative of elaborating on the sources and components of their SFA in their stability and convergence programmes. The Commission has strengthened its attention into the quality of the Member States' government accounts. This involves a careful scrutiny of the size and the components of SFA to identify issues that are relevant for budgetary surveillance or suggesting accounting difficulties.

[65] In most countries, coins are issued by the Treasury – not by central banks – and constitute government debt. The coins that lost their legal tender status and were not exchanged against euro were removed from government debt. This operation was recorded without any impact on the government deficit and led to a negative SFA.

[66] See ECFIN web site http://europa.eu.int/comm/economy_finance/about/activities/sgp/natnot.htm

2.3 The role of budgetary institutions in shaping budgetary outcomes

2.3.1 Introduction

In the European Union, while the co-ordination of fiscal policies is based on the common objectives of sound and sustainable fiscal policies, the implementation of fiscal policy remains in the hands of domestic authorities. The implication of this institutional set-up is that, for the system to function properly, the EU's budgetary goals must be embedded in the machinery of national policy-making. The EU Treaty explicitly recognises this point when it calls on Member States to '*ensure that national procedures in the budgetary area enable them to meet their obligations in this area deriving from this Treaty'*. The relevance of this point has been confirmed by a growing body of research that has investigated the interaction between national fiscal rules and institutions and budgetary outcomes. It has thus become increasingly clear that, whatever steps are taken to improve surveillance at EU level, it is equally important to ensure that domestic budgetary rules and institutions contribute towards sound public finances (European Commission, 2004a). The ECOFIN Council report of March 2005 on 'Improving the implementation of the Stability and Growth Pact' reflects these points in concluding that: '*national budgetary rules should be complementary to the Member States' commitments under the Stability and Growth Pact'* and '*the Council considers that domestic governance arrangements should complement the EU framework. National institutions could play a more prominent role in budgetary surveillance to strengthen national ownership, enhance enforcement through national public opinion and complement the economic and policy analysis at EU level'.*

The aim of this section is to contribute to the debate on the role of national budgetary institutions in shaping budgetary outcomes. Sections 2.3.2 and 2.3.3 briefly review the conceptual issues and available empirical evidence. Section 2.3.4 concentrates on the role of optimistic forecasts and creative accounting in explaining budget deficits. Section 2.3.4 discusses a specific institutional issue, i.e. whether the EU fiscal rules are compatible with fiscal policies in so-called delegation states. The last two sections focus in more detail on two topics that have arisen in the context of EU fiscal surveillance, i.e. the interaction between the EU fiscal rules, national expenditure rules and fiscal outcomes (section 2.3.5) and the role of national forecasting authorities in producing unbiased forecasts (section 2.3.6).

2.3.2 Conceptual framework

Fiscal institutions are *'all the rules and regulations according to which budgets are prepared, approved and carried out'* (Alesina and Perotti, 1999) while a fiscal rule can be defined as *'a permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance, such as the government budget deficit, borrowing, debt or a major component thereof'* (Kopits and Symanski, 1998). It follows from these definitions that fiscal rules can be seen as a subset of the budgetary institutions that guide the preparation, approval and implementation of budgets.

Fiscal institutions structure the decision-making process and restrain the range of possible budgetary outcomes. Why institutions matter can be understood on the basis of problems of (i) spending bias, (ii) deficit bias and (iii) a lack of transparency that characterise unstructured and unrestrained budgetary processes. First, externalities that influence the size of government (the expenditure-to-GDP ratio). *Oversized* government may arise from the common pool resource problem. Individual spending ministers, local governments or representatives in parliament are assumed to cater only for their small constituency, thus when making demands on the budget, they fail to realise that their spending implies a cost to the public at large. If budgetary constraints or the minister of finance are weak, adding up the spending demands in the budgetary process will underplay the total cost of spending and lead to an excessively high budget. Strong institutionalised constraints or a strong finance minister, representing the interests of all taxpayers, may ensure that the budget reflects the true cost to the public and define the size of the budget accordingly.

Second, governments may *overspend* relative to revenue, i.e. run deficits that lead to unsustainable government debt. Several explanations have been put forward as to why fiscal policy may suffer from a deficit bias, including political inaction due to conflicts of interest and debt as a strategic variable to affect policy choices of future governments (see Alesina and Perotti, 1994, for an overview). The typical institutional response to the deficit bias has been to introduce permanent constraints on fiscal policy, such as the fiscal rules that have been introduced both in Europe and the US in the early 1990s.

Lastly, even if fiscal arrangements are found that are designed to eliminate these above externalities, any particular budget may still *overshoot*, i.e. deviate from its planned outcome. This may be the case when the

fiscal arrangements work improperly, are based on unrealistic assumptions, are loosely implemented or not enforced, or softened when unforeseen economic developments affect the budget, or when the budgetary authority is not able to control fully side-budgets (e.g. social security). A possible remedy is to create independent bodies in charge of evaluating the transparency, accuracy, and projections of the government budget (Alesina and Perotti, 1999).

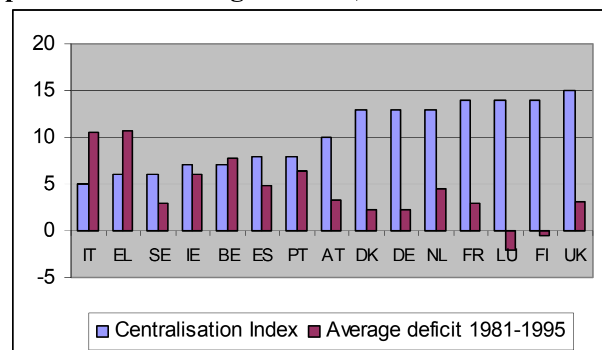
2.3.3 Budgetary outcomes and the centralization of the budget process: survey of empirical evidence

Empirical research on the interaction between budgetary institutions and measures of fiscal discipline has typically used indices that aim at capturing the key characteristics of the institutions in a single number. Such an approach requires making assumptions on which institutional aspects to include in the index and how to weigh them. In practice, the indices as used in different studies show overlap but also differ with respect to the emphasis that the researcher has put on different aspects. For example, the pioneering study by von Hagen (1992) emphasises common pool problems and builds an index that captures the degree of centralisation of the budget process. It covers the stages of: (i) budget formulation (including restrictions on the budget and the relative position of the Minister of Finance vis-à-vis the spending ministers) (ii) budget approval (focusing on the degree to which amendments in parliament may increase the size of the budget) and (iii) budget implementation (e.g.: can the Minister of Finance block expenditures?).[67] The index as developed by Alesina et al (1999) is build around three insights: (i) fiscal constraints may be conducive to fiscal discipline; (ii) hierarchical procedures should be conducive to fiscal discipline and (iii) transparent procedures should lead to more fiscal discipline.[68] In comparison with the index as developed in von Hagen (1992), this index thus puts a somewhat larger weight on ex ante constraints on the budget.

In interpreting the results from empirical research on the interaction between fiscal institutions and fiscal outcomes, a key consideration is whether the causality runs from institutions to outcomes or the other way around. On the one hand, the argument that the causality may run from budgetary outcomes to institutions is based on the observation that fiscal rules and institutional reform have generally been introduced in response to dissatisfaction with budgetary outcomes. They are therefore at least to some extent exogenous, with the implication that they cannot be used as explanatory variables of budgetary outcomes. On the other hand, the argument that budgetary institutions are exogenous to budgetary outcomes, so that they can be included in regression analysis as an explanatory variable, is that it institutions (laws, decision-making procedures) change very slowly over time so that it is reasonable to assume that they are exogenous. Finally, it may also be the case that both budgetary institutions and budgetary outcomes may be a function of a third variable of voter preferences (Poterba (1996)). If this view is right, then countries with a strong preference for particular types of budgetary outcome use the institutions as tools for reaching this particular budgetary outcome.

Graph II.11 and Graph II.12 briefly summarise the messages of research that uses budgetary institutions as an explanatory variable for budgetary outcomes. Graph II.11 visualises the correlation between the index of the degree of centralisation of the budget process, based on von Hagen et al (2002) for the period of 1981-1995, and average budget balances. Following the same approach, Graph II.12 presents the results for the period of 1994-1998 for several recently acceded Member States on the basis of Gleich (2003). Both studies thus find evidence of a statistically significant link between budgetary institutions and budgetary outcomes. In addition to such bivariate correlations, studies that have included the indices of fiscal institutions in fuller models of fiscal reactions functions have also concluded that budgetary institutions influenced budgetary outcomes in EU member states, although the effect may be small (de Haan, Moessen and Volkerink, 1999). The policy implication is that appropriate institutional reform of national budgetary institutions may be conducive to fiscal discipline.

Graph II.11. Centralisation of the budget process and average deficits, 1981-1995

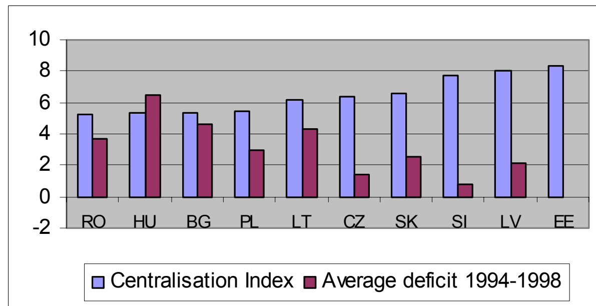


Source : Centralisation index: von Hagen et al (2002). Deficits (in % of GDP): EC Ameco database.

[67] The original index as developed by von Hagen also contains a section on the 'responsiveness of the budget'. Given that this element was dropped in later studies, it is not mentioned here.

[68] This index was used to study the effects of budgetary institutions Latin American countries and has subsequently been used by de Haan, Moessen and Volkerink (1999) for EU Member States.

Graph II.12. Centralisation of the budget process and average deficits in central and eastern European countries, 1994-1998



Source: Centralisation index: Gleich (2003). Deficits (in % of GDP): EBRD transition report 2000.

2.3.4 Explaining budgetary slippages: the role of optimistic forecasts and creative accounting

The previous paragraph has discussed research that investigates institutional explanations for the fiscal deficit bias. As a complement to this approach, recent research has investigated how institutionally weak governments may use a strategy of window dressing, i.e. of appearing in line with the objectives of the EU fiscal rules in the short run, while showing a deficit bias in a longer-term perspective.

A first possibility to do so is to base the budget on overly optimistic growth assumptions. In this case, expenditures are set in relation to revenue projections that are based on overly optimistic growth assumptions. Corrective measures can then be avoided ex ante, while ex post revenues will be lower than expected and a deficit bias will arise due to inertia on the expenditure side (i.e. overshooting). On this point, Milesi-Feretti and Moriyama (2004) argue that opportunistic governments may try to avoid the costs of improving budgetary positions by using more favourable growth assumptions so that the negative outcome can later be blamed on bad luck.

Another possibility for window dressing is to resort to creative accounting, as it allows for steering the measured deficit in the desired direction while avoiding structural adjustment measures. In this context, the model of creative accounting developed by Milesi-Feretti (2003) points to a trade-off between window-dressing and real fiscal adjustment, and relates it to the transparency of the budget.[69]

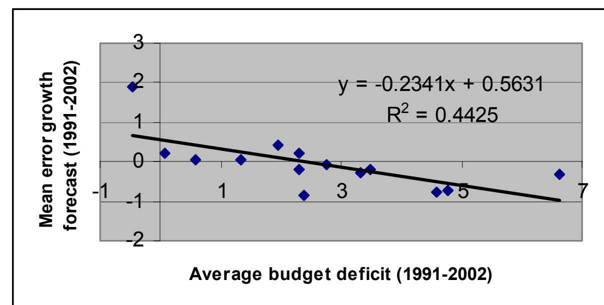
These arguments may be generalised into the hypothesis that budgetary outcomes may be correlated with with overoptimistic budgetary projections and creative accounting/one-off measures

Graph II.13 shows the correlation of the degree in optimism in growth forecasts on which the budgetary projections in the stability and convergence programmes are based with average budget deficits for EU Member states since the early 1990s. It confirms that, for the period as a whole, countries that have systematically based their budgetary projections on overly optimistic growth forecasts have recorded higher deficits. This evidence is further underpinned by the finding that overoptimistic projections for the budget balance are related with the size of deficits across countries, as shown in Graph II.14.

Graph II.15 shows the correlation between the average yearly incidence of one-offs and creative accounting for the period of 1993-2003 and the average deficit for the period of 1993-2003. [70] It confirms that countries that have used more one-offs and creative accounting have also recorded higher deficits.

Whereas these data point to an interaction between budgetary institutions and budgetary outcomes, they do not reveal the direction of causality. On the one hand, following a strategy of window dressing through overoptimistic growth assumptions and creative accounting will itself also lead to a deficit deficit bias in a longer time perspective. But in either case it follows that addressing the fiscal deficit bias through institutional reform at national level may improve fiscal policy outcomes. On the other hand, it might be that countries that do not address the problems of deficit bias and non-transparent fiscal procedures through appropriate budgetary institutions at national level will more easily run against the constraints of the EU fiscal rules, and then may choose a strategy of window dressing to circumvent these rules.

