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NATIONAL BUDGETS AND EUROPEAN SURVEILLANCE: SHEDDING LIGHT ON THE DEBATE

Sofia Fernandes | *Senior research fellow at Notre Europe – Jacques Delors Institute*

EXECUTIVE SUMMARY

Since 2013, euro area member states have had to submit their budgetary plan for the following year to the Commission by 15 October. This exercise fuels the image of a Europe narowing countries' fiscal sovereignty; and this, even though the Commission does not have the right to veto or even to modify a national budget. This assessment of national budgets on Brussels's part is attracting a lot of attention this year in particular, because the exercise is associated with the spectre of the potential levying of financial sanctions against France for failure to correct its excessive deficit in 2015.

The debate raises the issue of the degree of flexibility that the Commission should show in implementing the Stability Pact. Some people argue that France's budget consolidation efforts are being undermined by weak growth and weak inflation, and they appeal to the Pact's flexibility clauses. The Pact does in fact foresee that the Commission must take into consideration any "exceptional circumstances" and "relevant factors" (such as the implementation of structural reforms) in its analysis.

Others counter this "flexibility argument" with a "credibility argument". In the wake of the debt crisis, the member states decided to revise the Stability Pact and to sign a new intergovernmental Fiscal Compact, in an attempt to strengthen fiscal discipline within the euro area. In view of this, and with France and other countries in the euro area having already benefited from an extension to the deadlines granted them to correct their excessive deficits, should the Commission continue to show flexibility? Is France sincerely committed to undertaking "effective action" in this connection? Those in favour of stringent fiscal surveillance by the Commission, many of whom hail from the northern European countries and from Germany, harbour doubts on that score, to put it mildly. In the southern European countries, on the other hand, where numerous sacrifices have already been made on the altar of fiscal stringency, voices are also being raised against the eventuality of member states being accorded different treatment.

In order to clarify this debate, it is crucial to be aware of the rules, procedures and sanctions involved in EU's fiscal surveillance.

- Member states are required to comply with three fiscal rules: i) limit of 3% of GDP for the public deficit; ii) limit of 0.5% of GDP for the structural deficit, or improvement of the structural balance by 0.5% of GDP a year; iii) limit of 60% of GDP for the public debt, or reduction of the excessive debt at an average rate of 5% per year.
- The euro area countries submit their Stability Programmes to the Commission in April and their budgetary plans in October; they receive recommendations from the Council regarding their Stability Programme, and the Commission voices its opinion on their budgetary plan (the Commission has a timeframe of two weeks within which to ask a country to revise its budget; if that revision fails to meet the Commission's requirements, it will not automatically lead to a sanction but it will be considered an aggravating factor for a country subject to an excessive deficit procedure (EDP)).
- Those countries that fail to comply with the fiscal rules are subject to sanctions on a graded scale (rising from an interest-bearing deposit up to a fine). Yet fiscal surveillance is not an inflexible exercise, because the Stability Pact contains flexibility clauses that the Commission must take into consideration, on condition (for countries subject to an EDP) that the country in question is adopting "effective action" to correct its budgetary imbalance.

While Europe's fiscal rules fuel the image of a coercive Europe, it should be noted that compliance with these rules has been limited since the Stability Pact was first adopted back in 1997. In 17 years, only four countries out of 28 have never allowed their deficits to shoot above 3% of their national wealth (Estonia, Finland, Luxembourg and Sweden). And for some countries, compliance with that threshold has been the exception rather than the rule (France, for instance, has met the criterion only seven times, while Portugal and Greece have never met it yet).

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INTRODUCTION

In order for the EU member states that share in the common currency today to join the euro area, they had to meet a set of criteria laid down in Maastricht, known as "**convergence criteria**". The five criteria in question include two which concerned the fiscal policy and which set limits on member states' indebtment. These euro area "membership rules" then became "rules of conduct" – built into the Stability and Growth Pact (SGP) adopted in 1997 – designed to **ensure member states' budgetary discipline.**

"ACTING IN ACCORDANCE WITH COMMON RULES (...) TO ENSURE PROPER FUNCTIONING OF THE EURO AREA"

Acting in accordance with common rules is essential **to ensure the proper functioning of a common monetary area** in which there is only one monetary policy but eighteen different national economic and budgetary policies. But we should remember that these rules are not imposed by the European Commission, although it is the Commission's job to ensure that member states comply with them. It is the member states themselves that defined the rules when they created the euro area and it is they, too, who have **strengthened the rules and procedures for fiscal surveillance since 2010**, in particular through a review of the Stability Pact in 2011 and with the signing of the Fiscal Compact, which came into force in January 2013. If the Commission can levy a fine on a member state for being in breach of the rules, it is only because the member states themselves have given it the power to do so.

