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**Interpreting the Close to Balance  
Provision of the Stability and  
Growth Pact:  
Legal and Conceptual Aspects**

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## **1. Introduction**

The Stability and Growth Pact provides a mutually agreed code of conduct on how fiscal policy should be framed and practiced in member states from the onset of Stage III of EMU. National fiscal authorities must ensure that fiscal performance meets the requirements of the Pact. There are other organisations, such as the European Commission and the ESCB, whose task it is to assess member states' compliance with the Pact. It is important, therefore, that the Pact's specific provisions are examined in some detail in order to ascertain what the Pact requires of member states.

It is particularly important that the so-called "close to balance or in surplus" provision of the Pact (hereafter, for simplicity, referred to as the close to balance provision) is analysed and understood. In, perhaps, its most commonly quoted form, this provision stipulates that "adherence to the medium-term objective of budgetary positions close to balance or in surplus will allow member states to deal with normal cyclical fluctuations while keeping the government deficit within the 3 per cent of GDP reference value."<sup>1</sup> The importance of the provision is stressed in the recital: "firm political guidelines are issued in order to implement the Stability and Growth Pact in a strict and timely manner and in particular to adhere to the medium term objective of budgetary positions of close to balance or in surplus."

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<sup>1</sup> from the recital to Council Regulation (EC) No 1466/97 of 7 July 1997.

In spite of its prominence and critical role in the Pact, there is a vagueness surrounding the close to balance provision. There is no clearcut definition in the Pact of either of the key terms “medium-term” and “close to balance or in surplus”. The purpose of this paper is to interpret the close to balance provision and discern what it requires of member states in the setting of medium-term budgetary targets.

In section 2, the background to the adoption of the Pact and the close to balance provision is discussed. The Pact comprises a Resolution of the European Council of 16/17 June 1997 and two Council Regulations of 7 July 1997 (published on 2 August 1997). These provide a natural starting point for examining the detail and implications of the close to balance provision. The two Regulations and the Resolution, along with an agreed code of conduct on the content and format of stability and convergence programmes (Opinion of the Monetary Committee (16 September 1998) which was endorsed by the Council (12 October 1998)), are examined in section 3.

The key terms of “close to balance or in surplus” and “medium term” are each examined in turn in section 4. It is suggested that two safety margins – a minimum safety margin and a safety margin for long-term factors (of which the former is the more fundamental requirement) - should be calculated in assessing budgetary positions close to balance or in surplus. Section 5 concludes.

## **2. The Background to the Close to Balance Provision**

### **(i) Fiscal Policy in Monetary Union**

When assessing the role of fiscal policy in monetary union, a certain tension exists between maintaining fiscal discipline and allowing member states a degree of fiscal flexibility (see Buti et al).<sup>2</sup> The need to maintain fiscal discipline to complement the operation of monetary policy in EMU has long been stressed within the EU. In EMU, monetary policy is formulated at the euro-area level and its prime objective is to maintain price stability within the euro-area as a whole. Fiscal policy, however, continues to remain within the remit of national governments. An associated danger is that, in the absence of some external or commonly-agreed constraint, national authorities may pursue loose fiscal policies that taken together may threaten the monetary policy aim of maintaining price stability within the euro-area. For this reason, imposing discipline on the exercising of national fiscal policies within monetary union has generally been considered desirable.

At the same time, it has also been recognised that a degree of flexibility in fiscal management needs to be afforded to member states. With monetary policy being set at the euro-area level and being geared towards euro-area policy objectives, fiscal policy remains the sole macroeconomic policy instrument

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<sup>2</sup> Buti M., D. Franco and H. Ongena (1998), "Fiscal Discipline and Flexibility in EMU: The Implementation of the Stability and Growth Pact", *Oxford Review of Economic Policy*, 14, 3, pp. 81-97.

available for management of domestic economic conditions. Given that the common monetary policy stance might not be ideal at times for individual member states, fiscal policy could compensate for this by being utilised by member states in a manner which helped stabilise domestic aggregate demand growth.

