Summary

The Stability and Growth Pact is a mechanism of fiscal policy co-ordination in the EU. It was adopted in 1997, before the EMU was launched, when the need for co-ordinated macroeconomic policies had grown as a result of the creation of a common currency area. The application of strict fiscal rules, given the spillover effects of fiscal policy measures, contributes to the price stability of a monetary union and prevents macroeconomic destabilisation in a single-currency area and is therefore economically justified. The provisions of the Stability and Growth Pact can be roughly divided into two parts: first, the preventive system, which serves to identify the risks of member countries running excessive deficits by means of stability and convergence programmes and to take the necessary steps aimed at avoiding excessive deficit levels; and second, the corrective arm, which lays down the procedures for eliminating excessive deficits, including sanctions for offending member states.

The deterioration of the EMU member countries' fiscal positions seen in the first four years after the launch of the Stability and Growth Pact and the excessive deficits recorded in three member countries in 2001 and 2002 signalled that the provisions of the Stability and Growth Pact were not being adhered to effectively. In order to reinforce the Pact, the EC adopted the Communication from the Commission to the Council and the European Parliament on Strengthening the Co-ordination of Budgetary Policies in November 2002. The document outlined proposals aimed at improving the implementation of the Stability and Growth Pact, including the application of a safety margin in estimating the level of government deficits, and stressed the importance of fiscal policy co-ordination mechanisms to ensure growth and employment in line with the Lisbon Strategy and the need to maintain sustainable fiscal positions and uphold the role of fiscal policy in addressing the issue of population ageing.

The repeated breaches of the Stability and Growth Pact along with the EU's enlargement in May 2004, which created an even more heterogeneous Union, increasingly revealed that the Stability and Growth Pact was in need of a thorough reform in order to improve the efficiency of fiscal policy co-ordination in the EU. The Communication from the Commission to the Council and the European Parliament on Strengthening Economic Governance and Clarifying the Implementation of the Stability and Growth Pact (September 2004) was the first step in this direction. Subsequently, the Stability and Growth Pact reform was formally launched in 2005. It is based on a report of the Council of the European Union entitled *Improving the Implementation of the Stability and Growth Pact*, which was formally adopted by the European Council in March 2005. The legal basis for the Stability and Growth Pact reform was provided by the adoption of Council Regulation (EC) No. 1055/2005 and Council Regulation (EC) No. 1056/2005 that entered into force in July 2005. The reform of the Stability and Growth Pact followed up the proposals of the September 2004 Commission Communication and focused on five main areas: (i) enhancing the economic rationale for fiscal rules; (ii) strengthening the national economic policy-makers' commitment to the common fiscal rules; (iii) ensuring faster fiscal consolidation in 'good times' and preventing pro-cyclical fiscal policies of member states; (iv) taking better account in the surveillance of budgetary positions of periods when economies are growing below trend; and (v) placing more attention in the surveillance of budgetary positions on government debt levels and public finance sustainability. In order to ensure the delivery of some of the proposed solutions, the *Code of conduct on the content* *and format of the stability and convergence programmes* was adopted in 2005, setting out more detailed guidelines and clarifications regarding the implementation of the new Stability and Growth Pact.

The Stability and Growth Pact reform has been a positive step towards rectifying the shortcomings of the original Stability and Growth Pact, achieved notably through a stronger focus on government debt and country-specific economic circumstances in the member states. An analysis of EU fiscal rules against the Kopits-Symanski criteria shows that the Stability and Growth Pact reform has brought positive changes in the fiscal rules interpretation criteria of consistency, transparency, adequacy and flexibility, albeit at the expense of their simplicity. The analysis also showed that room for improvement still exists in nearly all of the criteria. The enforceability of sanctions, which is primarily a political issue, remains the main problem of the current system. Apart from that, the rules have become increasingly complex, challenging the Commission and the Council with the difficult task of assessing (non-) adherence to the new Stability and Growth Pact rules consistently and objectively.

Key words: public finances, fiscal rules, Stability and Growth Pact, government debt, public debt, EU, EMU