In the current situation, however, the budgetary discipline enforced on member states by "Brussels" does not attract unanimous support. In view of the weak growth and weak inflation afflicting a large number of EU member states, the budgetary stringency demanded by the EU is seen as having a **negative impact on the drive to impart a fresh boost to the European economy**. Others, on the contrary, point out that the EU did not succeed in enforcing compliance with the rules governing budgetary discipline before the crisis and that the Stability Pact's credibility is in question. Despite numerous breaches of the fiscal rules on the part of several European countries, **the Commission has never yet levied a financial sanction on a member state**. Each time that a state has asked for additional time to correct its excessive deficit, the Commission has granted its request. Today, however, the threat of financial penalties is weighing down heavily on certain countries in view of the difficulties that they are experiencing in correcting their excessive deficit. Moreover, now that (since 2013) the countries in the euro area have to submit their budgetary plan for the following year to the Commission in the autumn, this new step fuels the image of a Europe taking over member states' sovereignty over their budgets. And this, even though **the Commission does not have the right to veto a national budget or the power to make direct changes to it**.

In order to clarify the debate, it is worthwhile shedding light on the rules and procedures that govern fiscal surveillance in the EU and **understanding the extent of the European authorities' powers and action in the budgetary sphere**. To achieve this end, we begin by reviewing the budgetary rules with which the member states are pledged to comply and which extend well beyond the rule setting the public deficit at 3% of GDP *(§1)*. We go on to illustrate the fiscal surveillance procedure that unfolds throughout the year *(§2)* and the constraints enforced on member states which fail to comply with the budgetary rules *(§3)*. And lastly, we conduct an overview of member states' budgetary conduct since the adoption of the Stability Pact and we take a look at their current situation *(§4)*.

1. European fiscal rules... going beyond the threshold of 3% of GDP for the public deficit

When the member states joined the Economic and Monetary Union, they undertook to **restrict their public debt to 60% of GDP and their public deficit to 3% of GDP**. This 3% threshold was established taking into account some basic assumptions: in the context of a 5% nominal GDP growth rate (3% of real growth and 2% of inflation), the member states that have a public debt of 60% of GDP can stabilise the level of their debt only if the public deficit does not exceed 3%[1].

While the aim of Europe's fiscal surveillance rules and procedures is to ensure healthy public finances, the implementation of the Stability Pact during the euro's first decade has not prevented the appearance of serious budgetary imbalances in several member states *(see Appendix 1)*. The debt crisis in the euro area has prompted the member states to strengthen their crises prevention capacity, in order to ensure that such a threat to the euro area's stability does not recur in the future. To this end, the member states have improved their fiscal surveillance rules and procedures **through a review of the Stability Pact[2] and the adoption of the Fiscal Compact[3]**. While this reform does not alter the two fiscal rules enshrined in the treaties *(see Table 1)*, it does contain improvements in an effort to guarantee member states' fiscal discipline. Thus, special attention is devoted to the structural balance *(§1.1.)* and to bringing down any debt over the 60% of GDP threshold *(§1.2.)*.

1.1. Debt brake – a structural deficit limited to 0.5% of GDP

One of the goals of the recent reform of the Stability Pact was to increase the emphasis on the consolidation of national public finances in structural terms[4], which makes it possible to take into account the consequences of an economic slowdown or of any specific measures on the deficit. In this context, member states have to pursue a **medium-term budgetary objective (MTO), defined in terms of structural balance**. While the nominal public deficit is limited to 3% of GDP, the structural deficit cannot rise above 1% of GDP according to the Stability Pact rules. Thus a safety margin is created to prevent the public deficit from shooting through the 3% ceiling at a time of unfavourable economic conditions.

Yet the countries that have signed the Fiscal Compact (including all of the euro area countries) have gone one step further and have pledged **to limit their structural deficit to 0.5% of GDP**, apart from those countries whose public debt is well below 60% of GDP[5].