Graph II.13. Degree of optimism in growth forecasts and budget deficits (averages 1991-2002)

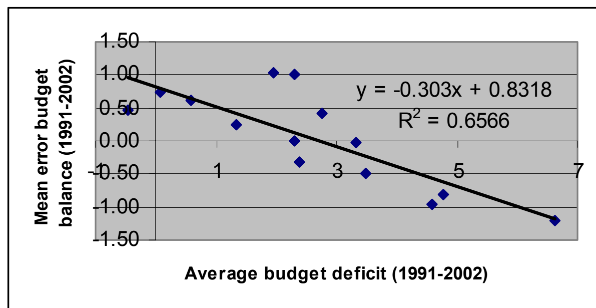


Sources: Ameco database for average budget deficits (1991-2002) and Strauch et al (2004) for mean error in difference between growth forecast and outcome in stability and convergence programmes for 1991-2002. Countries included are EU-15 Member States except LU. Variables are measured as % of GDP.

[69] Ceteris paribus, a rule imposed when the budget is not transparent yields more creative accounting and less fiscal adjustment.

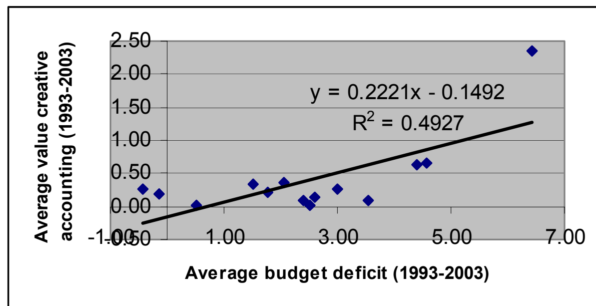
[70] Based on Koen and van den Noord (2005).

Graph II.14. Degree of optimism in budgetary projections and budget deficits (averages, 1991-2002)



Sources: Ameco database for average budget deficits (1991-2002) and Strauch et al (2004) for mean error in difference between planned budget balance and outcome in stability and convergence programmes for 1991-2002. Countries included are EU-15 Member States except LU. Variables are measured as % of GDP.

Graph II.15. Incidence of one-off measures and creative accounting and budget balances (averages, 1993-2003)



Sources: Ameco database for average budget deficits (1993-2003) and Koen and van den Noord (2005) for measures of average one-offs, creative accounting operations and classification errors for 1993-2003. Countries included are EU-15 Member States except LU. Variables are measured as % of GDP.

2.3.5 Performance of EU Member States under the SGP: commitment versus delegation as the key variable?

In addition to the argument that fiscal discipline is correlated with indices of budgetary institutions, it has also been argued that fiscal performance of EU member states under the SGP depends somehow on the institutional setting, i.e. whether a country uses a commitment or a delegation strategy for centralising the budget process (Hallerberg, 2004 and IMF, 2004b). The key argument is that the ideal way for a country to address common pool problems by centralising its budget process depends on its electoral system. Countries with an ideologically unified government (i.e. a one party government or if the parties in government are close to one another ideologically) need a strong Minister of Finance to centralise the budget process in order to obtain aggregate fiscal discipline. Conversely, in countries in which the government is less unified ideologically – notably multi-party governments –fiscal contracts (e.g., coalition agreements) are more suited to achieve a better control of the budget process. The underlying idea is that it is difficult for a strong Minister of Finance to constrain herself to fiscal rules, whereas rules are more useful in coalition governments.

It follows from the above reasoning that delegation states (typically France, Germany, Greece and Italy in the current context) should centralise the budget process by relying on the budgetary discretion of a strong Finance Minister, whereas the commitment states (Belgium, Netherlands, Finland) should rely on a rules-based approach. Since the SGP rules-based framework is a type of commitment approach, it should fit commitment countries very well, while in delegation countries there would be fewer incentives to follow the SGP rules.

A difficulty in identifying the approach to the centralizing the budget process (delegation versus commitment) as a key explanatory factor in explaining budgetary performance under the SGP is that the choice of a delegation approach is strongly correlated with the size of the country: large member states are mostly delegation countries. Buti and Pench (2004) address the question of why large countries have flouted the SGP. They put forward several related arguments to support the view that size has mattered: (i) in larger countries EU considerations may receive less weight than domestic considerations; (ii) large countries have more voting power in the enforcement procedures of the SGP; (iii) there may have been a perception of larger costs of fiscal consolidation in larger countries. Moreover, it may be difficult to distinguish between commitment and delegation countries since reforms of the fiscal institutions may change the classification of given countries over time.[71] Finally, it is also possible to directly question the argument that fiscal rules (i.e. either national fiscal rules or the rules of the SGP). However, there are examples of countries like the UK that combine a strong finance minister with a rules-based approach.[72] Moreover, Hallerberg, Strauch and von Hagen (2004) in a paper based on an update of the dataset in von Hagen (1992) argue that budgetary rules also seem to operate as disciplining devices for delegation states. The authors claim that, over the 1990s, fiscal constraints such as expenditure rules have been given a more prominent role in several EU member states.

[71] For instance, Spain and Austria moved towards a delegation approach as from 2000 (Hodson, (2005)).

[72] The two formal fiscal rules in the UK are the golden rule and the sustainable investment rule. Government departments are also given three-year spending limits (Departmental Expenditure Limits), while any spending that cannot reasonably be subject to such multi-year limits is included in Annual Managed Expenditure.

2.3.6 Expenditure rules and expenditure outcomes

Conceptual issues

The EU fiscal rules apply to the budget balance, i.e. the difference between total revenues and expenditure. Many member states have also introduced national fiscal rules that aim at controlling public expenditure in the context of medium-term expenditure frameworks. In many countries such national fiscal rules are seen as a key institutional tool for complying with the EU fiscal rules.

European Commission (2003a) contains a detailed discussion of the interaction between the EU fiscal rules and national expenditure rules. National expenditure rules can complement the EU fiscal rules in several ways:

- they help tackling deficit bias by helping to address the principal source of the fiscal profligacy: political and institutional temptation to raise expenditure in good times;
- they support the operation of the automatic stabilisers by helping to prevent tax increases in bad times;
- Expenditure rules can contribute to the policy objective of improving the quality of public spending;
- If adequately set and enforced, expenditure rules make tax reductions more credible by making economic agents anticipate that they will be permanent;
- Expenditure rules are helpful in the implementation of durable consolidation packages: the literature suggests that expenditure-based consolidations are more likely to be long-lasting.

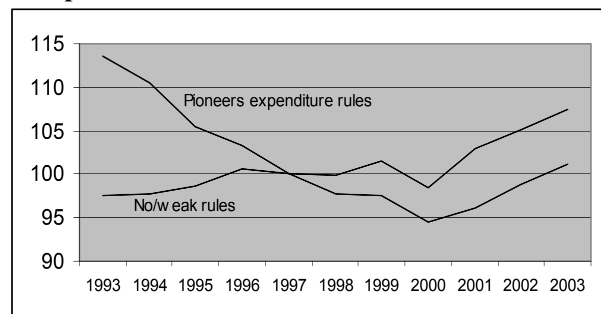
European Commission (2003a) there is also an empirical analysis on the design and implementation of expenditure rules in EU member states. The design includes the definition of the target (in real or nominal terms, as a ceiling or a rate of growth), what to leave out of the rule (cyclically sensitive items and/or productive expenditure categories), the legal base of the rule (political agreement or based on law) en the enforcement of the rules. The analysis suggests that the rules had contributed to expenditure control in countries that had implemented more ambitious rules. Subsequent analysis in (European Commission (2004a)) shows that consolidations are more likely to be expenditure-based in countries with stronger rules (Denmark, Netherlands, Austria, Finland, Sweden, UK).

Expenditure developments in countries with strong and weak expenditure rules

In order to further illustrate the interaction between expenditure developments, expenditure rules and political priorities, Graph II.16 shows the developments in primary expenditure for two groups of countries. The first group consists of countries that have pioneered the use of medium-term expenditure frameworks (Denmark, Finland, Netherlands, Sweden).[73] The second group consists of countries with less emphasis on expenditure rules in the context of a medium-term expenditure framework (Germany, Portugal, Italy) or for which a weak design and frequent overruns have made the rule largely ineffective (France). Expenditure trends are represented by index numbers for primary government expenditure-to-GDP ratios, with 1997 chosen as the base year.[74]

In the first group of countries primary expenditure was at a high level of 56% GDP in 1993. In all countries within this group, a strong political consensus emerged on the need to bring down public expenditure. An interesting feature is that public expenditure had been on a downward path for several years already when the rules were introduced. To some extent, the expenditure rules may therefore signal the political consensus rather than being an exogenous budgetary institution that can explain why expenditure was reduced by large amounts. A structural break in this trend of expenditure reductions seems to have occurred in 2000. In the second group of countries, primary expenditure started from a much lower levels of 31% GDP in 1993 and has slowly moved upwards since.

Graph II.16. Expenditure developments: effects of expenditure rules?



Source: Commission services.

[73] The UK could also be included in this group. It has been excluded, however, given that total expenditure in the UK is much lower than in these countries and given that the political preferences in the UK strongly shifted towards expenditure increases in recent years.

[74] The choice of the base year is dictated by the fact most countries introduced their expenditure rules around 1997 (the rules were introduced in 1994 in the Netherlands, in 1997 in Denmark and Sweden and in 1999 in Finland).

This trend continued despite the reductions in budget deficits during the 1990s that were based on increases in revenues. Again, the year 2000 represents a structural break after which expenditure has been on the rise again.

2.3.7 Explaining budgetary outcomes: the role of macroeconomic forecasts

Conceptual issues

Expenditure rules that are cast in numerical targets require an accurate revenue projection – based on unbiased economic growth forecasts – if these rules are intended to support the SGP's budget balance target. In its March 2005 agreement, the ECOFIN Council has confirmed the relevance of this topic: '*The Council recognises that it is important to base budgetary projections on realistic and cautious macroeconomic forecasts. It also recognises the important contribution that Commission forecasts can provide for the coordination of economic and fiscal policies*'.

Conceptually, the observed link between the optimism on the growth outlook and fiscal performance can be explained by inertia in the execution of the budget. On the revenue side it is reasonable to assume that any variation in the rate of economic growth will automatically translate into a corresponding variation in governments' receipts, as under unchanged fiscal policy tax bases should bear a stable relationship to the level of economic activity.[75] In the planning stage of the budget, projected revenues are a determinant of expenditures. In the execution phase of the budget, however, pre-set expenditure lines are hard to adjust to deviations of economic growth from the ex ante projection. Targeting the budget balance is thus facilitated if budgetary projections can rely on unbiased forecasts in the planning stage.

If official growth forecasts were unbiased (i.e. on average the projection does not differ from the true value), the effect of over- or underestimating economic growth on the budget balance target would have to be accepted as the price of uncertainty. However, a completely different conclusion is warranted if official growth forecasts suffer from some sort of structural optimism, systematically overrating the underlying rate of the economy.

Optimistic forecasts: empirical evidence

Strauch et al. (2004) analyse the track record of budgetary forecasts contained in the Stability and Convergence programmes presented between 1991 and 2002. Their results support the view that several Member States produced optimistic growth assumptions. Moreover, countries with the most optimistic growth outlooks are also those with the largest slippages from budgetary targets. The link between the forecast bias and fiscal performance is confirmed by Larch and Salto (2003). Focusing attention on the four largest economies of the EU (Germany, France, United Kingdom and Italy) and using a longer sample (1987-2003) they show first that forecast errors of potential output growth are significant in explaining variations in the CAB and second that official growth forecasts have an optimism bias in three out of the four countries considered. The same authors show that the bias can be as high as 0.2-0.3% of GDP per year, producing a measurable impact on the debt-to-GDP ratio in the medium term. For instance, over the past five years, since the beginning of EMU, the optimism bias can, ceteris paribus, account for around one full additional percentage point of the debt-to-GDP ratio. These estimates are confirmed by Forni and Momigliano (2004). They conclude that the misjudgement of cyclical conditions has an average yearly impact of 0.2% of GDP on the budget in more than half OECD countries.

Institutional issues

Table II.4 summarises current practice in forecasting in EU member states. In most Member States, the government itself is responsible for the economic forecasts that underlie the budgetary planning. Usually, the forecasts are produced by the Ministry of Finance. In a few cases other government agencies are involved, e.g. the economics ministry in Germany and the statistical institute as a division of the economics ministry in Luxembourg. Only four Member States have their economic forecast produced outside the government. It should be noted that these countries are small, so that the forecasting institute almost has a monopoly position (Netherlands, Belgium) or only few competitors (Austria) within the country's forecasting landscape. The extent of delegation ranges from a pure gentleman's agreement in Austria to a formal obligation in Belgium. As regards the legal status of the external forecasters, they are all intellectually independent, but receive most of their funds from the government and are in some cases government agencies. In Belgium, the most formalised case of delegation, the National Accounts Institute, comprising the national statistical institute, the central bank and the Federal Planning Bureau (a public agency with legally granted intellectual independence), produce the forecast. The government is expected by law to use this forecast in the budgetary process. 2001 was the only year, in which the government made use of its power to override the forecast – for a more prudent one.