While recognising this tension between discipline and flexibility, it has generally been considered to be of paramount importance that fiscal policy does not jeopardise the credibility of monetary policy in EMU. Consequently, when drawing up the fiscal rules to which EU member states must adhere, it was considered necessary to impose some form of constraint on national fiscal policies within monetary union. The Stability and Growth Pact was adopted by the European Council in 1997 with the purpose of ensuring fiscal discipline in monetary union. It followed the initial fiscal rules laid down in the Maastricht Treaty in 1992 and a proposal for a “Stability Pact for Europe” put forward by the German finance minister, Theo Waigel, in November 1995.

## **(ii) The Maastricht Treaty**

The need for fiscal discipline in EU member states prior to and within monetary union was first encapsulated in the Maastricht Treaty (1992). Article 104c of the Treaty states that “Member States shall avoid excessive government deficits”. Budgetary discipline is examined on the basis of:

(a) whether the government deficit exceeds a reference value (specified, in the Protocol on the excessive deficit procedure annexed to the Treaty, as being equal to 3 per cent for the ratio of the planned or actual government deficit to gross domestic product at market prices), unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

and

(b) whether the ratio of government debt to gross domestic product exceeds a reference value (specified in the Protocol as being equal to 60 per cent), unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The Treaty empowers the Commission to prepare a report if a member state does not fulfil the requirements under one or both of these criteria. It may also prepare a report if it is of the opinion that there is a risk of an excessive deficit in a member state. If it considers that an excessive deficit in a member state exists or may occur, the Commission addresses an opinion to the Council. In turn, the Council decides, after an overall assessment, whether an excessive deficit exists. If an excessive deficit is decided to exist, the Council will make recommendations to the member state concerned with a view to bringing that situation to an end within a given period. The member state then must put into practice the recommendations of the Council. If the member state fails to implement these recommendations, the Council may decide to apply one or more of a number of measures. Among the measures available are requiring the member state to make a non-interest-bearing deposit “of an appropriate size” with the Community until the

excessive deficit has, in the view of the Council, been corrected and imposing fines “of an appropriate size”.

### **(iii) The Waigel Proposal**

In November 1995, the German finance minister, Theo Waigel, proposed a “Stability Pact for Europe” to strengthen and to complement the Treaty’s fiscal performance criteria. The salient features of the Waigel proposal were:

- setting a medium-term deficit goal of 1 per cent of GDP in ‘normal’ economic conditions;
- allowing exceptions to the observance of the 3 per cent deficit limit only in exceptional circumstances such as an annual fall in real GDP of at least 2 per cent or a decrease in GDP for four quarters in a row;
- reducing progressively debt levels below the 60 per cent of GDP level indicated in the Treaty.

The Waigel proposal also sought to strengthen the excessive deficit procedure by putting certain arrangements on an automatic footing. A member state would be automatically in breach of its obligations if the government deficit exceeded 3 per cent of GDP, except in the exceptional circumstances outlined above. The pecuniary sanctions for a breach of the 3 per cent threshold would also be put on an automatic footing with non-interest-bearing deposits of 0.25 per cent being required for each point or fraction of a point by which the deficit exceeded the 3 per cent of GDP level. The deposit would be transformed into a fine if the excessive deficit remained two years later.



#### **(iv) The Stability and Growth Pact**

A number of the provisions of the Waigel proposal were not included in the Stability and Growth Pact adopted in 1997. The constraint on the government debt was discarded, the uniform medium-target for the deficit of 1 per cent was deemed not to take sufficient account of country-specific requirements and was considered neither necessary nor sufficient to guarantee respect of the 3 per cent of GDP ceiling, the “exceptionality” clause was considered too restrictive, and the automaticity of sanctions was deemed to go beyond the provisions of the Treaty, which left a degree of discretion to the European Commission and the Ecofin Council in this respect.<sup>3</sup>

The Pact, adopted by the European Council in Amsterdam in June 1997, comprised a Resolution of the European Council on the Stability and Growth Pact (16/17 June 1997), Council Regulation (No. 1466/97 of 7 July 1997) on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, and Council Regulation (No. 1467/97 of 7 July 1997) on speeding up and clarifying the implementation of the excessive deficit procedure. The Regulations entered into force on 1 July 1998 and 1 January 1999, respectively.

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<sup>3</sup> For more detail on the Waigel proposal and the reasons why a number of its provisions were not retained see Buti et al, *op. cit.*, pp, 83-4.