Moreover, the countries that have signed the Fiscal Compact are also **committed to building this structural balance target into their own national legislation[6]**. Thus it is a matter of including this "debt brake" in national law (preferably in the Constitution) in order to improve the national ownership of European fiscal rules. A report published by the German Council of Economic Experts on the implementation of the Fiscal Compact suggests that out of all the countries in the euro area which had introduced this fiscal rule into their

1. See Yves Bertoncini and Sofia Fernandes, "The 'stupidity pact' is not stable", *Tribune – Viewpoint*, Notre Europe – Jacques Delors Institute, April 2014.
2. The Stability and Growth Pact was revised in 2011 with the entry into force of the "Six-Pack" legislative package comprising five regulations and a directive, with two of the regulations modifying the Pact: EU Regulation n° 1175/2011 and EU Regulation n° 1177/2011. Budgetary supervision was further strengthened in 2013 with the entry into force of the "Two-Pack" comprising two regulations which apply only to countries within the euro area and which are designed to harmonise budgetary procedures (a common budgetary timetable and independent macro-economic estimates) and to strengthen budgetary supervision, in particular for those countries that apply for financial aid (EU Regulation n° 472/2013 and EU Regulation n°473/2013).
3. The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG or Fiscal Compact) has been signed on March 2012 by all EU countries except the United Kingdom, the Czech Republic and Croatia (Croatia joined the EU in July 2013). This Treaty, intergovernmental in nature, treaty includes a fiscal part, an economic policy dimension and some provisions concerning the governance of the euro area. It entered into force on January 2013 in the 25 signatory countries.
4. Data adjusted to account for cyclical variations and with exceptional measures deducted.
5. The Fiscal Compact provides for member states whose indebtment ratio falls considerably below the 60% of GDP mark and whose risk regarding the sustainability of their public finances are minimal to enjoy a structural deficit of up to 1% of GDP.
6. Article 3 in the Fiscal Compact stipulates that member states' structural deficit must be lower than 0.5% of GDP and that this measure shall take "effect in the national law of the Contracting Parties at the latest one year after the entry into force of this Treaty through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes". The Fiscal Compact's signatory countries can be fined up to 0.1% of GDP if they fail to correctly build the Fiscal Compact into their national law.

national legislation by January 2014 (all of them save Belgium, Estonia, Greece, Malta and Slovakia), **only four** (Germany, Spain, Italy and Slovenia) **have built it into their Constitution**[7].

The new European legislation also provides for an "**adjustment path**" whereby member states that have failed to meet their MTO are obliged to cut their structural deficit by at least 0.5% of GDP per year. Furthermore, following the entry into force of the Fiscal Compact, signatory countries have had to build the creation of an automatic **fiscal correction mechanism** into their national law "through provisions of binding force and permanent character, preferably constitutional". This mechanism must be activated in the event the structural deficit rises above the specified limit (or deviates from the adjustment path designed to correct it). On the basis of common principles established by the Commission, member states have introduced different types of fiscal correction measures into their national legislation; the majority of them has introduced the measure through a means-related constraint (the adoption of a binding action plan designed to correct the gap identified).

1.2. A new path for reducing debt over the 60% of GDP threshold (5% per year)

Since the Stability Pact was reformed in 2011, more attention is paid to the criterion concerning the public debt, which Article 126 in the TFEU stipulates must be limited to 60% of GDP or "approach the reference value at a satisfactory pace".

The debt criterion had two shortcomings before the reform of 2011. On the one hand, this "satisfactory pace" was not clearly defined and the assessment of whether those countries whose debt was over 60% of GDP were or were not complying with this requirement rested solely on the Commission's view. On the other hand, failure to comply with the rule could not be punished because financial sanctions could be applied only to countries in an excessive public deficit situation.

"MEMBER STATES FAILING TO COMPLY WITH THIS DEBT-REDUCTION RULE ARE SUBJECT TO THE EXCESSIVE DEFICIT PROCEDURE"

Since the Six-Pack came into force, the criterion for reducing excessive debt is deemed to have been met if **the gap with the reference value (60% of GDP) has dropped over the previous three years at an average rate of one-twentieth (5%) per year**[8]. Member states failing to comply with this debt-reduction rule are subject to the Excessive Deficit Procedure (EDP) even if their public deficit is not higher than 3% of GDP. It needs to be stressed that this criterion is not applied to member states subject to an excessive deficit procedure before the Six-Pack came into force until they have remedied their excessive deficit and, in the first three years thereafter, the Council may set less stringent objectives.