In those cases where the forecast remains within the domain of the government, the forecast can still be subject to outside checks before it is published. The central bank is consulted in many member states, though

[75] In addition, if the tax system is taken to be roughly proportional, which would seem to be the case for most EU countries, the revenue-to-GDP ratio should be broadly neutral with respect to growth.

on a formal basis only in those that delegated the forecast.

Table II.4. Characteristics of forecasting institutions in EU Member States.

Country	Responsibility for forecast			Consultation process			Publication		
	Ministry of Finance	Indepen-dent institute	Government can override forecast	Statutory involve-ment of central bank	Consulta-tive in-volvement of central bank	Academic and/or political peer review	Compari-son with other forecasts	Explicitly errs on the side of caution	Date of last update
Austria		X					X		Sept
Belgium		X	X						Sept/Oct
Czech Republic	X				X	X	X		Sept
Cyprus	X				X				Sept
Denmark	X						X		Aug
Estonia	X					X	X		Aug
Finland	X								Sept
France	X								Sept/Oct
Germany	Econ Min				X				Oct
Greece	X								June
Hungary	X				X		X		Sept/Oct
Ireland	X					X			Dec
Italy	X								Sept
Latvia	X			X					Aug/Sept
Lithuania	X				X	X			Sept
Luxembourg	STATEC/Econ Min			X		X			Nov
Malta	X				X				Oct
Netherlands		X					X		Aug/Sept
Poland	X								Aug/Sept
Portugal	X						X		Oct
Slovakia	X				X	X	X		Aug/Sept
Slovenia		X	X				X		Oct
Spain	X								Sept
Sweden	X					X	X		Sept
United Kingdom	X				X	X	X	X	March*

*Fiscal year starts in April.
Source : Commission services.

Academic institutes are consulted in many cases. In the UK, the National Audit Office has the mandate to audit many of the assumptions on which the forecasts are based, e.g. on trend growth, price developments, claimant unemployment etc., with access to all relevant government documents. The weakest form of outside control during the forecasting process is the timing of the forecast. Despite the lack of outside consulting, in Germany, for example, the forecast is constrained as it is published usually after the independent institutes published their joint forecast. In France, in contrast, no independent institute systematically monitors the government's growth and budgetary forecasts. Smaller countries, especially the new member states but also Portugal and Greece, sometimes lack a monitoring infrastructure of independent research institutes, so that forecasts of international institutions are the only comparator.

Upon publication, the government forecast is compared with other forecasts in about half of the countries. The degree of openness about competing forecasts varies. In Italy, for example, a formally independent public body (ISAE), the central bank and the national statistical institute discuss the government's forecast during a parliamentary hearing. The UK Treasury, for example, makes a comparison of independent forecasts available on its website, which is monthly updated. The UK employs a further safeguard against over-optimism: It is the only country that bases budgetary projections explicitly on trend growth ¼ pp below its neutral view.

Due to the implementation lag of corrective measures on the expenditure side, frequent updates of forecasts can win time. Although the Finance Ministries in almost all countries record public finance developments on a monthly basis, most countries produce official macroeconomic forecasts only twice a year, at the beginning of the budgetary process and towards its end.

Towards unbiased forecasts: do institutional characteristics matter?

Strauch et. al (2004) investigate for the EU-15 in the period from 1991-2002 whether there is a forecasting bias, using the projection horizons contained in the Stability and Convergence Programmes. These are usually submitted in December by the Member States, after the budgetary process for the forthcoming year is completed, although before 1998 they were not always

submitted regularly. Thus they are based on the most recent forecast underlying the budget. An interesting finding is that national forecasts of GDP growth that are produced by independent institutes (in Austria, Belgium and the Netherlands) show no bias. This is confirmed by Jonung and Larch (2004) with data taken directly from the national forecast publication and with a longer time horizon.

A further noteworthy result is that forecasts produced by the government may be biased but need not be. Germany, Italy, Portugal and Luxembourg (according to Strauch et al. (2004)) plus France (according to Larch and Salto (2003)) are systematically optimistic in their growth projections. However, in Denmark, Finland, Greece, Spain, UK, where the finance ministry also produces the official forecast, a significant bias could not be detected.

Moreover, it is also found that, where the forecast is produced by the government, other institutional characteristics do not seem to fully explain the difference between having a bias or not. In Spain and the UK, the official (unbiased) forecasts are validated against competing forecasts from the central bank or other forecasters and academics. In contrast, this is not the case in France, but neither in Denmark nor Greece. Yet, according to Strauch et al. (2004), the French and the Greek budgetary forecasts have systematically underestimated the deficit. Furthermore, Ireland and Sweden systematically err on the cautious side, according to Strauch et al. (2004) Nonetheless, it seems that the more transparent the official forecast is towards peer review and the stronger the outside monitoring, the less is there a tendency for an over-optimistic bias.

In sum, available analysis find some support to the view that one way to reduce the optimism bias in official growth forecasts and thus the ensuing effect on the budget is delegation to a body that is protected against political pressure. The task of producing forecasts of relevant variables for the budgetary process could be assigned to an independent institution with the commitment by the ministry of finance to use these forecasts in the planning of the official budget. A less clear-cut route to safeguard the forecast against political pressure could be to expose it to outside scrutiny by consultation processes with independent forecasters and, after publication, provide comparisons with other forecasts. The frequency of the forecasts is also important: While the forecasts are often timed to the budget preparation with two exercises per year, in the execution phase of the budget more frequent updating could be useful, given the time lags in making adjustments on the expenditure side. For example, there could be two major official forecasting exercises per year, which are updated twice after the release of quarterly data.

2.3.8 Conclusion

The EU Treaty calls upon member states to ensure that national procedures in the budgetary area enable them to meet their obligations deriving from the Treaty. The recent Council agreement on improving the implementation of the Stability and Growth Pact has confirmed the importance of this issue and has included references to national fiscal rules, national institutions, realistic and cautious macro-economic forecasts. In this context, this section has reviewed the interaction between domestic budgetary rules and institutions and budgetary outcomes. Overall, the data seem to provide a certain support to the view that deficit bias, overoptimistic budgetary projections, creative accounting and one-off measures may all be linked to underlying institutional weaknesses. Given that the literature stresses that both budgetary outcomes and budgetary institutions may also be related to political priorities, it seems that a virtuous circle of improved policy outcomes across all these indicators may require improved national ownership of common objectives as well as institutional reforms of national budgetary processes.

3. Sustainability analysis in EU multilateral surveillance: what has been done, what should be done?

3.1 Introduction

During the 1980s and the first half of the 1990s, significant rises in the level of public debt increased concerns about the sustainability of deficit spending policies in the very long run. For the EU-15 countries on average, public debt shifted from around 30% of GDP in the mid-1970s to almost 75% of GDP in the mid-1990s. During the same period the old-age dependency ratio (measured as population aged 65 and over as a share of population aged 15-64) increased only slightly, from 20.6% to 23%, showing that the majority of the shift in debt ratios could not be attributed to demographic pressure.[76] In the second half of the 1990s, preliminary estimates of the budgetary impact of ageing populations pointed to an additional risk.[77] This has been the backdrop for the increased focus on long-term fiscal sustainability.

In EU countries, sustainability of the public finances is typically analysed with a long-term perspective.[78] Available demographic and budgetary projections show increases in budgetary expenditures driven by demographic changes in all countries over the next 30 years. A currently sustainable position may thus easily turn unsustainable if the expected cost of ageing is not anticipated somehow, e.g. through budgetary or structural reforms or through accumulation of budgetary surpluses.

[76] Source: Eurostat's NewCronos database.

[77] See the work conducted at the OECD by Roseveare, Leibfritz, Fore and Wurzel (1996).

[78] This is not the case, for instance, for emerging economies where debt sustainability is mainly a short-to-medium term issue. See, IMF (2002).

Monitoring the likely trends of public finances is therefore of paramount importance to preventing the burden of public debt from becoming unsustainable. The revised Code of Conduct on the content and format of the Stability and Convergence Programmes (July 2001) commits Member States to include information on the quality and sustainability of public finances, including long-term budgetary projections of the implications of ageing populations.[79]

However, fiscal surveillance of long-term sustainability entails a high degree of uncertainty. The results may differ according to assumptions on future trends of e.g. demographic developments, macroeconomic developments (mainly growth conditions), and budgetary development of age-related expenditures. In addition, sustainability depends on the impact of structural reforms that may affect either the potential

[79] Available at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/codeofconduct_en.pdf . In the last part of the second paragraph under the heading 'Objectives' it is stated '….Furthermore, appropriate medium-term budgetary targets, consistent with the general and country specific recommendations in the BEPGs, should also take into account the need to cater for the costs associated with population ageing'; last paragraph of the heading 'Measures' says 'Furthermore, the programmes should outline the countries' strategies and provide summary information on the countries' short- to medium term concrete measures to tackle the long-term budgetary implications of ageing'; the second paragraph of the heading 'Time horizon' lays down 'Given the impact of longer-term demographic developments on the sustainability of public finances, information over a longer period should be included in the annual updates of the programmes in summary form. However, more detailed information should be included and updated regularly, at least every three years, …'.

growth rate or the budgetary profile of certain expenditure categories, cf. Section 3 in Part II.

In the reformed SGP, sustainability is at the core of budgetary surveillance. Sustainability concerns are reflected in several ways: (i) in formulating an opinion on the annual update of the Stability or Convergence Programme; (ii) the definition of the medium-term objective for a Member Sates' budgetary position will take account of the Commission and Council assessment on the sustainability risks; (iii) if a Member State introduces a major reform that have direct long-term budgetary saving, for example a reform of the pension system, then a deviation from the medium-term objective or the adjustment path towards can be allowed; and; (iv) in applying the excessive deficit procedure, the net cost of pension reforms that introduces a mandatory fully funded pillar will be considered carefully, as such reforms involve a short-term budgetary cost while the long-term impact is positive[80]; (v) there will be an increased focus on the debt criterion set down in the Treaty. In particular, Member States with high debt-to-GDP ratios should make great efforts to reduce tem rapidly, thus contributing to sustainability of the public finances.

The increased relevance of longer-term issues in the context of the Stability and Growth Pact requires a well-established methodology to gauge possible sustainability risks. This section presents the state of the art of long-term sustainability analysis and its use in fiscal surveillance at EU level. It both discusses how the methodology has developed since the first round of assessment in 2001, and presents possible future developments.

3.2 The current assessment of sustainability of public finances in the stability and convergence programmes

Since 2001 long-term sustainability of public finances has been examined in the context of the annual assessment of the Stability and Convergence Programmes and their updates. Sustainability is thus discussed both in the technical assessment prepared by the Commission services[81] and in the Council Opinions.

These assessments are based on both quantitative and qualitative tools which try to capture the degree of budgetary risks associated with current policies and ageing populations. Sustainability refers to the capacity of a country to be solvent now and in the future given current legislation and policies and without major corrections on the budget. The assessment of sustainability is a matter of judgement of what a 'major correction' is: this depends on the size of the required correction and the specific conditions linked to the country (its past history, the presence of reserves, the level of taxation etc.). As underlined by the IMF, 'no framework can dispense with the need for making judgements: at best, it can help inform such judgements' (IMF, 6:2002).[82] The Commission's and the Council's assessment of sustainability of public finances takes into consideration both quantitative information (sustainability indicators based on the projected evolution of the debt-to-GDP ratio, cf. Section 3.2.4) and qualitative considerations. In Section 3 of Part I, the latest assessment is described.

The experience accumulated during the four rounds of sustainability analysis in the context of the SGP allows some preliminary conclusions. Four particular aspects of the Commission's approach merit consideration: (i) the

[80] The terminology used when distinguishing between different pension 'pillars' characterising the pension arrangements prevailing in a country is not universally agreed. In the EU, a three pillar terminology is generally used: (i) 1st pillar: consisting of statutory basic schemes; (ii) 2nd pillar: consisting of occupational schemes; and, (iii) 3rd pillar: consisting of individual pension plans. A pension system might be statutory, comprising both a PAYG part and a funded part. This could be seen as a statutory two-tiered 1st pillar pension system, comprising a public PAYG part and a funded part being privately managed. The different 'pillar terminologies' does not have any direct legal implications. The World Bank has instead developed a multi-pillar terminology as follows: 0 pillar: social assistance schemes; 1st pillar: earnings-related schemes; 2nd pillar: mandatory savings; 3rd pillar: occupational schemes; 4th pillar: individual pension plans; and, 5th pillar: family plans (World Bank (2005), 'Terms Behind Pension Discussions', http://www.worldbank.org/). However, a pension reform that introduces a "mandatory fully funded pillar" has a special significance in terms of the ECOFIN report of 20 March 2005 on the reform of the SGP (see Section II.1). Such a reform normally involves a partial shift to funding within the statutory pension system. According to Eurostat's decisions of 2 March and 23 September 2004, contributions to a funded defined-contribution pension scheme should be classified outside government by March 2007 at the latest (see the Boxes II.5 and III.3). This normally implies a loss of social security contributions recorded in government and therefore a short-term deterioration of the general government budget balance when such a scheme is introduced.