The recitals to the Regulations convey the intention of the Pact. Sound government finances are “a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.” As a means to achieving this goal, member states are expected to adhere to the medium-term objective of budgetary positions close to balance or in surplus.

Council Regulation No. 1466/97 requires member states to present stability programmes (for member states which have adopted the single currency) and convergence programmes (for member states which have not adopted the single currency) on a periodic basis that, inter alia, present the medium-term objective for the budgetary position of close to balance or in surplus and the adjustment path towards this objective for the general government balance. Based on assessments by the Commission and the Economic and Financial Committee, the Council shall examine whether the measures being taken and or proposed are sufficient to achieve the targeted adjustment path towards the medium-term budgetary objective.

The Council is required to deliver an opinion on each programme. If it considers that the objectives and contents of a programme should be strengthened, the Council will ask the member state concerned to adjust its programme in this respect. The Council is also required to monitor the implementation of both stability programmes and convergence programmes with a view to identifying actual or significant divergence of the

budgetary position from the medium-term budgetary objective, or the adjustment path towards it, as set out in the programme. If it identifies such occurrences, the Council is required to issue a recommendation to the member state concerned to take the necessary adjustment measures. If these divergences from the medium-term budgetary objective persist or worsen, the Council makes a recommendation to the member state to take prompt corrective measures and may make its recommendation public.

The second Regulation, No. 1467/97, clarifies the implementation of the excessive deficit procedure. The excess of a government deficit over the 3 per cent reference value resulting from a severe economic downturn shall be considered to be exceptional only if there is an annual fall of real GDP of at least 2 per cent. However, the Council is obliged to take into account any observations made by the member state concerned that show that an annual fall of real GDP of less than 2 per cent is nevertheless exceptional in the light of further supporting evidence, in particular “on the abruptness of the downturn or on the accumulated loss of output relative to past trends”.

The Regulation also clarifies the speed at which the excessive deficit procedure is implemented. It, for example, establishes a deadline of four months at the most for effective action to be taken by a member state against whom an excessive deficit finding has been made. Finally, the Regulation outlines the sanctions applicable to a finding of an excessive deficit. A non-interest-bearing deposit is to be taken where non-

compliance with the deficit criterion arises. The deposit comprises a fixed component equal to 0.2 per cent of GDP, and a variable component equal to one-tenth of the difference between the deficit as a percentage of GDP in the preceding year and the reference value of 3 per cent of GDP. Any single deposit taken, however, would not exceed 0.5 per cent of GDP. A deposit is to be converted into a fine after two years if the excessive deficit persists.

#### **(v) Fiscal Policy in EMU: The Importance of the Close to Balance Provision**

Article 104c of the Treaty and the subsequent Stability and Growth Pact constitute important steps in helping to define rules for governing fiscal behaviour within EMU. While the Pact has clarified many of the important aspects of the excessive deficit procedure, there are still a number of issues and anomalies that remain with regard to the fiscal rules agreed for EMU.

One commonly-noted issue remaining unclarified by the Pact is whether an excessive deficit would be declared in circumstances where the debt level rose from or to a level above the 60 per cent reference level even though the deficit remained below the 3 per cent benchmark (see Balassone and Monacelli, 2000<sup>4</sup>). While a situation of a rising debt level accompanying a deficit below 3 per cent is conceivable, there is a more universal and immediate difficulty for member states and monitoring

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<sup>4</sup> Balassone F., and D. Monacelli (2000), "EMU Fiscal Rules: Is there a Gap?", *Temi di Discussione*, Banca d'Italia, forthcoming.

organisations having to interpret the close to balance provision in preparing and assessing stability and convergence programmes. Unlike the Waigel proposal where a medium-term goal of 1 per cent is specified, there is no numerical value mentioned in the Pact in respect of the medium-term fiscal balance target, rather the medium-term target is required to be “close to balance or in surplus”. There is also no specific definition of “medium-term”.