Moreover, the reformed Stability Pact sets a limit on the **annual growth rate of public spending** which, for those member states that have not yet reached their MTO, must be below their GDP's potential growth rate in the medium term[9], unless this exceeding the ceiling is made up for by an equivalent increase in revenue.

7. Burret T. Heiko and Schnellenbach Jan, "Implementation of the Fiscal Compact in the Euro Area Member States", *Working Paper 08/2013*, November 2013 (updated in January 2014).
8. This measure in the Stability Pact is also enshrined in the Fiscal Compact.
9. For those countries that have achieved their MTO, the public spending growth rate may be equal to but no higher than their GDP's potential growth rate in the medium term.

TABLE 1 ► Budgetary discpline rules enshrined in the Treaty, the Stability Pact and the Fiscal Compact

	NOMINAL PUBLIC DEFICIT	PUBLIC DEBT	STRUCTURAL DEFICIT	PUBLIC SPENDING
Treaty (Article 126 and protocol n°12 in the TFEU)	Public deficit limited to 3% of GDP	Public debt below 60% of GDP and reduction of excessive debt at a satisfactory pace.		
Stability Pact	Public deficit limited to 3% of GDP	Public debt below 60% of GDP; Reduction of excessive debt at an average rate of one-twentieth (5%) per year over three years .	Structural deficit limited to 1% of GDP; Reduction of at least 0.5% of GDP per year in the event of excessive structural deficit.	Growth in public spending below or equal to GDP's potential growth rate in the medium term, unless the overshoot is compensated by an equivalent increase in revenue.
Fiscal Compact		Public debt below 60% of GDP; Reduction of excessive debt at an average rate of one-twentieth (5%) per year over three years.	Structural deficit limited to 0.5% of GDP; Reduction of at least 0.5% of GDP per year in the event of excessive structural deficit; This debt brake must be built into national law.	

2. Fiscal surveillance procedure in the EU

Brussels' powers over member states do not translate only into rules with which each country is obliged to comply but also into the powers of supervision which the European authorities have available to them to ensure compliance with those rules. In order **to ensure transparency and confidence in relations between the national and European authorities**, the recent reform of European fiscal surveillance includes new measures concerning both the quality of national fiscal frameworks and the reliability and independence of macroeconomic forecasts and statistics *(see Box 2)*.

The fiscal surveillance procedure is built into the coordination cycle christened "**European semester**". In the budgetary sphere, we can identify two key stages in the relationship between member states and the European authorities: each member state's submission of its Stability or Convergence Programme in the spring *(§2.1.)* and the submission of national budgetary plans in the autumn *(§2.2.)*.

BOX 1 ► Guaranteeing transparency and confidence in relations between national and European authorities

The "Six-Pack" includes a directive providing for a series of measures aiming to **improve national fiscal frameworks** by monitoring the **quality of accounting and statistics systems** as well as **forecasting practices**. This directive confirms the principle of national statistics authorities' independence and the option for the Commission to organise tracking missions on the ground, in order to ensure that the European institutions' multilateral supervision is based on **reliable and independent statistics**. For the euro area countries, the "Six-Pack" directive also countenances the **possibility of levying a fine**, capped at 0.2% of GDP, on any country that makes erroneous declarations, whether deliberately or through gross negligence, regarding data relating to its deficit or to its debt.

The Fiscal Compact and the "Two-Pack" make an additional requirement on member states, namely that they set up **fiscal councils which are either independent** or which operate autonomously, to monitor the implementation of the fiscal rules. These fiscal councils must produce or approve independent macroeconomic forecasts and monitor the transparency and credibility of national fiscal correction mechanisms (in the event of a gap with the adjustment path). These fiscal councils' opinions, however, are not binding on national governments, but the **"comply or explain" principle** – whereby member states either have to follow their budget councils' advice or else explain why they are not going to do so – is designed to ensure that their assessments cannot be simply ignored, yet without this impinging in any way on the fiscal authorities' political prerogatives.

2.1. Presentation of the Stability or Convergence Programmes and the country-specific recommendations

The first annual stage consists in **each member state submitting either a Stability Programme (for euro area countries) or a Convergence Programme (for non-euro area countries) to the Commission by 30 April**. In these programmes the member states present their medium-term fiscal strategies. Following an analysis of each member state's Stability or Convergence Programme, the European institutions address **country-specific recommandations**[10]. Two clarifications are required regarding the guidelines which member states receive from Brussels every year.