[81] Available the DG ECFIN website at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

[82] See IMF (2002), 'Assessing Sustainability', page 6, 2002. As developed in the 2004 PFR, sustainability is not a purely quantitative issue. For example, and this may be a particular challenge in some recently acceded Member States on which Part IV provides a specific focus, under-investing today in environmental protection and technologies may lower governmental expenditures in the short term, and thus have a *temporary* positive impact on public finances, but it would usually imply much larger spending in the future, with an overall significant *negative* impact on intergenerational discounted financial sustainability. Hence the necessity to follow both a quantitative and a qualitative approach.

cooperation with Member States in the Ageing Working Group attached to the Economic Policy Committee; (ii) the yearly sustainability analysis in the context of the overall assessment of the updated SCPs; (iii) the input data of the sustainability analysis (the medium-term scenario, the long-term budgetary projections and the long-term macroeconomic assumptions); (iv) the debt projections (the set of quantitative indicators, sensitivity tests and qualitative factors used in the assessment).

3.2.1 The cooperation with EU Member States

In 1999 the Ageing Working Group (AWG) was established as a technical working group attached to the EPC. The purpose of the AWG was to build the framework for monitoring and assessing the budgetary impact of ageing populations. This framework included a first set of long-term budgetary projections which took place in 2001 and covered pension and health care expenditures.[83] The exercise was completed in 2003, when additional age-related expenditures (education and unemployment transfers) were added. This meant that by the end of 2003, long-term budgetary projections for EU-15 Member States covered around 2/3 of primary expenditures.[84] The projections were based on national quantitative models for pension expenditures and common methodologies for the other budgetary items. To project these items an agreed demographic scenario prepared by Eurostat and agreed macroeconomic assumptions were used.

The harmonised projections were based on consistent assumptions across countries in terms of GDP and demographic developments. However, the national models used to produce pension projections remain to a great extent unknown at EU level (see section 3 in Part II). Comparability has also been reduced by subsequent revisions of the national projections taking place without peer reviews within the AWG.

In addition, the AWG became the forum to discuss methodological aspects for the assessment of long-term sustainability of public finances. An ex-post evaluation of the exercise from a methodological point of view has allowed regular improvements of the methodology.

3.2.2 The annual assessment

The European Council in Stockholm of March 2001 agreed that ‘the Council should regularly review the long-term sustainability of public finances, including the expected strains caused by the demographic changes ahead. This should be done both according to the Broad Economic Policy Guidelines (BEPGs) and in the context of the stability and convergence programmes.’ This has been implemented by carrying out annual reviews of sustainability in the context of the updated stability and convergence programmes and including a summary assessment in the BEPG Implementation report.

The annual assessment has helped maintaining political pressure for structural reforms (in particular in the field of pensions) and on running down debt.[85] The pressure has increased over years given the higher relevance devoted to the assessment of long-term sustainability in both the technical Commission documents and the Council Opinions. While in the first two rounds of assessment, sustainability analysis was presented as an annex to the main Commission technical document, it became part of the core assessment in the following rounds.

However, the annual assessment has some drawbacks. Because of timing and space limitations, it keeps the analysis fairly general and based on few indicators. This has raised some criticism and the issue of a possible need of a more in-depth assessment of underlying budgetary risks. As the long-term budgetary projections are not updated every year, and as major reforms generally takes place rather infrequently, only very limited changes in the assessment of public finance sustainability can be expected from one year to the next.

3.2.3 The input data

Input data in the sustainability analysis are a key concern to produce reliable estimations of sustainability risks. Three types on input are necessary to perform the analysis:

- The budgetary profile for the medium-term;
- The long-term budgetary projections;
- The long-term macroeconomic assumptions.

The medium-term scenario relies on data provided by Member States in their updated stability or convergence programmes. This information includes primary expenditures and total revenues, interest payments, debt ratio and the stock-flow component, one-off measures with budgetary impact, and the cyclical component of the budget balance. The main advantage of using such data is that the sustainability analysis incorporates the planned policies for the medium-term, making it fully consistent with the overall strategy of the government.

[83] See Economic Policy Committee (2001).

[84] For the methodology applied to project education expenditures see Montanino et al. (2004). For an overall view of the budgetary projections see Economic Policy Committee (2003).

[85] Pension reforms have taken place in a number of countries since 2001 (Germany, France, Austria, Italy) while other countries (notably Sweden, The Netherlands, Denmark, Finland) have aimed at running down the debt. In other cases (such as Belgium, Ireland and Spain) Member States have started accumulating reserve funds to deal with the ageing problem in the future.

Box II.4. Sustainability analysis carried out by the IMF

Sustainability analysis is carried out by the IMF under the Article IV Reports. The standard template considers a five-year horizon where debt dynamics are assessed.[1] However, for industrialised countries this standard approach is modified somewhat to include the risks associated with ageing populations. The framework applied to EU countries consists of three main elements. First, a baseline scenario for the public debt dynamics is defined, which includes estimates of age-related expenditure trends provided either by the Member State or by the IMF staff. The main macroeconomic assumptions are set up by the IMF staff. Projections are generally carried out up to 2050. Second, on the basis of this scenario a series of sensitivity tests is applied. The sensitivity tests mainly include macro-economic shocks to GDP growth and real interest rates (risks associated with exchange rates are of limited relevance in EMU). These sensitivity tests provide different scenarios for the debt dynamics over the long-term. Third, a judgement of the resulting debt dynamics under the baseline and alternative scenarios is made. The interpretation of the debt ratios tries to answer the following questions: (i) Is the debt ratio, either along the path or at the end of the horizon, so high that the country is vulnerable to a crisis? (ii) Can the country plausibly generate and maintain the primary surpluses required over the medium-term to at least stabilise the debt ratio? (iii) Are the gross financing needs required along the path so large that the country may run into a funding crisis?

Clearly, the answer to these questions needs to take into consideration the country-specific context and therefore a good deal of judgement is needed. This is particularly true for EU countries, where crises are not associated with levels of public debt similar to those of emerging countries and thus past crises cannot be used as a benchmark for assessing sustainability risks.[2]

Overall, the IMF's and the Commission's approaches are similar. Both are based on the public debt dynamics over the long-term, which includes estimates of age-related expenditures and some judgement of the sustainability risks associated with the results. However, some differences should be underlined. First, the Commission produces sustainability analysis for all EU countries on a regular basis, i.e. following the yearly submission of updated Stability or Convergence Programmes, while the IMF covers around half of the countries on a regular basis. A second difference is the design of the sensitivity tests. The Commission produces tests for an alternative medium-term scenario and higher (nominal and) real interest rates, while the IMF tests real interest rates and GDP growth (and, if relevant, exchange rate shocks). Third, the Commission publishes synthetic indicators (sustainability gaps and the required primary balance) to make more explicit the budgetary effort needed to reach sustainable positions.

In terms of input, both institutions rely on national projections, although the Commission also uses some harmonised projections for education and unemployment transfers. It should be noted that the Commission will use harmonised projections for age-related expenditures and macroeconomic variables once updated projections are produced by the Economic Policy Committee.

1. The main references for the methodology used by the IMF are: 'Assessing Sustainability' (2002) available at http://www.imf.org/external/np/pdr/sus/2002/eng/052802.htm and 'Sustainability Assessments – Review of Application and methodological Refinements' (2003) available at http://www.imf.org/external/np/pdr/sustain/2003/061003.htm.
2. The IMF paper 'Sustainability Assessments – Review of Application and methodological Refinements' (2003), reports that more than half of sovereign debt crisis have occurred at public (or external) debt ratios of below 40 % of GDP.

However, the medium-term scenario planned by governments in their updated programmes has in a number of cases been fairly optimistic, underestimating sustainability risks, cf. Section 2.1 of Part II. The Commission services therefore also analyse a scenario that assumes no consolidation in the medium term (see section 4 of Part I).

Long-term budgetary projections and macroeconomic assumptions may either come from a national source or be the result of common projections carried out at EU level. The sustainability analysis uses both sources. Table II.5 shows the source of budgetary projections for pensions (either national or EPC) used in the sustainability analyses for EU-15 Member States. In most cases the common pension projections of 2001 are not used. This is mainly because national projections are considered more updated and more detailed on the country-specific pension systems.

The use of national projections in the context of multilateral surveillance provides a regular update of the common projections. However, detailed information regarding the differences between the national and common projections are frequently lacking, making an analysis based on the national projections more difficult. As illustrated in Table II.6, the future changes in pension expenditures as reported in the updated stability programmes are in a number of cases quite different from the 2001 EPC projections. Still, very little or no information is available to explain and thus exert multilateral surveillance with regards to these differences. Possible explanations include different underlying assumptions on macroeconomic variables or demographic trends, different assumptions on agents' behaviour, new reforms, or a revision of actual data on pension expenditure.

National projections are also in a better position to incorporate relevant country-specific detail. In addition, common projections are normally not run every year because of the complexity of setting the common framework.

Table II.5. The source of pension expenditure projections in the sustainability analysis

	2001	2002	2003	2004
BE	National	National	National	National
DE	EPC	National	National	National
EL	EPC	National	National	National
ES	National	National	National	National
FR	EPC	EPC	National	National
IE	EPC	EPC	EPC	EPC
IT	EPC	National	National	National
LU	EPC	EPC	EPC	EPC
NL	National	National	National	National
AT	EPC	National	National	National
PT	EPC	National	National	National
FI	National	National	National	National
DK	National	National	National	National
SE	National	National	National	National
UK	National	National	National	National

Source: EPC, National Stability and Convergence Programmes, European Commission technical assessments.

In general, common projections still fit better with the need of multilateral surveillance as they facilitate the Commission's and the Council's interpretation of the results since. As there is, in principle, full transparency regarding the methodology and the underlying assumptions, the results are easy to compare across Member States.

Long-term macroeconomic and demographic assumptions must be coherent with budgetary projections. If the latter incorporate national scenarios different from the common assumptions, this must be explicitly spelled out and information should be provided in order to facilitate multilateral surveillance. However, the use of national scenarios may risk providing long-term assumptions that are not consistent with each other. This could go against expectations of some convergence among EU countries as for labour productivity growth rates, life expectancy, or interest rates on public debt.

3.2.4 Debt projections

As mentioned in Section 3.2, a country is often considered to be in an unsustainable situation if the debt-to-GDP ratio reaches a level beyond which the country faces difficulties in issuing new debt.[86] Since this maximum level of debt is not measurable ex-ante, sustainability is measured looking at the dynamics over time, in particular whether debt is stable, declining or increasing.[87]

The main indicator of the sustainability analysis is the gross debt dynamics over the long-term.[88] This requires the estimated trends of age-related expenditures (pension, health care, education, long-term care and unemployment transfer). Such long-term debt projections take account of future obligations that are not necessarily backed by law but are very likely to translate into actual government expenditure. These are often referred to as implicit liabilities.[89] While implicit liabilities are highly relevant to sustainability analysis, their definition and measurement is in general not straightforward (see Box II.5).

In the first two waves of assessment (2001 and 2002) the budgetary position of the last year of the programme was measured in nominal terms (not adjusted for the cycle). This implied that temporary budgetary effects due to the cycle or to one-off measures were assumed constant over time. In the subsequent rounds of assessment, the way debt is projected has been modified to better take into account the underlying budgetary position. Since the 2003 assessment the budgetary figures have been corrected for the cycle and in the 2004 assessment they were also corrected for one-off measures. Below-the-line operations which affect the debt have on the other hand always been included in the medium-term debt development and from the first year of projection onwards it has been assumed a zero stock-flow adjustment.

The revenue-to-GDP ratio and ratio of other primary expenditures to GDP are in general held constant over the projection period. However, projections of national revenue dynamics based on legislation already in place, are taken into account. This largely concerns deferred tax revenues from contributions to funded pension systems as well as accumulated earnings prior to disbursement.[90]

[86] See Blanchard (1984).

[87] See Perotti, Strauch and Von Hagen (1997).

[88] See European Commission (2002a) for the way public debt is projected.

[89] See European Commission (2004a).

[90] In Denmark, the Netherlands and Sweden, projected tax revenues vary as they can largely be attributed to the deferred tax revenues from contributions to funded

The definition of debt

For the assessment of sustainability, different definitions of public debt can be envisaged. The definition also depends on statistical conventions. The debt concept used by the Commission, Maastricht gross debt, is defined in the Protocol on deficit and debt of the Maastricht Treaty. Although gross debt is only a partial indicator of sustainability, the concept entails the advantage of being measurable with a high degree of certainty and being comparable across countries in the EU and across time. The choice of focussing on gross debt keeps the analysis simple and transparent while giving enough information on sustainability risks.

However, it has been argued that governments may hold assets which might guarantee the sustainability of public finances even at very high level of outstanding gross debt, or they may decide to use budgetary surpluses to accumulate assets instead of repaying the stock of gross debt. In those cases, the gross debt ratio may not decline or decline at a slower pace without signalling a deterioration of sustainability.

To remedy this, an adjusted gross debt measure was used for several countries in the 2004 assessment round. This elaboration of the Maastricht gross debt measure takes into account the financial position of public pension funds, in particular those funds that are established and/or legislated with a strict purpose of using them only to cover the future pension related public expenditures, cf. Box II.6 for a detailed description.