It is imperative that the close to balance provision is tied down, as many other provisions of the Pact (particularly those relating to the surveillance of budgetary positions) hinge on some notion of what the close to balance provision means in practice. Before examining the two Regulations and the Council Resolution that comprise the Pact and subsequent official documents as to what they say in respect of the close to balance provision, the chronology of proposals and discussion leading to the formulation and adoption of the Pact provides some initial, important guidance to interpreting the close to balance provision. In particular, the replacement of the 1 per cent of GDP medium-term goal espoused in the Waigel proposal with a medium-term goal of close to balance or in surplus in the final Pact text reflected a view that a uniform numerical medium-term goal for all member states is not appropriate. On the one hand, a 1 per cent deficit target might not guarantee the maintenance of a deficit below 3 per cent in normal economic conditions for some member states. On the other hand, a 1 per cent deficit target might prove unnecessarily

demanding of other member states for ensuring no breach of the Treaty deficit requirement and, therefore, would restrict those member states' scope for fiscal flexibility beyond that necessary for compliance with Article 104c.

A common numerical medium-term budgetary target across member states is, therefore, neither intended nor required by the Pact. However, a common basis for arriving at close-to-balance targets for individual member states is warranted to ensure a consistent series of targets across member states. In the remainder of this paper, a possible common interpretation is outlined and developed.

### **3. A Review of Official Documents**

#### **(i) The Two Council Regulations and the Council Resolution**

A natural starting point for attempting to interpret the close to balance provision is to examine what the two Regulations and the Resolution that comprise the Pact have to say with regard to the provision.

#### ***Resolution of the European Council on the Stability and Growth Pact (16/17 June 1997)***

The Resolution predates the regulations. It emphasises that there is a clear Treaty obligation on member states to avoid excessive deficits and stresses also “the importance of safeguarding sound government finances as a means to

strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.” It continues that “adherence to the objective of sound budgetary positions close to balance or in surplus will allow all Member States to deal with normal cyclical fluctuations while keeping the government deficit within the 3 percent of GDP reference value.”

***Council Regulations (EC) No 1466/97 and No 1467/97 (7 July 1997)***

Of the two Regulations, the first, EC no. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, addresses the close to balance provision. Section 2, Article 3 and Section 3, Article 7 specify that stability and convergence programmes shall present

“the medium-term objective for the budgetary position of close to balance or in surplus and the adjustment path towards this objective for the general government surplus/deficit and the expected path of the general government debt ratio”.

Section 2, Article 5 and Section 3, Article 9 add:

“Based on assessments by the Commission and the Committee ..., the Council shall, ..., examine whether the medium-term budget objective in the stability/convergence programme provides for a safety margin to ensure the avoidance of an excessive deficit, ... and whether the measures being taken and/or proposed are sufficient to achieve the targeted adjustment path towards the medium-term budgetary objective.”

The recital to the Regulation also contains reference to the close to balance issue. Item 4 reiterates the Resolution in stating that: “whereas adherence to the medium-term objective of budgetary positions close to balance or in surplus will allow Member States to deal with normal cyclical fluctuations while keeping the government deficit within the 3 per cent of GDP reference value”.

Item 14 states that

“whereas the Council, when examining and monitoring the stability programmes and the convergence programmes and in particular their medium-term budgetary objective or the targeted adjustment path towards this objective, should take into account the relevant cyclical and structural characteristics of the economy of each Member State”.

**(ii) 12 October 1998 Opinion of the Monetary Committee  
(MC/II/482-98-final)**

In October 1998, an Opinion of the Monetary Committee was published that provided an agreed code of conduct on the content and format of stability and convergence programmes. In this respect, this Opinion is particularly useful in seeking to understand the medium-term objective of close to balance or in surplus that is to be outlined in those programmes.

According to the Opinion, the Resolution’s requiring that the cyclical position and its effect on the budget be accounted for in the assessment of medium-term budgetary objectives implies that the time frame for interpreting the medium-term is the length of the business cycle. It is also stressed that it is important that the medium-term budgetary position of close to balance or in surplus does not become “a moving target”. In practical terms,



the medium-term objective should be achieved as quickly as possible and by no later than by the end of 2002.

In assessing how actual and expected budgetary developments compare with the medium-term budgetary objective, it is suggested that “an approximate approach” must be adopted in practice. Assessing the cyclical component would serve as a useful starting point in this respect. The need to take into account other relevant factors in assessing budgetary developments is also recognised. Specific consideration should be given to other (non-cyclical) sources of variability and uncertainty in budgets, to the need to reduce high debt ratios, and to the need to prepare for the greater burden on government budgets in the future arising from population ageing. It is also noted that member states that might wish to make use of discretionary policy would need to create the additional room in medium-term targets necessary for such manoeuvre.