On the one hand, the recommendations addressed to the member states are proposed by the Commission but they are endorsed by the members of the European Council and adopted by the Council of Ministers. The country-specific recommendations are therefore not the Commission's recommendations but **recommendations from the Council, which each country's finance minister and head of state or government have endorsed**. Moreover, the Commission's proposals for recommendations can be amended by the Council. By way of an example, we might point out that in the course of financial year 2013 France won adjustments to the final version of the recommendation concerning the reform of its pension system: instead of calling on France to raise the "legal" retirement age as the Commission had proposed, the Council endorsed a recommendation urging France to raise the "real" retirement age[11].

On the other hand, **what the European authorities address to member states are "recommandations", not "demands"**. Member states are encouraged to take on board the recommendations addressed to them, but even though it may be compulsory to achieve the result enshrined in them, there is no obligation regarding the means to achieve that result. If a member state fails to comply with the fiscal recommendations addressed to it but does comply with the fiscal rules or with the path for reducing its public deficit (if it is subject to an Excessive Deficit Procedure) by adopting different measures from those recommended by the Commission, it cannot earn a "reprimand" from Brussels on those grounds.

2.2. The Commission's opinion on national budgetary plans

"THE COMMISSION DOES NOT HAVE THE POWER TO VETO A NATIONAL BUDGET"

The second stage in the fiscal surveillance procedure takes place in the autumn and concerns only euro area countries. Since 2013[12], in an effort to ensure that member states do take the country-specific recommendations into account when devising their budgets, countries sharing the same currency **have until 15 October to submit their budgetary plan** for the coming year before approval by their national parliaments. **The Commission** analyses these national budgetary plans and **submits its opinion to each member state** (an opinion not endorsed by the Council, unlike the country-specific recommendations adopted in June).

In this context, if the Commission identifies a particularly serious instance of failure to comply with the fiscal policy obligations provided for in the Stability Pact, it has two weeks after submission to call on the member state in question to revise its plan. This new stage in fiscal supervision, however, **does not give the**

10. The recommendations that the Commission and the Council make to each member state also include their assessment of National Reform Programmes submitted at the same time as the Stability or Convergence Programmes.
11. The Commission's version of the recommandation: "The French authorities should adopt measures (...) to strengthen the long-term sustainability of the pension system by no later than 2020, for instance by adapting indexation rules, by further raising the legal retirement age and the contribution period required to enjoy a full pension and by reviewing special pension schemes (...)"; Recommandation adopted by the Council: "The French authorities should adopt measures (...) to strengthen the long-term sustainability of the pension system by no later than 2020, for instance by adapting indexation rules, by further extending the contribution period required to enjoy a full pension, by further raising real retirement age, by aligning retirement age or pension benefits with the growth in life expectancy and by reviewing special pension schemes (...)".
12. This new stage is provided for in Article 6 in Regulation no 473-2013 dated 21 May 2013 in the "Two Pack".

Commission the power to veto a national budget, nor even to change a budgetary plan in any direct sense. And furthermore, the member state in question can opt not to subscribe to the Commission's opinion, the only penalty it can incur in doing so being that its non-compliance is considered an aggravating factor if it is subject to the Excessive Deficit Procedure and fails to meet the deadline set to bring its public deficit back down to below the 3% of GDP mark.

During the exercise conducted in 2013, the Commission did not call on a single country to review its budgetary plan. Austria had to submit a new draft budgetary plan for 2014 last spring but this was due to a change of government.

3. Correcting budgetary imbalances: European action based on a sanction system, but including flexibility clauses

In the awareness that political incentive would have its limitations in the fiscal discipline demanded of each country, EU's leaders provided as long ago as the Maastricht days for fiscal surveillance to be accompanied by a sanction mechanism (for countries in the euro area). Thus when a country fails to comply with the fiscal rules, it is subject to an **Excessive Deficit Procedure** (EDP) and is given a deadline within which to correct its deficit. This means that it is subject to increased supervision; for instance, in addition to their budgetary plan, euro area countries subjected to an EDP also have to submit an "Economic Partnership Programme" (EPP) in the autumn describing the measures that they plan to adopt in order to consolidate their public finances[13].