Synthetic indicators

On the basis of the debt dynamics, three synthetic indicators of the so-called sustainability gaps have been calculated in the 2004 round of assessments:

S1 indicates the difference between the constant tax ratio required to reach a debt ratio in 2050 of 60% of GDP and the current tax ratio. If the difference is positive, the Member State concerned is not able to ensure the respect of the 60% reference value over the very long run on the basis of the current policy. An increase in the primary balance is therefore required. However, even a zero or negative value of this indicator, does not ensure sustainability *after* 2050 since debt dynamics can be on an explosive path. The intertemporal budget constraint may then not be respected.

The *S2* indicator is based on the intertemporal budget constraint. It indicates the change in the tax ratio that would equate the present discounted value of future primary balances to the current stock of gross debt (Blanchard, 1990). Given the government intertemporal budget constraint, the evolution of the debt-to-GDP ratio is a reflection of i) the inheritance from the past, in the form of the product of the ratio of accumulated debt to GDP times the difference between the real interest rates and the growth rate, and of ii) the current spending policies, in the form of a primary balance.

The value of the S2 indicator depends on the differential between the interest rate and the growth rate, i.e. on the discount factor, the level and the profile of age- and non-age-related expenditures, the current stock of gross debt and the current tax-to-GDP ratio.[91]

The indicators S1 and S2 both have a long-term character. Thus, while the size of the two indicators points to the required magnitude of change in the tax policy if the respective sustainability conditions are to be fulfilled at some point, their informational content with regards to the short -to-medium term policy-making may be limited.

pension systems as well as accumulated earnings prior to disbursement. For Germany, the projected rise in the revenue-to-GDP ratio was additionally influenced by the path of social security contributions which follows the laws that govern the social security system resulting from unchanged legislation including the 'pension insurance sustainability law'. In the countries that implemented systemic reforms of pension systems, total revenues projections were adjusted for the expected dynamics in the pension contributions to the funded pillar (Latvia, Lithuania, Estonia), in order to ensure consistency with the public pension expenditure projections where such delimitation was made available. Changes in non age-related expenditures over time were incorporated only in the UK, as several transfer payments from government are indexed to inflation and should therefore fall in relation to GDP.

[91] In more practical terms, as an assumption during the calculation of the indicator, the interest rate-growth differential is positive.

Table II.6. Change of government expenditure on pensions over the period 2005-2050 (change in % of GDP)

	EPC 2001	2001 Update*	2002 Update	2003 Update	2004 Update	Diff. between 2004 update and EPC 2001
AT	2.5	0.7	1.8	0.4	-0.6	-3.1
BE	3.8	3.9	2.9	3.7	4.0	0.2
DE	5.5	4.8	5.4	3.9	2.7	-2.8
DK	2.0	1.9	2.5	2.3	3.0	1.0
EL	12.4	9.8	10.2	10.2	10.2	-2.2
ES	8.2	8.3	5.1	5.1	5.1	-3.1
FI	5.0	5.1	3.1	3.2	3.6	-1.4
FR**	3.6	3.6	3.6	2.2	2.2	-1.4
IE	4.5	4.5	3.9	3.8	3.8	-0.7
IT	0.3	-0.2	0.2	0.0	0.3	0.0
LU	1.9	:	1.9	1.9	1.9	0.0
NL	5.3	5.3	3.6	3.7	3.3	-2.0
PT	2.5	4.4	2.3	1.2		
SE	1.4	1.2	1.8	1.1	0.9	-0.5
UK	-0.9	-1.0	-0.2	0.3	0.6	1.5
EU-15	3.3	3.0	3.0	2.4	2.2	-1.1

* The starting year for EL, PT, and ES is 2000 instead of 2005
** The projections end in 2040
Sources: Economic Policy Committee (2001), Commission services' technical assessments of the Stability and Convergence Programmes, Commission services' calculations.

The *required primary balance, RPB*, is an indicator with a medium-term focus that has been introduced to translate the messages of the S2 indicator into requirements for medium-term policy-making. Calculated on the basis of the fulfilled sustainability condition for the indicator S2, the RPB indicates the average required primary balance to be maintained over the first five years of projections after the end of the programme period.

The time profile of the RPB is negatively correlated to the projected dynamics of the age-related expenditures. Given a previously set tax rate that would ensure sustainability and assuming an increasing path of the age-related expenditures, the RPB time profile will be downward sloping. The steeper the time profile, the higher the sustainability concerns arising from the population ageing. Thus, the change in the policy needs to be more substantial in the Member States that are projecting a higher increase of the age related expenditures in the period.

The evolution of sustainability indicators across different round of assessments

During the different round of assessments these indicators have developed over time to better summarise sustainability risks in the EU context. Table II.7 presents the methodological evolution of these indicators. In the first three rounds of assessments (from 2001 to 2003) the main indicator was the so-called T1 (in 2003 renamed S1), which was based on the SGP requirement of keeping a close-to-balance or in surplus budgetary position every year up to 2050.[92] Clearly, this indicator leads to a convergence toward zero of the debt-to-GDP ratio. Despite the fact that low levels of debt reduce vulnerability of public finances and risks of big policy changes to correct imbalances, a zero debt ratio may even be counterproductive.[93] Therefore, the policy advice derived from this indicator may imply a more restrictive budgetary policy relative to what would be needed to ensure sustainability over time.

In addition, this indicator would lead to a stricter policy than what is envisaged in the SGP, targeting a debt-to-GDP ratio clearly below the Maastricht ceiling of 60%. The debt ratio in 2050 according to the T1 indicator (S1 in 2003) was for all countries far below the Treaty threshold. In 2004 the AWG and the Commission therefore replaced this indicator by the new S1 which explicitly includes the reference value for debt in the long term.

[92] See European Commission (2002a) for an explanation of the T1 indicator.

[93] Bishop (2003) argues that government debt plays a role in determining the structure of interest rates and it is also a risk-free investment for families and pension funds.

Box II.5. Different measures of implicit liabilities

A key factor for governments' expected future expenditure commitments is the projected demographic change. In most Member States the old-age dependency ratio is projected to double over the coming decades (see e.g. Economic Policy Committee (2001), Heller (2004)). Implicit liabilities linked to the projected demographic change have therefore been given special attention and are an integral part of the EU's multilateral budgetary surveillance. However, countries also face other long-run budgetary risks, e.g. contingent liabilities in the form of bail-outs of insolvent companies, disaster relief or climate change. One possibility would thus be to add implicit liabilities to the explicit liabilities or debt (e.g. Wyplosz (2004)).

Pension debt arises in PAYG pension schemes when current liabilities are not met by current contributions. This could result from a rise in the old-age dependency ratio while at the same time contributions to and disbursements from the pension scheme are kept unchanged. Franco et al. (2005) distinguishes between three different definitions of pension liabilities: accrued-to-date liabilities include the present value of pensions to be paid in the future on the basis of accrued rights. Neither the future contributions of existing workers, nor their accrual of new rights are considered; current workers and pensioners' net liabilities also include the present value of both the future contributions of existing members and their new rights; open-system net liabilities also include the present value of future contributions and pensions of new workers under current rules. One can choose to include only children born, but not yet in the labour force or to use an infinite perspective. Among these three definitions, only accrued-to-date liabilities – or pension debt - could be linked to conventional explicit public debt. The other two definitions are only potential liabilities, while explicit debt is backward-looking.

There are several different possibilities to measure accrued implicit pension debt, ranging from leaving the SNA unchanged to including all unfunded pension obligations as liabilities. These issues are being discussed in the current review of the System of National Accounts (SNA) and the European System of Accounts (ESA)[94]. The latter approach could very significantly change the government finance position compared to the current methodology[95]. Moreover, there may be considerable measurement problems involved, such as delimitations of expenditure and revenue linked to pension obligations and its implications for discounting such future flows, which could compromise the reliability and usefulness of the government accounts. In this context it should be borne in mind that the multilateral budgetary surveillance in the EU, and in particular in the euro area, is based on the national accounts and the government finance statistics according to ESA. Changes in the compilation of government finance statistics might therefore require a review of the budgetary surveillance framework in the EU and in particular in the euro area.

In addition, pension debt is a rather different concept from conventional explicit debt: (i) the maturity and principal of pension debt is uncertain; (ii) pension rights are not always embodied in formal contracts; (iii) pension rights are not tradable and does therefore not exert any direct pressure from financial markets.

An alternative possibility to acquire estimates of pension debt in the SNA/ESA framework could be to introduce such estimates as a compulsory memorandum item or as specific satellite accounts. Such an approach would have the advantage of leaving the national accounts unchanged, while at the same time providing important additional information. In addition the measurement problems involved would be kept separate from the government accounts.

The Commission services' current approach to measuring implicit liabilities is to project expenditures over the long run, given a demographic scenario. This means a flow concept is used, instead of an estimate of the stock of implicit liabilities. This approach may be better suited to provide useful policy-relevant input for the purposes of assessing the fiscal position over the long-term. It takes the explicit debt and deficit situation of the country as the starting point and on the basis of the projected expenditures and revenues over the long run, extrapolates the evolution of deficit and debt for a given demographic scenario. In this sense, the analysis takes implicit liabilities into account from two strands: (i) the impact of accrued pension rights, as well as other welfare payments, or provisions and; (ii) the impact of projected future welfare payments. The Ageing Working Group attached to the Economic Policy Committee has stated a preference for the flow approach as measures of the stock of implicit pension liabilities, is (i) a narrower concept, as it does not include other age-related expenditure items and; (ii) is very sensitive to starting conditions and underlying assumptions[96].

Nevertheless, estimates of implicit pension liabilities, e.g. in the form of calculating these as memorandum items of satellite accounts in the SNA/ESA framework, can provide useful insights for other purposes. For example, it can be used to provide an estimate of shifting implicit liabilities to explicit liabilities. This would contribute to raise awareness of future fiscal obligations.

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[94] See the electronic discussion forum 'The Treatment of Pension Schemes in Macroeconomic Statistics' set up by the IMF at the request of the Intersecretariat Working Group on National Accounts (ISWGNA), http://www.imf.org/external/np/sta/ueps/index.htm.

[95] Boskin et al. (1987) notes that, referring to the USA 'Moving all of the economic and demographic projections from intermediate to optimistic or pessimistic [assumptions] results in a change which is larger than the privately held national debt.'

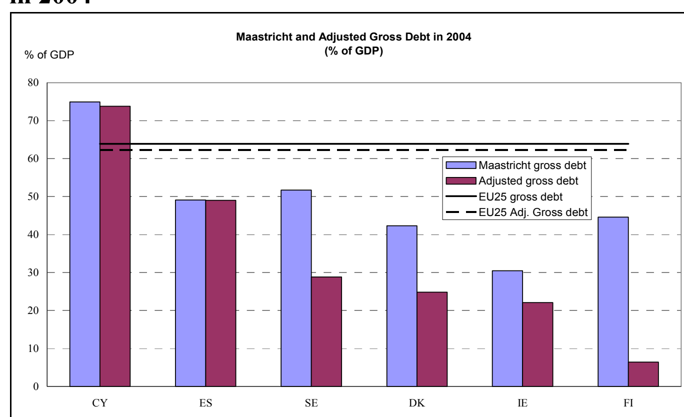
[96] Economic Policy Committee (2003).

Box II.6. The adjusted gross debt

Several Member States have established funds with a strict purpose of covering pension-related expenditure. Accumulating financial assets has a similar effect on sustainability as reducing debt. In the assessment round of the 2004/05 updated Stability and Convergence Programmes, the Commission services adjusted gross (i.e. Maastricht) debt by taking into account certain financial assets when assessing the sustainability of public finances. In order to make this adjustment, three issues need to be addressed; (i) which assets should be considered, (ii) which funds should be considered, and (iii) how to distinguish between national government bonds and other bonds.

In principle, all assets held by governments contribute to ease the pressure on the public finances in the longer term. For some financial assets, such as shares in non-floated public enterprises, it may not be straightforward to determine their current value or they may not be considered as liquid. This is one reason why the adjusted gross debt concept used does not include all assets. First, only currencies, deposits and tradable securities for which a market value can de determined are considered as liquid assets. Second, public *pension fund assets* that are established or legislated with a strict purpose of covering pension-related expenditure are included and not fund assets accumulated for other purposes. In principle, dedicated pension funds should not be used for any other purpose and therefore explicitly eases the budgetary impact of ageing. The sectoral delimitation within general government of pension fund assets is not uniform across Member States and a case-by-case approach was followed to include all the relevant assets. Third, in order to avoid double-counting, the consolidated financial balance sheets is used, in which national government bonds have already been netted out when calculating gross debt.

Graph II.17. Maastricht gross debt and adjusted gross debt in 2004



Source: 2004 updates of the Stability and Convergence Programmes.