#### **4. Interpreting the Close to Balance Provision**

In seeking to understand and interpret sensibly the close to balance provision, it is perhaps best to assess separately the key terms “budgetary positions close to balance or in surplus” and “medium term”.

##### **(i) What is Meant by “Medium-Term”?**

What is meant by the phrase “medium-term” in the Pact’s text concerning the close to balance or in surplus provision? There is little by way of explanation or definition in the Pact. Regulation 1466/97 requires that stability and convergence programmes should present “the medium-term objective for the budgetary position of close to balance or in surplus and the adjustment path towards this objective”. Perhaps, the most obvious reading of a medium-term objective of achieving a budget balance close to balance or in surplus is that that target should be achieved on average over the economic cycle. Such an interpretation could also have a practical benefit insofar as if it is assumed, for simplicity, that the economic cycle is symmetrical in its impact on the budget balance then the medium-term target would involve keeping the underlying structural budget balance close to balance or in surplus. In any one year, an estimate of the underlying structural budget balance could be compared with the close to balance or in surplus target in order to assess a member state’s compliance with the Pact.

A medium-term target of a budgetary position close to balance or in surplus, therefore, seems to require that that target is achieved on average over the economic cycle. It should be noted that this does not require that the actual budget balance in each year be close to balance or in surplus. Fiscal policy remains a national responsibility within EMU and can be used as a means of stabilising aggregate demand growth at national level. To stabilise aggregate demand growth, the actual budget balance must be free to move in response to economic

fluctuations on a year-to-year basis. A fall in the underlying budget balance below the close to balance benchmark, however, increases the risk of an excessive deficit arising in normal economic circumstances. It is important, therefore, that movements in the actual budget balance are analysed according to their underlying and normal-economic-fluctuation components.

**(ii) What is Meant or Intended by “Close to Balance or in Surplus”, and What Factors Enter into its Calculation?**

***The Need to Deduct from the 3 per cent. Excessive Deficit Benchmark***

The phrase “close to balance or in surplus” in itself does not specify any particular budget balance value. The only numerical value explicit in the Pact in specifying the “close to balance or in surplus” provision is the 3 per cent. Treaty excessive deficit benchmark. A budget balance of close to balance or in surplus will, according to the Resolution, allow “Member States to deal with normal cyclical fluctuations while keeping the government deficit within 3 per cent.” Thus, it seems reasonable to argue that the close to balance or in surplus calculation will involve some deduction from the 3 per cent. mark. This interpretation seems to be consistent also with another statement in the Regulation: “the Council shall... examine whether the medium-term budget objective in the stability programme provides for a safety margin to ensure the

avoidance of an excessive deficit [i.e. a deficit in excess of the 3 per cent deficit limit].”

### ***Why Cyclical and Random Factors should enter the Close to Balance Arithmetic***

What adjustment should be made to the 3 per cent. deficit figure to arrive at the “close to balance or in surplus” level? Both the Resolution and the recital to the Regulation say that “normal cyclical fluctuations” must be entered into the arithmetic. The Regulation itself requires the provision “of a safety margin to ensure the avoidance of an excessive deficit”.

A “safety margin” has a broader connotation than “normal cyclical fluctuations”. It suggests making allowance in a quantifiable manner for all uncertainties that can impinge on the deficit. The time frame for this assessment is the medium term. In the medium term (i.e., over the economic cycle), uncertainties impacting on the budget balance include both cyclical variation in economic activity and random, non-cyclical factors. The extent of business cycle variation in any future year is ex-ante unknown. Random influences are, by definition, not predictable. Thus, it seems that a *minimum safety margin* should at least account for both cyclical and random influences on the budget balance.

### ***Should Allowance be Made for Discretionary Policy?***

The October 1998 Opinion specifies that if member states wish to make use of discretionary fiscal policy then they should build

an additional margin into their medium-targets for this purpose. This requires an additional margin for discretionary policy being built into medium-term targets only if member states intend to pursue an active fiscal policy over the medium-term.

