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The application of the EDP to the ten new Member States

(Note for the Economic and Financial Committee)

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1. Introduction

The EU budgetary surveillance framework will apply to the new Member States immediately after accession. This includes, where relevant, the activation of the Excessive Deficit Procedure (EDP).

At the High Level Meeting in Athens on 28 May 2003, the framework was set on how to integrate the acceding countries into the EU budgetary surveillance framework. The purpose of this note is to clarify how this will be done.

The EDP will be applied to the new Member States by taking into account their status as Member States with a derogation and special circumstances will be considered where appropriate. Compliance with the budgetary objectives will be closely monitored and encouraged through the peer pressure instruments foreseen by the Treaty and the Stability and Growth Pact (SGP), although the sanctions part of the excessive deficit procedure does not apply to countries with a derogation.

2. The Athens Conclusions

At the High Level Meeting in Athens on 28 May 2003, the framework was agreed on how to integrate the acceding countries into the budgetary surveillance mechanism of the EU. With respect to the Excessive Deficit Procedure and the assessment of the convergence programmes, the following conclusions were agreed:

- The acceding countries agree to observe from 2004 onwards the reporting deadlines (before 1 March and before 1 September) on the bi-annual fiscal notifications of budgetary data. This early submission will allow the Commission to initiate the Excessive Deficit Procedure, where necessary, in May/June 2004.
- The new Member States are invited to submit their first convergence programmes by 15 May 2004, which could be an update of the Pre-Accession Economic Programme submitted in August 2003.
- In line with the Code of Conduct¹, the new Member States should submit their updates of the convergence programmes shortly after national governments have

¹*Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes*, endorsed by the ECOFIN Council on 10.7.2001.

presented their budget proposals to national parliaments, but not earlier than mid-October and not later than the 1st of December 2004.

- The Code of Conduct shall be observed from accession by the new Member States. They are invited to pay more systematic attention to the impact of structural reforms on the medium-term economic scenario and on budgetary implications of structural reforms. Whenever possible, they should provide information on cyclically-adjusted budgetary positions. They are also invited to more systematically include information on the long-term sustainability of public finance.

3. The application of the Excessive Deficit Procedure to the new Member States

A. Implications of the status of ‘Member State with a derogation’ for budgetary surveillance

The new Member States will enter the EU with the status of *Member State with a derogation*². The new Member States will be subject to legislative provisions regarding the EU budgetary surveillance. These stem from Article 99(4) and/or Article 104 of the Treaty, supplemented by Council Regulations (EC) No 1466/97 and No 1467/97, which together constitute the Stability and Growth Pact (SGP).

The derogation does not exempt the new Member States from the obligation to avoid excessive deficits, which applies to all Member States since the start of the third phase of EMU on 1 January 1999³. The derogation implies that Article 104 does not apply in its entirety to the new Member States. In particular, according to Article 122(3) of the Treaty, Member States with a derogation, when in a situation of an excessive deficit and failing to put into practice the Council recommendations under Article 104(7) with a view to bringing that situation to an end, cannot be submitted to the last two steps of the excessive deficit procedure, namely the procedures of Articles 104(9) and (11). **Therefore, the new Member States cannot be subject to enhanced budgetary surveillance by the Council (Article 104(9)) nor to sanctions (Article 104(11))**⁴.

²Article 4 of the Act concerning the conditions of accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic and the adjustments to the Treaties on which the European Union is founded specifies that “Each of the new Member States shall participate in Economic and Monetary Union from the date of accession as a Member State with a derogation within the meaning of Article 122 of the EC Treaty.”

³Articles 104(1) and 116(3) of the Treaty.

⁴ In addition, Member States with a derogation have no voting right on decisions provided for under the two paragraphs.

What are the consequences of this in terms of deadlines and obligations? In case of non-compliance, the overall maximum period of 10 months, from the reporting date of the figures indicating the existence of an excessive deficit until the decision to impose sanctions, does not apply to Member States with a derogation.⁵ However, the first steps of the procedure and the relative deadlines apply to all Member States regardless of their status:

- the Commission prepares the report referred to in Article 104(3),
- the EFC formulates an opinion on the report (Article 104(4)) within two weeks of its adoption by the Commission,⁶
- the Council decides on the existence of an excessive deficit (Article 104(6)) within three months of the reporting dates established in Article 4(2) and (3) of Regulation (EC) No 3605/93, and, at the same time, makes recommendations to the Member State concerned with a view to correct the excessive deficit (Article 104(7)),⁷
- in its recommendations under Article 104(7), the Council establishes a deadline of four months at the most for effective action to be taken by the Member State concerned⁸. The effective action requested to the Member State will have to be in line with the adjustment path to correct the deficit defined in the recommendation under Article 104(7).