Some countries have chosen to accumulate liquid assets in public pension funds, and for these this adjustment had a considerable impact (see Graph II.17). This is particularly true for Finland, Sweden and Denmark, where the accumulation of funds has taken place for many years. Other countries have started accumulating funds recently, and in the Spanish case the fund has only a small fraction in assets other than national government bonds, which are already netted out in the Maastricht gross debt measure. At the EU aggregate level the difference between the debt definitions are small, reflecting that asset accumulation predominantly takes place in small Member States. Maastricht gross debt in 2004 in EU-25 was 63.9% of GDP, dropping to 62.2% when looking at adjusted gross debt.

Looking ahead, a review of the concept of adjusted gross debt could be considered. First, Eurostat's decision of 2 March 2004 on the classification of pension schemes implies that funded defined contribution pension schemes should be classified outside government. The argument is that pensions to be paid depend on financial market developments (and on households' investment choices), not on government decisions. According to Eurostat's decision of 23 September 2004, Member States are required to implement this by March 2007 at the latest. In the Swedish and Danish cases this will in all likelihood involve a re-classification of a part of their funds outside government. This will imply an upward revision of both Maastricht and adjusted gross debt. The *public* pension projections would then, for reasons of consistency, need to be adjusted downwards. Second, all liquid assets for which a market value can be determined when making the adjustment could be considered. While public pension fund assets that are established or legislated with a strict purpose of covering pension-related expenditure explicitly eases the budgetary impact of ageing, assets accumulated for other purposes also contributes to reduce the net debt position. The issue of establishing a value would be feasible with the restrictions currently used, i.e. liquid assets for which a market value can be determined.

The 2002 assessment also included an indicator called T2 (see Table II.7 for an explanation). The experience showed that this indicator did not add additional information to the one already available with the other two indicators (renamed S1 and S2 in 2003). Thus, it has been decided to discontinue its use.

Three lessons may be derived from an evaluation of the use of the sustainability indicators:

First, there is a clear need to translate the results of the long-term indicators into short-term policy. The indication of a medium-term requirement to respect a sustainable path may help the conduct of economic policies.

Second, attention should be focused on the sign of the indicators and their magnitude, not the exact value. The sign gives information on whether a budgetary

consolidation is needed to cope with sustainability risks, while the magnitude indicates whether a budgetary consolidation is feasible or whether large structural reforms are indispensable.[97] The exact value of the indicator is clearly highly sensitive to the underlying debt projections and, for what concern the S2, to the applied discount factor.

Third, once correctly interpreted for their sign and magnitude and not for their exact value, the two long-term indicators S1 and S2 give broadly the same message. Currently, the sustainability analysis provided by the Commission presents six sustainability indicators for each country (S1, S2 and RPB, all under two different scenarios, cf. Section 4 of Part I). It may be considered whether a reduction of the indicators may increase clarity in the sustainability analysis.

Sensitivity tests

Debt developments are extrapolated up to 2050 under two different scenarios. Under a baseline or programme scenario, the starting position in terms of the underlying balance, level of debt, primary spending and tax revenues (all expressed as percentages of GDP) corresponds to the final year of the period covered by an update of the Stability or Convergence programme. In order to fully consider the impact of current budgetary policies on long-term sustainability, the underlying balance is calculated net of the cyclical component and one-off measures.

This baseline scenario assumes that Member States actually achieve the budget targets (for the final year) set in their programmes. However, such an outcome is by no means assured. In order to assess the importance of the medium-term consolidation process for the achievement of long-term sustainability, an alternative scenario is run. In this scenario debt levels are extrapolated for the period between the year in which the update was submitted and 2050, assuming that no budgetary consolidation is achieved. This means that the underlying primary balance in the last year of the programme period remains at the same level as in the starting year and no stock-flow operations take place.

In addition, a sensitivity test on interest rates has been introduced for both scenarios. This is done by running debt projections assuming an interest rate that is 50 basis points higher throughout the projection period.

Qualitative considerations

Most, but not all information regarding long-term sustainability of public finances can be quantified. Besides, the quantitative sustainability indicators should not be interpreted in a mechanical manner. Table II.8 above summarises the various types of qualitative information used by the Commission in reaching its policy recommendations. For example, several Member States are implementing structural reforms, in particular in the field of pension and health care. While this is reflected in the quantitative indicators through the country specific budgetary projections of age-related expenditures, qualitative information and analysis regarding the reform strategy and implementation should also be considered. In this context, the overall analysis is enriched with qualitative considerations, which include an assessment of relevant strategies/reforms and points to the risks that could jeopardise their implementation and therefore their projected benefits.

Such an approach also contributes to an evaluation of whether the government strategy is sufficient to achieve the medium-term policy objectives regarding government balances, debt and, where relevant, planned implementation of structural reforms. In addition it ensures continuity in the qualitative assessments of the strategy, and allows for a consistent and comprehensive analysis as regards the changes in quantitative indicators over time.

[97] Clearly, the feasibility of a fiscal adjustment depends on the initial level of revenues. Countries with a low level of revenue to GDP ratios may consider feasible to adjust on the revenue side because this may have a limited impact on the allocation of factors.

Table II.7. The evolution of the indicators in the Commission's sustainability analysis

2001	2002	2003	2004
T1 (the difference between the current tax ratio and the constant tax ratio required to reach the same debt level in 2050 that would result from a balanced budget position over the entire projection period)	T1 (same as T1 in 2001)	S1 (same as T1 in 2001 and 2002)	S1 (the difference between the current tax ratio and the constant tax ratio required to reach a debt to GDP ratio of 60% in 2050)
	T2 (the difference between the current and constant tax ratio required to reach a debt level of 40% of GDP in 2050)		
	T3 (the change in revenues to GDP ratio that would guarantee the respect of the intertemporal budget constraint)	S2 (same as T3 in 2002)	S2 (same as T3 in 2002)
			RPB (the average required primary balance in the first five years of projections needed to respect the intertemporal budget constraint)

Source: Commission services.

3.3 An EU wide perspective of long-term sustainability of public finances

Sustainability concerns differ widely across EU countries. Focussing on EU-15, graph II.2 plots debt dynamics in EU-15 from the mid-1970s onwards, including the projected path under the different rounds of assessments. It also plots the old-age dependency ratio over the same period (people aged 65 or more as a share of people aged 15-64). All variables are indexed (1977=100). As shown, from the mid-1970s to the mid-1990s, debt increased much faster than the old-age dependency ratio, suggesting that demographic change was not the main explanation for the increase in debt. In fact, the old-age dependency ratio increased by around 10% while the debt ratio increased by around 70% during that period. The debt ratio then declined somewhat in the run-up to joining the euro for most of the EU-15 countries. For the coming decades, debt dynamics are forecasted to be less pronounced than the old-age dependency ratio dynamics in the all the baseline scenarios. Debt dynamics are on the other hand more pronounced in the alternative scenario, in which the planned budgetary consolidation does not take place.

At country level, three main issues are relevant in the context of the results of the sustainability analysis:

1) Are public finances sustainable?

2) Do the budgetary measures in the programme improve sustainability?

3) What are the key policy challenges?

An overview of the assessments of sustainability for the EU-15 Member States across rounds is provided in Table II.9.[98] As can be seen, the assessments have shown a high degree of stability in the judgement across years for half of the EU-15 countries (i.e. Denmark, Greece, France, Ireland, Luxembourg, Finland and Sweden). In some of these countries reforms and/or a budgetary strategy to cope with budgetary pressures were implemented already several years ago, in others, such actions have yet to be taken.

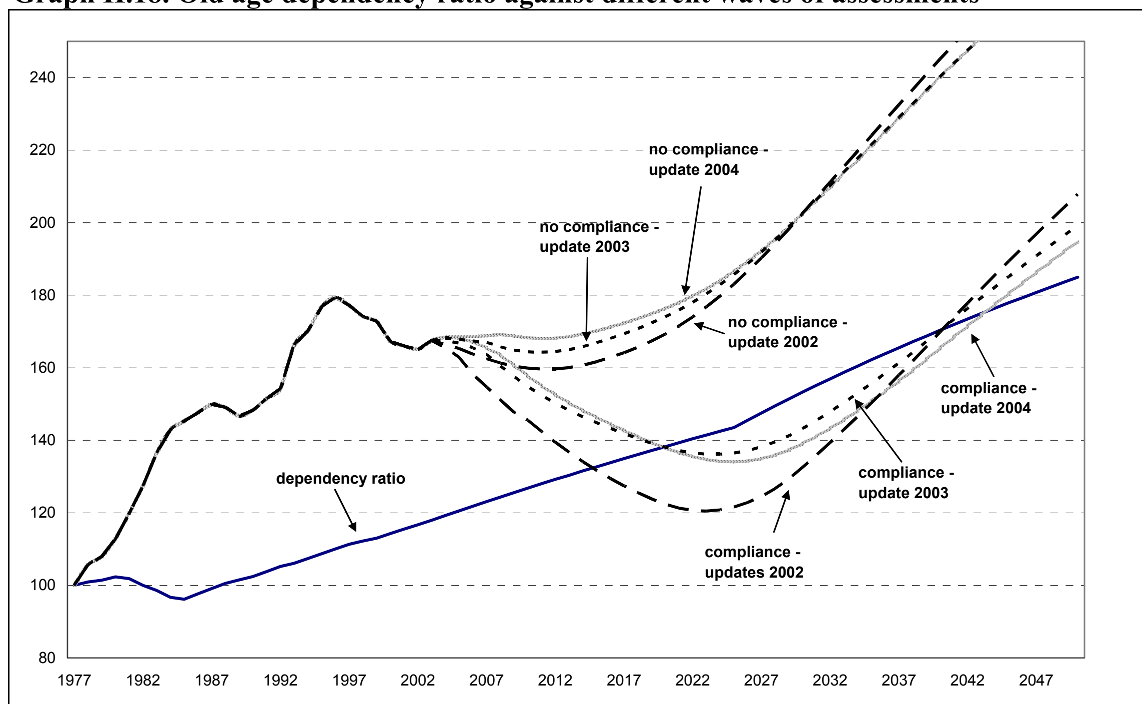
[98] With regard to the assessment of 2004 round of Stability and Convergence Programmes, these issues are analysed in section 4 of Part I of this report.

Table II.8. Qualitative factors taken on board by the Commission in reaching policy recommendations on the sustainability of public finances.

Area	*Specific issue*	*Concern about sustainability*	*Explanation*
Public debt	*High level of outstanding public debt well above 60% of GDP reference value*	*Increases*	Vulnerability to negative interest rate shocks, and a deterioration in the underlying budget balance could lead to a more rapid accumulation of public debt. A higher than average primary surplus required for several decades which in practice may be hard to achieve given competing budgetary pressures.
	Low debt levels	*Decreases*	Reverse of arguments above
	Debt increasing financial operations (e.g. contingent liabilities)	*Increases*	Large positive stock-flow adjustments linked to debt-increasing financial operations. Particularly relevant in MS where debt reduction is central to meet the budgetary costs of ageing.
Budget balance	*One-off budgetary operations*	*Increases*	Only a transitory improvement in the budget balance and debt reduction. Measures of structural nature required for a permanent improvement
	Contribution to pension reserve funds and other budget reserves	*Decreases if large but no effect if small*	Contributions to pension reserve fund may be recorded as current expenditure and thus increase the recorded deficit level hence, the positive contribution of contributions to pension reserve funds to the sustainability of public finances needs to be taken on board.
Robustness of age-related expenditure projections	*Sensitivity of projections to key parameters*	*Increases*	High sensitivity of results to demographic factors, indexation rules and numbers of cross-border workers. An appreciation of risk factors complements the analysis of projected changes in public expenditures but also
	Underlying assumptions	*Increases*	Earlier cut-off dates than 2050 may underestimate budgetary impact as effects of baby-boom generation on population size and age-structure may not have peaked. Projections in some cases are based on assumptions of large increase in labour force participation rates. While in line with the upper-limit of AWG, increases of this magnitude may require additional policy measures to be taken.
Tax ratio	*High tax ratio*	*Increases*	The viability and desirability of high tax ratios (e.g. above 50% of GDP) over long term may be affected by increased factor mobility affecting tax bases. Also, some governments have the stated objective of lowering the tax burden. The challenge is to do so while preserving sustainable public finance positions and adequate provision of public services.
	Low tax ratio	*Decreases*	Low tax ratio provides greater margin to raise taxes (if necessary) to meet increased age-related expenditures.
The impact of structural reforms	*Pension / health-care system reforms*	*Decreases*	Efficient, effective and streamlined pension and health care systems contribute to reduction of the budgetary risks.
	Risk of implicit contingent liabilities related to performance of private occupational schemes	*Increases* *Limited for now*	In some MS, the performance of overall pension system will be increasingly reliant on private occupational schemes and individual pension savings. Pressure for higher public spending could emerge (implicit contingent liability) if such schemes have insufficient coverage or fail to generate returns that secure an adequate level retirement income. In countries where success of reforms partially depends on an effective regulatory and fiscal framework for private occupational and individual pension schemes, and thus allow citizens to supplement their retirement income.

*Source:*Commission services based on Economic Policy Committee (2003)

Graph II.18. Old age dependency ratio against different waves of assessments



Source: Commission services.

In the other half of the countries, some improvement can also be observed.