It is possible that a suggestion could be made that irrespective of their intentions with regard to using discretionary policy that member states be required in all cases to make an allowance for possible discretionary policy action, perhaps based on an analysis of past fiscal policy behaviour. There are, however, good arguments against requiring a specific allowance for discretionary policy in medium-term targets.

Most importantly, requiring that member states make additional allowance for discretionary policy appears to go beyond what is intended by the Pact which strictly requires only an allowance for the impact on the budget balance of normal economic fluctuations which are outside the control of government. In contrast, discretionary fiscal policy is, by definition, at the control of government and, therefore, does not have to enter into the safety margin arithmetic.

There may also be an issue relating to the principle of subsidiarity in requiring an additional margin for discretionary fiscal policy. Member states not intending to pursue an active fiscal policy would be meeting the fiscal discipline required in setting a medium-term budget target that provided for a safety margin in respect of normal economic fluctuations. In this

regard, requiring an additional margin in respect of discretionary policy could be construed as impinging on member states' fiscal flexibility.

Advocates of an additional margin for discretionary policy might suggest, for instance, that the influence of past discretionary policy on the budget balance should be measured and added into the minimum safety margin that already accounts for the influence of both cyclical and random influences on the budget balance. Besides posing empirical measurement difficulties, there would also be a practical signalling issue involved in choosing to incorporate past discretionary fiscal behaviour into safety margin calculations. A retrospective analysis of discretionary fiscal policy might indicate for any number of member states that fiscal policy has been pro-cyclical in nature (Lane (1998)<sup>5</sup>, for example, finds evidence of pro-cyclical fiscal behaviour in Ireland in the 1980s and 1990s and public choice literature would suggest that pro-cyclical fiscal behaviour might be expected to be the norm). If this was the case then discretionary fiscal policy would be systematically countering the influence of the economic cycle on the budget balance. This would mean that incorporating past discretionary fiscal behaviour into margin calculations would lead to lower safety margins being required of member states than would be the case where cyclical and random factors alone were accounted for. In turn, this would mean that lower safety

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<sup>5</sup> Lane P. (1998), "On the Cyclicity of Irish Fiscal Policy", *The Economic and Social Review*, 29,1, pp.1-16.

margins would be espoused than would be warranted by cyclical and random factors alone.

It seems, therefore, that the inclusion of an allowance for discretionary fiscal policy is not required in setting medium-term safety margins. Using past discretionary policy action as a basis for providing a margin may present empirical measurement and signalling difficulties.

### *Allowance for Other Factors?*

The Opinion of the Monetary Committee suggests that longer-term, structural influences should be accounted for in the setting of budget targets consistent with the Pact. It suggests the need for a steady and rapid decline in debt ratios in high-debt countries and the need to prepare for a greater burden on the public finances as the population dependency-ratio increases should be addressed in the setting of budget targets.

Identifying these two factors as relevant to the issue of the setting of budget targets is consistent with the clause in the recital to the Regulation stating that “relevant cyclical and structural characteristics” should be considered by the Council “in examining adherence to the medium-term budgetary objective”. However, it must be asked whether *considering* structural characteristics implies that they must be actually pencilled into the close to balance or in surplus arithmetic.

In the medium term, the influence of structural developments, such as the outlay on pensions arising from demographic changes, on the budget balance in any year will be known and can be effectively taken as given. There is no reason to expect any significant exogenous shock to that pension expenditure projection in the medium term time frame. Consequently, if one considers safety margin as being synonymous with risk, pension expenditures would not seem to enter the calculation of the minimum safety margin that embraces both cyclical and random influences on the budget balance.

While future pension outlays are predictable in their impact on the deficit, the situation with regard to the debt is, to some extent, different. On one hand, the debt level is directly comparable to the pensions issue in its implications for the minimum safety margin insofar as its size per se does not pose any implications for the deficit and, thus, no additional margin in respect of the level of debt needs to be made in setting the minimum safety margin.

The costs of servicing that debt, which impacts on the budget balance, does, however, have implications for the calculation of the minimum safety margin. On one level, given that the economic cycle will affect the size of the primary balance, there will likely be a pass-through effect from the deficit to the level of the debt. In turn, this will affect the debt-servicing costs in the deficit arithmetic.