B. The deadline for the correction of the excessive deficit and “special circumstances”

Article 3(4) of Council Regulation (EC) No 1467/97 states that the Council recommendation under Article 104(7) should establish a deadline for the correction of the excessive deficit and that this correction should be completed in the year following its identification unless there are *special circumstances*⁹. Without special circumstances, the new Member States found to be in a situation of excessive deficit in

⁵ Council Regulation (EC) No 1467/97 Recital (15): "Whereas in the light of the above, in the event that a participating Member State fails to take effective action to correct an excessive deficit, an overall maximum period of ten months from the reporting date of the figures indicating the existence of an excessive deficit until the decision to impose sanctions, if necessary, seems both feasible and appropriate in order to exert pressure on the participating Member State concerned to take such action; in this event, and if the procedure starts in March, this would lead to sanctions being imposed within the calendar year in which the procedure had been started".

⁶ Council Regulation (EC) No 1467/97, Article 3(1).

⁷ Council Regulation (EC) No 1467/97, Article 3(3).

⁸ Council Regulation (EC) No 1467/97, Article 3(4).

⁹ Article 3(4): "The Council recommendation made in accordance with Article 104 (7) shall establish a deadline of four months at the most for effective action to be taken by the Member State concerned. The

2004 would therefore have to complete the correction in 2005, which may not be appropriate from an economic point of view.

If “special circumstances” are present, the Council may give the Member State concerned a longer period to correct the excessive deficit than the year following its identification.

This multiannual approach would be consistent with the way the EDP was applied after 1994 to today’s members of the euro area¹⁰. Every year a recommendation under Article 104(7) was issued until the country brought the deficit below 3% of GDP and the EDP was abrogated.

The concept of “special circumstances” does not appear in the Treaty. It is mentioned in Article 3(4) of Council Regulation (EC) No 1467/97 quoted above and in the European Council Resolution on the Stability and Growth Pact with respect to the Council¹¹ and the Member States¹², but no definition is given to this concept.

It appears possible that the economic and budgetary situation of the new Member States provides arguments for considering special circumstances. Although the identification of such circumstances will have to be done on a case-by-case basis, some relevant features may be common to several new Member States, on which the assessment of the convergence programmes will shed further light.

A first element to consider is the **initial level of the government deficit**, which will affect the length and the size of the implied necessary adjustment. If the initial deficit level is substantially above the reference value, the new Member State could be allowed to undertake the necessary budgetary adjustment in a period appropriately longer than one year. Naturally, it will be necessary to take into account the reasons behind the excessive deficit, past budgetary developments and the convergence programme, to assess whether the government deficit has been and is expected to be on a sustained decreasing path. Moreover, the level of government debt must also be considered.

Council recommendation shall also establish a deadline for the correction of the excessive deficit, which should be completed in the year following its identification unless there are special circumstances."

¹⁰ The SGP regulations were not in force at that time and thus the deadline for correcting the deficit was not pre-established as it is now the case (see footnote 9).

¹¹ The Council [...] "2. is urged to regard the deadlines for the application of the excessive deficit procedure as upper limits; in particular, the Council, acting under Article 104 (7), shall recommend that excessive deficits be corrected as quickly as possible after their emergence, no later than the year following their identification, unless there are special circumstances".

¹² The Member States [...] "5. will correct excessive deficits as quickly as possible after their emergence; this correction should be completed no later than the year following the identification of the excessive deficit, unless there are special circumstances".

A second element is the **interaction between budgetary policy and the ongoing structural shift in the economies** of the new Member States. Indeed, a number of product market issues, such as privatisation, administered prices and factors affecting the sectoral composition of the economy, its business environment and implementation of competition policies still need to be addressed. This might have budgetary consequences. Moreover, public finances themselves are in many of the new Member States in a process of restructuring, e.g. through tax and pension reform.

C. Monitoring compliance with the recommendations under Article 104(7)

If a new Member State is given a multi-annual period for bringing its deficit to below 3% of GDP, the period granted for the correction of the excessive deficit could be based on its convergence programme. The assessment by the Commission and the Council should help ensure that the budgetary targets adopted by the Member State are credible and realistic.