Table II.9 essentially reflects the judgement of the Council expressed in its Opinion on the stability and convergence programmes. The Council opinion implies judgement on the likely future developments of the budgetary position of a country. It thus reflects both the current budgetary situation, and the overall framework including considerations on the evolution of this framework in the past and on its likely future developments, as based on legislated reforms.

Most countries have implemented strategies to deal with sustainability issues. Budgetary measures in the programmes presented in the last years tend to improve sustainability to a great extent. The tax reforms implemented in Germany (2001) and Italy (2004) are exceptions as their first-round effects are direct budgetary costs that deteriorate sustainability. This may be counteracted if the reforms entail higher potential growth over time.

Denmark, Finland and Sweden began to prepare for the impact of the ageing population earlier than other European countries. They have devised similar approaches to the ageing challenge. In order to ensure long-term sustainability and intergenerational fairness the governments have started to accumulate assets specifically allocated to finance future pension expenditure. These three countries also pursue similar attempts to shrink future public expenditure through streamlining of their social security systems (both pension and health care). This approach is likely to find followers from other Member States. For instance Belgium has adopted a law aiming to ensure sufficient attention to be paid to long-term sustainability when a government defines its fiscal policy. The same law has set up a fund, financed by means of budget surpluses, planned to help matching the increased expenditure on pension during the period 2010-2030. Already early in 1999, Ireland decided to reform its pension system in order to address the ageing challenge, and a National Pensions Reserve Fund was established. In 2004 a new regulation affecting the pensions of the public sector was introduced. Spain has or plans to set up different initiatives to face the challenge of the ageing population. Amongst them is the accumulation of assets in specific funds to be allocated to finance future public spending in pension, and the creation of a complementary pension scheme.

Not all Member States have pursued the strategy of setting apart specific assets in order to absorb the impact of the increased age-related expenditure. Germany pursues a comprehensive approach including reform of the social security system and reform to curb the health care costs. In addition reform of the labour market should help tackling the burden of the ageing population by increasing the employment rate and productivity. The Federal Ministry of Finance has announced its intention to submit a report on the long-term sustainability of public finances, in order to increase awareness and credibility of its commitment.

Table II.9. Assessment of the sustainability of public finances across the period 2001-2004.

	Are public finances sustainable?			
	2001	2002	2003	2004
BE	+	+	=	=
DK	+	+	+	+
DE	-	-	=	=
EL	-	-	-	-
ES	-	-	+	+
FR	-	-	-	-
IE	+	+	+	+
IT	-	-	-	=
LU	+	+	+	+
NL	+	+	=	+
AT	-	-	=	+
PT	-	-	=	
FI	+	+	+	+
SE	+	+	+	+
UK	+	+	=	+

Source: Commission services.
Ratings have been attributed as follows: + for ‘Appear to face limited risks’, = for ‘Risks cannot be rule out’, - for ‘Risk of emerging budgetary imbalances’.

This ‘Sustainability Report’ should present the most recent reform measures, set out the need for further action and identify starting points for prompt countermeasures both in fiscal policy (e.g. continued consolidation, greater emphasis on future-oriented tasks, subsidy cuts, sustainable tax policy) and in other areas such as the social security systems. The strategy of France is also based on a two pronged approach: (1) fiscal policy aimed at a reduction of the government debt thus lowering debt service charges; and (2) structural reform of the social security system (enacted in 2003 and planned to be reviewed in 2005) and of the health care system. The effectiveness of this approach has not been proved yet as many difficulties have been encountered in making the foreseen reforms operational. Italy’s approach aims to gain control of the two main age-related items. To ensure effective control of health care spending, the Government will fully implement the State-Regions Agreement, which calls for the stabilization of health care expenditure at six percent of GDP. Measures to this end are included in the Finance Bill for 2003. As for the social security system, pension reforms have been put in place (last one in 2004) aiming to curb the dynamics of the pension expenditure. Netherlands relies first of on reducing the level of government debt. However, this reduction has not taken place yet. In 2003 Austria adopted a pension system reform that will decrease the future burden on the government finances. Similarly advances towards improved sustainability are expected from higher rate of participation in the labour market in the next years.

United Kingdom seems to be in a very special situation as the ageing of the population will only have a feeble impact on the public finances. Together with the fact that the government gross debt is among the lowest in the EU, this places UK in a comfortable situation to face the ageing challenge. The British government has nevertheless not neglected the issue. Since 2002 it has produced a yearly ‘Long-Term Public Finance Report’ providing a comprehensive analysis of long-term economic and demographic developments, and their likely impact on the public finances.

On the other end of the scale, Greece still seems to be lacking a serious approach to the challenge of the ageing population. Reforms already enacted or even planned are clearly not sufficient to face the incoming burden.

The S2 indicator discussed above can be used to indicate whether budgetary strategies can be considered sufficient to ensure sustainability. The size of the indicator indicates the scale of the budgetary effort required. One can assume that a large permanent increase of the revenue-to-GDP ratio to ensure sustainability over time may prove to be unwarranted and unfeasible. In such cases, a broad-based approach based both on budgetary consolidation and reforms that aim at e.g. increasing labour force participation rates or reducing the dynamics of age-related expenditures is vital. For the 2004 assessment round, Table II.10 shows for which countries sustainability concerns may be tackled through a budgetary consolidation strategy solely and for which countries this seems unfeasible, given that the limit is set at two percentage points. To do so, the S2 indicator according to both the 2004-scenario of non-consolidation, and the baseline scenario of consolidation were used.

Table II.10. Assessing sustainability according to the S2 indicator, 2004 assessment round

	Small or negative S2	Positive but limited S2	Positive and high S2
2004 scenario*	BE, DK, EE, AT, FI	DE, ES, IE, HU, PL, SE	CZ, EL, FR, IT, CY, LV, LT, LU, MT, NL, SI, SK, UK
Baseline scenario**	BE, DK, DE, EE, IT, MT, AT, PL, FI	ES, IE, HU, NL, SE, UK	CZ, EL, FR, CY, LV, LT, LU, SK, SI

* no budgetary consolidation over the medium-term
** budgetary consolidation achieved as planned in the stability or convergence programme
Source: Commission services. Where applicable, the S2 indicator was calculated on the basis of adjusted gross debt.

Countries are divided into three categories[99]: (i) limited sustainability problems (S2 equal to 0.5 or less); (ii) a sustainability problem that can be tackled solely through budgetary consolidation (S2 between 0.5 and 2), and; (iii) cases where budgetary consolidation may be not sufficient (S2 higher than 2).

Table II.10 indicates that there could be sustainability risks in about half of the Member States in the 2004-scenario. Moreover, there could be sustainability risks in about a third of the Member States even if the planned budgetary consolidation in the medium-term is achieved. This suggests that in these cased more than a budgetary consolidation strategy might be required.

Even countries in the first to columns of Table II.10, should of course implement structural reforms if judged beneficial to the functioning of the economy at large. The grouping is purely meant to illustrate the size of the challenge to public finances.

It is important to recall that the purpose of debt extrapolation is to signal possible imbalances on the basis of current policies and projected age-related expenditure trends. However, being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of likely or even possible outcomes and should not be taken at face value. Instead, the indicators are a tool to facilitate policy debate and at best provide an indication of the timing and scale of emerging budgetary challenges that could occur on the basis of 'no policy change'. Qualitative considerations are therefore central in order to enrich the information provided by the sustainability indicators.

3.4 Are the results stable?

Sustainability indicators help in assessing budgetary risks over the long-term. They will change with major structural changes, such as shifts in demographic or macroeconomic trends or major reforms affecting government revenues and expenditures permanently. Relevant structural changes do not take place every year, thus in principle quantitative indicators of sustainability should be stable for several years.

The left hand side of Table II.11 shows the debt ratio in 2050 under the programme scenario. The last two columns show to which extent the outcomes are stable. Debt levels in 2050 are very different across different waves of assessments in most countries, in several cases the change is more than 100 percentage points of GDP from one year to the next.

Attempts to explain these differences need to distinguish between the sources from which they stem. A first explanation is methodological. Slightly different approaches have been used to determine the starting value of the primary balance. In the 2002 round of assessments the budgetary position of the last year of the programme was measured in nominal terms, implying that temporary budgetary effects due to the cycle or one-off measures were projected over the time. In the 2003 round the budgetary figures were corrected for the cycle, while in the 2004 round they were also corrected for the one-off measures reported in the updated programmes.

The importance of these differences can be illustrated by calculating the debt dynamics that one would have obtained under the 2002 round of assessment if the primary balance had been calculated in underlying terms as in the 2004 round.

The following step is to identify the main sources of the difference in debt dynamics once the same methodology is applied over the different rounds of assessment. To this end, it is useful to group the non-methodological factors in three different categories (see Graph II.19):

- The medium term scenario, i.e. the debt ratio and the underlying primary balance at the end of the programme period
- The long-term budgetary projections, in particular age-related expenditures (pensions, health care, long-term care, education and unemployment benefits)
- Elements that affect the long-term macroeconomic scenario, e.g. long-term economic growth, interest rates on public debt and the GDP deflator

[99] The values distinguishing these categories are arbitrary and are used as an illustration.

Table II.11. Projection of the debt level in 2050 in EU-15 across the long-term projection exercises on the basis of the programme scenario

	2002	2003	2004	2003 versus 2002	2004 versus 2003
BE	-108	-5	29	103	34
DK	-51	-35	18	16	53
DE	89	176	23	87	-153
EL	160	151	403	-9	252
ES	89	37	56	-52	19
FR	248	72	219	-176	147
IE	220	105	81	-115	-24
IT	-38	-28	-6	10	22
LU	51	1	74	-50	73
NL	99	140	154	41	14
AT	123	16	-19	-107	-35
PT	107	-42	181	-149	223
FI*	-39	6	-14	45	-20
SE*	-35	47	60	82	13
UK	78	139	90	61	-49

Source: Commission services.
* Government debt net of financial assets.

To calculate the relative contribution of each of these elements, the 2002 macroeconomic scenario, long-term budgetary projections and medium-term scenario (up to 2010) has been substituted one by one with the corresponding figures coming from the 2004 round of assessment. However, in the 2002 round long-term projections were based almost exclusively on information about pension and health care expenditure, while in the 2004 round information on education and unemployment benefit was also included. Therefore it is not possible to apply the different dynamics to each single item of the overall age related expenditure. The dynamics of the overall total age-related expenditure of 2004 have thus been applied to the 2002 exercise.

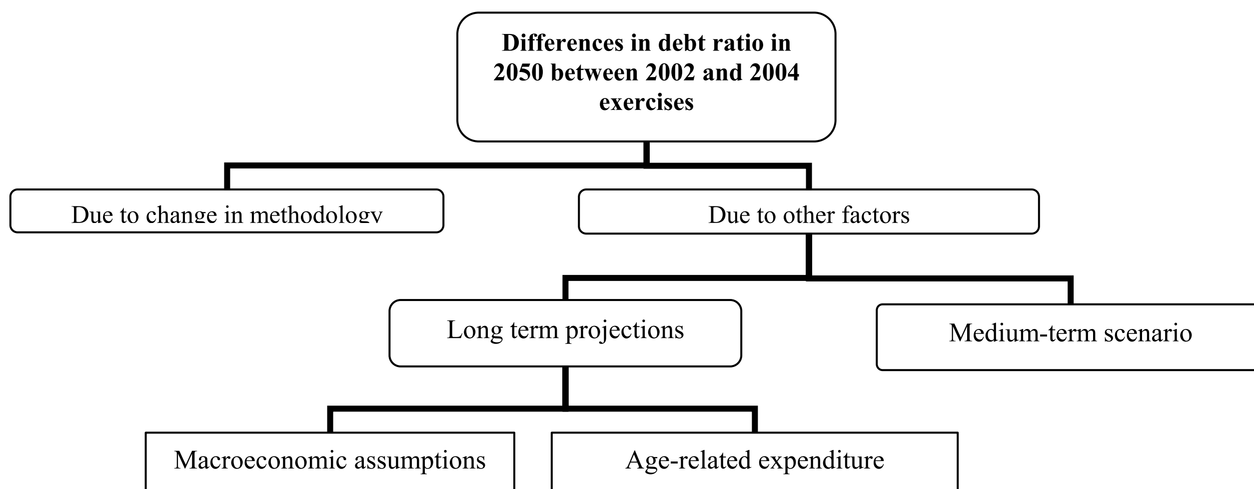
Changes due to new macroeconomic scenarios are in general minimal, underlying that the scenario set up by the Economic Policy Committee in 2001 has remained fairly stable and has been widely used by Member States in evaluating long-term budgetary trends (see interest rate-growth differential in Graph II.20). Most of the gap is instead due to either revisions in the age-related expenditure projections or different medium-term outcomes. Revisions of the age-related expenditure projections have contributed negatively in more than half of the countries, with Germany and Austria as the most notable exceptions.

However, a significant role is also played by the medium-term scenario. In the majority of the EU-15 countries the medium-term scenario has been revised downwards, showing a lower primary surplus (or a higher primary deficit) in 2004 than planned two years earlier. This revision leads to unstable debt projections since debt dynamics are greatly influenced by the structural primary balance in the medium-term. It seems that the Stability and Convergence Programmes of most countries tend to overestimate their structural balance in the medium-term. Since projections are based on the medium-term scenario provided by the Member State in its programme, this reduces the stability of the long-term debt projections.