"AN EARLY WARNING MECHANISM IS DESIGNED TO AVOID MAJOR BUDGETARY DISTORSION"

The reform of the Stability Pact included a review of the **financial sanctions that can be applied to euro area countries** in breach of European fiscal rules, in an attempt to ensure that they constitute a genuine incentive for states to be serious about budget discipline *(§3.1.)*. Yet if no financial sanction has ever been levied since 1997 despite the numerous breaches of the 3% rule on the member states' part, it is because the Stability Pact contains clauses allowing the Commission to take "exceptional circumstances" or other "relevant factors" into account when analysing each country's budgetary situation *(§3.2.)*.

3.1. Earlier and more automatic financial sanctions

Since the reform of the Stability Pact, **the sanctions levied on the euro area countries not complying with the rules can be applied earlier and have become more gradual** *(see Table 2)*. Thus a sanction can be applied even before a country is subject to an Excessive Deficit Procedure, in the event of a "major gap" with its medium-term budgetary objective or with the adjustment path designed to achieve it (a reduction in its structural deficit of 0.5% of GDP) and if that gap has not been corrected after a year. This is an early warning mechanism designed to avoid major budgetary distortion. The country in question would be required to establish an interest-bearing deposit of 0.2% of GDP, and that deposit would be returned to the member state in the event the gap were to be corrected, or else it would be transformed into a non-interest-bearing deposit if the country's budgetary situation were to deteriorate (thus subjecting the country to the excessive deficit procedure).

13. This requirement was introduced by the Fiscal Compact (Article 5). Yet it is worth stressing that these programmes have no legally binding value, simply reflecting an obligation to inform. The Council adopts an opinion, based on a proposal from the Commission, relating to each country's EPP. Some member states subject to EDP, however, submit a single document to the Commission in October, that single document taking the place of a "budgetary plan" and of an "economic partnership programme", as in France's case.

The **eight countries in the euro area subject to an excessive deficit procedure** *(see Table 4)* have avoided the first two financial sanctions because they were already subject to an EDP when the new regulations came into force. Thus the financial sanction that can be applied to these countries today is the heaviest of all, namely a fine for failure to correct their excessive public deficit within the deadline granted and if the Commission finds that the member state is not adopting the "effective action" required to correct its excessive deficit.

Yet before a fine is levied, the member state which the Commission feels has failed to adopt the "effective action" required to correct its excessive deficit must first be given notice on the basis of the provisions enshrined in Article 126.9 in the TFEU. Only if the member state fails to then adopt the effective action required to respond to its notice can the Commission, within four months of the Council's decision to give notice to the member state in question, recommend levying a fine on the member state (the resulting revenue being allocated to the European Stability Mechanism).

TABLE 2 ► **Financial sanctions for euro area countries provided for in the Stability and Growth Pact (SGP)**

PREVENTIVE ARM OF THE SGP	CORRECTIVE ARM OF THE SGP	
Interest-bearing deposit at 0.2% of GDP	Non-interest bearing deposit at 0.2% of GDP	Fine at 0.2% of GDP (can rise to 0.5% of GDP)
In the event of a "major gap" with the MTO or with the adjustment path intended to lead to it, the Council addresses a warning to the member state. If the member state's situation fails to improve after a year, the Council can demand the establishment of an interest-bearing deposit worth 0.2% of GDP. The deposit is reimbursed to the member state if the gap identified is corrected.	A non-interest bearing deposit worth 0.2% of GDP is established after the decision has been reached to subject a country to excessive deficit procedure.	The deposit set up is converted into a fine worth 0.2% of GDP in the event of failure to comply with the Council's initial recommendation urging correction of the deficit. If the country persists in failing to comply, the penalty is increased, and can rise to as much as 0.5% of GDP.

"SANCTIONS ARE ADOPTED ON THE BASIS OF THE REVERSE QUALIFIED MAJORITY RULE"

Moreover, the sanctions provided for in the Stability Pact are now more automatic once they are **adopted on the basis of the reverse qualified majority rule**, whereby the Commission's recommendation to levy penalties for failure to comply with the Stability Pact is held to be adopted unless the Council rejects it by a qualified majority (prior to the reform the sanctions had to be approved by a qualified majority of member states).

These new developments in the "Six-Pack", however, still leave the Council with "blocking" powers because the decision to levy a penalty must be preceded by a decision taken by an ordinary qualified majority (for subjecting a country to an EDP or taking note of the absence of effective action to correct its excessive deficit)[14]. **The Fiscal Compact offers a response to these blocking powers in the "Six-Pack"** because it includes a measure providing for the signatory countries to work on extending the reverse qualified majority principle to all of the Commission's recommendations regarding the EDP[15].