While the impact on debt-servicing costs of changes in the primary balance should be accounted for in the safety margin calculation, they could be expected to be comparatively small relative to the impact that changes in interest rates can have on debt-servicing costs and, thus, the overall deficit. This raises the question as to whether cyclical and random movements in interest rates should also be accounted for in the calculation of the minimum safety margin to be deducted from the 3 per cent. excessive deficit benchmark.

The case for accounting for fluctuations in interest rates is strong. The text of the Pact stresses the need for member states' budgetary positions "to deal with normal cyclical fluctuations while keeping the government deficit within the 3 per cent. of GDP reference value." Fluctuations in interest rates, along with fluctuations in real economic activity, are normal economic events and impact directly on the budget deficit. The impact of interest rate fluctuations on the budget balance should, therefore, be included, alongside those of fluctuations in real economic activity, in the calculation of the minimum safety margin.<sup>6</sup>

### ***The Need for a Long Run Safety Margin***

It has been argued above that structural influences on the budget balance, such as demographic factors, should not enter the

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<sup>6</sup> The question arises as to whether, in practice, part of this variation would be captured in the aforementioned safety margin calculations for cyclical and random real economic factors. This highlights the more general concern of the need to avoid double-counting when calculating the safety margin.

calculation of the *minimum safety margin* (that dealing with the impact that normal economic fluctuations can have on the budget deficit). In the case of demographic factors, for example, their development and influence on the budget balance can be taken as given. There are no grounds for expecting any exogenous shock to impact significantly on the outlay government has budgeted for in respect of pensions in the medium term. Thus, demographic factors do not need to be accounted for in the calculation of the minimum safety margin.

This, however, is not to deny that factors such as the prospect of a greater outlay on pensions in the long run or the desirability of reducing debt levels towards sustainable levels should not be addressed or highlighted in assessments of member states' current and medium-term budget plans. It must be recognised that if one assumes no change with respect to government policy on pension funding ageing populations will result in increased outlays on pensions in the future, which (*ceteris paribus*) will cause the budget deficit to rise over time and with it the risk of an excessive deficit being incurred in the long run will also increase. It may be advisable on such grounds to provide some allowance in current medium-term budget targets to help offset the negative impact that demographic developments will have on the budget balance in the long run. One means of doing so is to have lower medium-term deficit targets. This would lower long run debt levels and thereof reduce debt-servicing outlays in the long run. This would act to offset the impact that higher ageing-related expenditures will

have over time on the budget balance.<sup>7</sup> Ensuring that the safety margin built into medium-term budget targets is sufficient to offset the increased costs of the ageing of the population should be given important consideration.

Notwithstanding that reducing the debt can help pay for increases in ageing-related expenditure, the possibility of an excessive deficit being declared so long as the ratio of government debt to gross domestic product exceeds the 60 per cent. Treaty reference value highlights the need for debt levels to be brought down. Member states whose debt levels exceed the 60 per cent. benchmark should endeavour to set deficit targets that ensure a sufficiently rapid movement to below the 60 per cent. level.

Thus, alongside the minimum safety margin discussed above, an additional margin for long term factors could be calculated that might be incorporated into stability and convergence programme budget targets. This *margin for long-term factors* would indicate the budget balance targets that would ensure that an excessive deficit does not arise in the long run.

## **5. Conclusions**

This paper has sought to identify how the close to balance provision of the Stability and Growth Pact should be interpreted and to ascertain what it requires of member states in setting their

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<sup>7</sup> D. Franco and T. Munzi (1997), "Ageing and Fiscal Policies in the European Union", *European Economy*, No. 4.

budgetary targets. Among the conclusions reached were that a budgetary position of close to balance or in surplus can be objectively calculated by deducting a safety margin from the Treaty deficit limit of 3 per cent. of GDP. It was argued that the safety margin should at least take account of those factors whose impact on the budget balance in the medium term can not be forecast with certainty. In this respect, both cyclical and random factors must be included in the safety margin. This safety margin can be thought of as a minimum safety margin – it indicates the safety margin required to avoid an excessive deficit in the medium term. It was also argued that an additional, supplementary margin for long-term factors should be considered.