

Box 7

THE FISCAL POLICY REQUIREMENTS OF THE TREATY ESTABLISHING THE EUROPEAN COMMUNITY AND THE STABILITY AND GROWTH PACT

Member States' stability programmes must be assessed against the fiscal policy requirements of the Treaty establishing the European Community (hereafter "the Treaty") and the Stability and Growth Pact. This box provides a summary of the principal requirements.

1. *The avoidance – or timely correction – of excessive deficits.* Article 104(1) of the Treaty requires that Member States avoid excessive government deficits. The question of whether

or not a deficit is excessive is assessed in terms of deficit and debt ratios, for which the reference values of 3% and 60% of GDP respectively apply. If a deficit is deemed to be excessive, the EU Council (ECOFIN) issues a recommendation for corrective action to the Member State concerned; if the Member State fails to comply, the Council will then issue a notice. In its recommendation (or its notice), the Council establishes a deadline for the correction of the excessive deficit. To this end, the Member State is normally requested to achieve an annual improvement of at least 0.5% of GDP in its cyclically adjusted budget balance net of one-off and other temporary measures. Where appropriate, the required adjustment may be considerably more than this.

2. *The medium-term budgetary objective.* Under the revised Pact agreed in March 2005, each Member State sets its own medium-term objective for its budgetary position, expressed in cyclically adjusted terms net of one-off and other temporary measures. The medium-term objective should aim to: i) provide a safety margin with regard to the reference value of 3% of GDP for the deficit ratio; ii) ensure rapid progress towards sustainable public finances; and iii) without prejudice to those first two objectives, allow room for budgetary manoeuvre, taking account of the need for public investment. In the case of Member States that have adopted the euro (and also Member States participating in ERM II), medium-term objectives should lie within a range of between -1% of GDP and “in balance or surplus”. These objectives should be set taking particular account of a Member State’s debt-to-GDP ratio and potential growth (i.e. medium-term objectives should be more ambitious for countries with higher debt ratios and lower potential growth). The intention is also that implicit liabilities (relating to increasing public expenditure in the light of ageing populations) should be taken into account as soon as appropriate criteria and modalities for doing so have been agreed by the ECOFIN Council.
3. *The adjustment path towards the medium-term objective.* Member States that have not yet achieved their medium-term objectives are required to take steps to do so over the cycle. As a benchmark, Member States should pursue an annual improvement in their cyclically adjusted budget balance – net of one-off and other temporary measures – of 0.5% of GDP. The adjustment effort should be higher in good times, but can be more limited in bad times. Temporary deviations from the medium-term objective and from the adjustment path may be permitted in order to help finance major structural reforms that have a positive and verifiable impact on the long-term sustainability of public finances.