The Council recommendations under Article 104(7) would then include intermediate targets for the correction of the deficit, referring to the convergence programme. Setting intermediate targets is necessary to allow an efficient monitoring of the budgetary adjustment towards the 3% of GDP reference value.

This monitoring throughout the period will involve comparing the recommended intermediate budgetary targets with the budgetary outcomes reported in the regular fiscal notifications, taking also into consideration the regular updates of the convergence programmes. The monitoring could include the issue of further Council recommendations under Article 104(7), which appears to be the only means available to exercise pressure or control on the Member State concerned given the impossibility of moving to the next step in the EDP, namely a recommendation under Article 104(9), on account of the derogation.

In addition to Council recommendations, three other channels may act as complementary disciplinary mechanisms.

Firstly, the authorities of most of the new Member States have made their intentions known with respect to ERM II participation and subsequent euro adoption. Before adopting the euro, full compliance with the Maastricht convergence criteria must be achieved. Therefore, non-compliance with the adjustment path for fiscal convergence would delay the abrogation of the decision on the existence of an excessive deficit and consequently the adoption of the single currency.

Secondly, market perceptions of the ability and readiness of policy makers to live up to the commitments required by participation in a system such as ERM II will play an important role in ensuring the sustainability of the mechanism. In this context, compliance with the budgetary adjustment path as regularly assessed by the Council will be an important indication of the credibility of economic policies. Markets may put the exchange rate under pressure if they detect incompatibilities between a commitment to a central rate within ERM II and budgetary developments in the new Member State concerned.

The convergence programmes of the new Member States should therefore set credible and realistic budgetary targets. Failure to meet the medium-term or even intermediate objectives could lead to a series of damaging repercussions for economic policies of the new Member States and undermine the planned strategy for the adoption of euro.

Thirdly, there is the possibility of suspending Cohesion Fund funding for the new Member States. Article 6 of Council Regulation (EC) No 1264/99 amending Council Regulation (EC) No 1164/94 on establishing the Cohesion Fund states that *“no new projects or, in the event of important projects, no new project stages shall be financed by the Fund in a Member State in the event of the Council, acting by a qualified majority on a recommendation from the Commission, finding that the Member State in the application of this Regulation has not implemented the programme referred to in Article 2(4) [i.e. the convergence programme] in such a way as to avoid an excessive government deficit”*. This decision is abrogated when the Council finds that *“the Member State concerned has taken measures to implement that programme in such a way as to avoid an excessive government deficit”*.

D. New Member States not subject to the excessive deficit procedure in 2004

For those new Member States whose actual or planned deficit is not estimated to exceed the reference value at the time of accession, there is no ground for initiating the Excessive Deficit Procedure. Upon accession their budgetary positions become the subject of multilateral surveillance as foreseen by the Treaty (Article 99) and Council Regulation (EC) No 1466/97 (‘preventive’ arm of the Stability and Growth Pact).

Specifically, the required adjustment toward the objective of a budgetary position of close to balance or in surplus will be monitored in the framework of the examination of the convergence programme, which each Member State with a derogation is obliged to submit and regularly update. In their assessment of convergence programmes, the Commission and the Council can be expected to take into account specific conditions

bearing upon the definition of the appropriate adjustment path much in the same vein as special circumstances will be taken into account in defining the appropriate adjustment path for the correction of excessive deficits, as discussed above.

In line with the provisions of the Pact, in the event of a “significant divergence” from the adjustment path towards the medium-term objective, the Member State concerned should be addressed a recommendation in accordance with Article 99(4) “with a view to giving early warning in order to prevent the occurrence of an excessive deficit” (Article 6(2) of Council Regulation (EC) No 1466/97). In assessing the case for recommending to the Council the activation of the early-warning mechanism, the Commission can be expected to be guided by the general criteria identified by past practice, namely, i) the size of the budgetary slippage, that is, the extent to which the budget position diverges from targets set down in the stability and convergence programmes; ii) the reason for the budgetary slippage, that is, whether the budgetary slippage reflects a departure of government policy from the programme or the impact of unforeseen developments in the economy; and iii) the risk of an excessive deficit, that is, in first approximation, the distance between the projected budgetary outcome and the 3% of GDP nominal benchmark.