At country level the decomposition shows some interesting features. For instance no reforms have been adopted in Greece between 2002 and 2004 and a worsening of the short-to-medium term budgetary position has thus lead to a considerable worsening of its long-term sustainability position. In France the worsening over the assessments is mainly due to the long-term age related expenditure. These results are quite surprising considering the France adopted a pension reform in 2003 that according to the more recent estimate should bring savings amounting to at least 1% of GDP. The explanation can be found in Table II.12: an increase in health-care and long-term care expenditures more than offsets the benefits of the pension reform.[100] In Table II.12, projected expenditure in 2050 on health-care and long-term care expenditure are reported together, for simplicity. It should however be noted that they are distinct separate expenditure items and that a country with a possible need to reform their health-care system does not necessarily need to reform their long-term care system.

[100] It should be noted that in the 2004 update of the French stability programme, an improved, broadened estimate of health-care expenditures were provided. Therefore, despite a health-care reform in 2004 in France, health-care spending rises more up to 2040 according to the 2004 update compared with the 2003 update.

Graph II.19. Analysis of the source of the difference in long-term debt dynamic indicator



Source: Commission services.

In the case of Italy, Graph II.20 shows a positive contribution of the revision of age-related expenditure projections despite the fact that both pension and health care expenditures have been revised upwards. The likely explanation lays on the particular structure of the pension reform in Italy, where saving are foreseen in between the time of the application and 2050, while at around 2050 the pension expenditure should be higher than prior to the reform.[101]

3.5 Possible avenues for improving the assessment of long-term public finance sustainability

As noted above, remarkable progress has been made in the EU over the last few years in terms of sustainability analysis. The Commission, the AWG and the EPC have gained considerable experience in terms of long-term budgetary projections and the analysis of the sustainability of public finances. The quantitative indicators have been improved and greater effort has been made to incorporate qualitative considerations in a systematic manner in order to enrich the sustainability assessment. This has successfully contributed to an increased policy focus on safeguarding the sustainability of public finances.

However, the assessment of sustainability could be further developed through a more in-depth analysis of the different sustainability risks.

3.5.1 Comparable budgetary projections

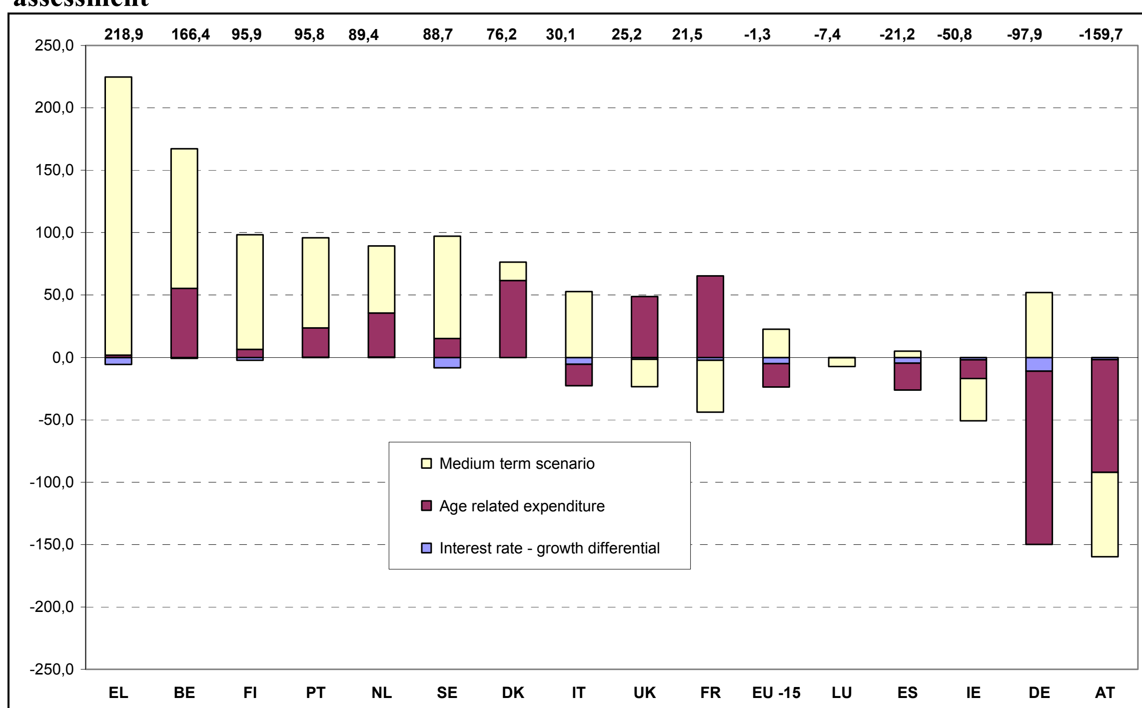
In order to have a comparable view of the long-term budgetary trends across EU Member States, it is crucial that they have been calculated on the basis of commonly agreed coverage, methodology and underlying assumptions. Furthermore, information on how the long-term budgetary trends are affected by changes in the underlying assumptions provides valuable insights on their sensitivity.

Based on the results of the common budgetary projection exercise expected to be finalised at the end of 2005, a comprehensive assessment of sustainability could be made. Such an analysis concerning long-term issues should remain valid for some time. This may imply an in–depth assessment every 3 years.

At the same time, an annual update of the assessment in the context of the stability and convergence programmes may consider possible new information available and the impact of short- to medium term budgetary developments on sustainability.

[101] From the 2004 Update of the Stability programme of Italy: 'Compared to the previous 2003 Update (which did not take into consideration the effects of the recently approved reform), the current projections of pension expenditure as a percentage of GDP will be significantly lower for about a thirty-year period starting from 2009, with a saving of around 0.7 percentage points from 2012 to 2020 and 0.6 from 2020 to 2035. Then, until the end of the forecast period, the expenditure to GDP ratio will be 0.3 percentage points higher than that presented in the 2003 Stability Programme Update'.

Graph II.20. Graphic illustration of the difference in the debt ratio in 2050 across waves of assessment



Source: Commission services.

Table II.12. Comparison of 2050 pension and health care expenditure according to 2002 and 2004 update of the Stability and Convergence programme

	Pension expenditure		Health and long-term care expenditure	
	2002 Update	**2004 Update**	**2002 Update**	**2004 Update**
BE	11.4	13.0	8.2	10.6
DK	7.2	7.8	9.3	11.0
DE	14.9	13.8	7.1	9.5
EL	22.6	22.6	6.6	6.6
ES	13.0	13.0	n.a.	7.2
FR	15.8	14.5	8.9	12.6
IE	7.7	7.7	7.8	7.8
IT	14.1	14.4	7.6	8.1
LU	9.3	9.3	n.a.	n.a.
NL	13.6	8.3	10.4	10.7
AT	16.4	13.6	7.9	7.9
PT	15.3		n.a.	
FI	14.4	15.2	9.1	13.4
SE	10.9	9.4	14.4	13.1
UK	4.8	5.5	9.8	10.9

Source: Commission services..

3.5.2 A comprehensive assessment of possible risks to sustainability

The sustainability analysis based on debt projections over the long-term would benefit from additional sensitivity tests in order to better highlight policy challenges that a country may be facing.

In addition to the currently used budgetary 'non-consolidation' scenario, the impact of modifying long-term macro-economic assumptions (e.g. long-term growth, employment, productivity) as well as budgetary projections (e.g. age-related expenditures) could add important insights into possible sustainability risks.

3.5.3 Assessing the impact of structural reforms

A distinction needs to be made between reforms that improve public finances by affecting directly the current

and future stream of government revenues and expenditures (e.g. pension reforms) and those reforms whose impact on public finances in mainly indirect, via improved potential output.

The distinction between reforms having mainly a direct or indirect impact on public finances is crucial with regard to the methodological approach for their quantitative assessment. The assessment of the long-term public finance impact of reforms directly affecting revenues or expenditures may involve updating revenue or expenditure projections on the basis of the new policies. However, when reforms mostly have an indirect impact it is also necessary to have at hand modelling techniques that permit to link the policy change to the determinants of potential output.

Better knowledge on the impact of reforms with a direct budgetary impact on public finances, notably pension reforms but also health care reforms, can be obtained by performing simulations with national models and a process of peer review by the AWG. This would increase transparency of how the projections are made. In this way, consistency across Member States in terms of underlying assumptions would be ensured while at the same time the most recent reform measures would be taken into consideration in the peer review by the AWG and in the assessment sustainability of public finances by the Commission and the Council.

3.5.4 Sustainability considerations in the definition of budgetary medium-term objectives

The 20 March 2005 ECOFIN Council emphasised in its report that that the Stability and Growth Pact should place increased focus on safeguarding the sustainability of public finances. To this end, the budgetary consequences in light of ageing populations should be taken into account when specifying the MTO for the Member States' budgetary position, as soon as the criteria and modalities for doing so are appropriately established and agreed by the Council.

While it is premature to point to specific criteria and modalities at this stage, some broad characteristics of how sustainability risks to public finances could be taken into account in the context of defining the MTO may be identified.

First, the method should consider the risks to public finance sustainability over the long-term. This implies that future projected developments on both the expenditure and the revenue side should be taken into account, as the overall budgetary position affects the debt position over the long-term.

Second, the method should lead to a stable solution so that risks to the sustainability of public finances are not unduly influenced by factors that can be expected to have a non-lasting impact on the public finances or that they are surrounded by a high degree of uncertainty. To this end, sensitivity tests provide valuable information on how changes in assumptions, including changes due to implemented reform measures, impacts on possible risks to sustainability of the public finances.

Third, the method should be transparent and simple so as to facilitate a broad understanding. In this regard, basing the analysis of risks to the sustainability of public finances on information which have been compiled in a transparent and comparable way across the Member States and conducting and using this analysis according to a transparent and clearly defined method will lead to greater acceptability and enforceability.

These very broad considerations will be duly explored further and the Commission will prepare a report to the Council on progress made in view of preparing a methodology for incorporating the sustainability of the public finances into the medium-term objective before the end of 2006.

3.6 Conclusions

The sustainability analysis conducted by the European Commission during the last years has demonstrated that this is a multifaceted issue that needs several indicators and a lot of qualitative judgement. The experience showed some drawbacks with the current approach. First, common budgetary projections are only available every 3-4 years. The previous projections were published in October 2001 and the new projections will be ready by the end of 2005. In between, Member States have updated their projections as e.g. new national demographic projections were available or reforms with an impact on long-term budgetary trends have been implemented. On the one hand, national projections may have the advantage of being more up to date. On the other hand, they may not be fully comparable across countries in terms of the underlying assumptions, which is vital for the purposes of budgetary surveillance in the EU. Second, the annual assessment of the SCPs has a constraint in terms timing and space. Very few sensitivity tests are used and the richness of the analysis is therefore limited. This has raised some criticisms and the issue of a possible need of a more in-depth assessment of underlying risks to the sustainability of public finances.

The experience so far demonstrates the importance of having a comprehensive sustainability analysis to guide policy makers in the conduct of their budgetary policies and to pursue structural reforms. A comprehensive analysis of the sustainability should have the following elements:

Comparable budgetary projections. At EU level, a reliable and comparable budgetary projection exercise is made every three to four years by the Council committees (the AWG/EPC) and the Commission.

This exercise uses common methodologies, agreed macroeconomic assumptions and agreed demographic

projections. This makes projections comparable across countries and sufficiently transparent to gauge sustainability risks on the basis of such projections. However, common projections do not take place every year. To this end, possible new information may be considered in the context of the annual stability and convergence programmes.

A comprehensive assessment of possible risks to sustainability. The analysis of possible risks to sustainability cannot be summarised in a single number; several indicators are necessary to support the judgement. Sensitivity tests around a baseline scenario may help in assessing the robustness of the main results to different hypothesis.

The sensitivity tests developed by the Commission and the AWG provide insights into risks associated with different scenarios. However, a more comprehensive analysis may improve the capacity to gauge sustainability.[102]

Assessing the impact of structural reforms. Assessing risks to long-term budgetary projections involves formulating a view of the probability that a certain outcome will actually materialise.

In addition, expenditure projections are also affected by the future impact of structural reforms currently under way. Better knowledge on the impact of reforms with a direct budgetary impact on public finances, notably pension reforms but also health care reforms, can be obtained by performing simulations with national models and a process of peer review by the AWG.

This would increase transparency of how the projections are made. Such an assessment requires detailed knowledge of the institutional functioning of the economy, not least with regard to the pension systems, and would benefit from a close involvement of national experts in the relevant Council committees.

Such a revised analysis would better serve the purpose of increasing the focus on sustainability concerns and it could also increase the consistency between medium-term budgetary strategies and longer-term sustainability concerns.

[102] To give an example, the UK report on long-term sustainability produced by the HM Treasury is around 60 pages. Also in Sweden (The 2003/2004 Long term survey) and in Denmark (the Welfare Commission) comprehensive studies on long-term sustainability have been prepared recently.