14. The only exception is the adoption of the penalty provided for in the context of the preventive arm of the SGP, which is preceded by a reverse simple majority decision.
15. Article 7 in the Fiscal Compact states that: "The Contracting Parties whose currency is the euro commit to supporting the proposals or recommendations submitted by the European Commission where it considers that a Member State of the European Union whose currency is the euro is in breach of the deficit criterion in the framework of an excessive deficit procedure. This obligation shall not apply where it is established among the Contracting Parties whose currency is the euro that a qualified majority of them, calculated by analogy with the relevant provisions of the Treaties on which the European Union is founded, without taking into account the position of the Contracting Party concerned, is opposed to the decision proposed or recommended". Thus this measure does not include decisions relating to the preventive arm of the SGP.

3.2. Flexibility clauses in the Stability Pact

While under the recent reform of fiscal surveillance sanctions become almost automatic the moment the Commission proposes them, it is worth highlighting the fact that these sanctions are primarily a deterrent: levying a financial sanction on a member state already having to cope with budget issues would in fact worsen the state of its public finances and is thus a situation to be avoided, both for the member states and for the Commission.

But then, the Commission does not systematically recommend enforcing a sanction on a member state if it fails to correct its excessive deficit within the deadline granted to it. The Commission has resorted to this power only once, back in 2003, against France and Germany. No sanctions were nevertheless enforced because **they were blocked by the Council**.

If the Commission has a certain amount of room for manoeuvre in overseeing compliance with fiscal rules, it is because the Stability Pact contains flexibility clauses which have to be taken into consideration in the Commission's assessment of countries' fiscal situation *(see Table 3)*. **These clauses are envisaged as early as in the Pact's preventive arm**, in other words as soon as the early warning is sounded in the event of a gap with a country's MTO or with the adjustment path designed to achieve that objective.

These flexibility clauses lie at the heart of the debate on budgetary discipline today because they are appealed to by those countries subject to an EDP that cannot manage to meet the deadline granted to them to correct their public deficit. **Several member states have benefited from this flexibility in recent years**, being given an additional one or two years to correct their excessive deficits. This was the case, for instance, with Spain, Portugal and Greece in 2012, and with France, The Netherlands, Poland and Slovenia in 2013.

Reference to these exceptional situations shows that the exercise of **fiscal surveillance by the European institutions is not an inflexible exercise but an exercise in which there is room for flexibility.** The degree of that flexibility depends on the degree of accountant's zeal adopted by the members of the European Commission. Thus for example, as Eulalia Rubio has pointed out, even though the implementation of structural reforms is not explicitly mentioned in the flexibility clauses for countries subject to the excessive deficit procedure, the Commission can take it into consideration among the "relevant factors" in its economic and budgetary analysis of countries subject to an EDP when it deliberates on extending the deadline for correcting the excessive deficit. Having said that, the importance assigned to "relevant factors" and the assessment of the "effective action" taken by the member states rely exclusively on the Commission's discretion[16].

16. Eulalia Rubio, "Promoting structural reforms in the euro area: what for and how?", *Policy Paper No. 119*, Notre Europe – Jacques Delors Institute, October 2014.

TABLE 3 ► **Flexibility Clauses in the Stability and Growth Pact**

COUNTRY SITUATION	COUNTRIES TEMPORARILY FAILING TO MEET THEIR MTO OR THE ADJUSTMENT PATH DESIGNED TO ACHIEVE IT	COUNTRIES WHOSE PUBLIC DEFICIT IS HIGHER THAN 3% OF GDP OR FAIL TO MEET THE PATH FOR REDUCING THEIR EXCESSIVE PUBLIC DEBT	COUNTRIES SUBJECT TO AN EPD FAILING TO MEET THE DEADLINE GRANTED TO THEM TO CORRECT THEIR EXCESSIVE DEFICIT
Flexibility clauses	**The implementation of major structural reform** "with direct, long-term positive budgetary effects, including a strengthening of potential for sustainable growth, and thus having a verifiable impact on the long-term sustainability of public finances" allows temporary deviation, as long as an appropriate safety margin is maintained in relation to the deficit's reference value.	**The occurrence of "exceptional circumstances"** on condition that the excessive deficit remains close to its reference value and is only temporary. A public deficit is considered exceptional if it is the result of an "unusual circumstance outside the control of the member state in question and has a considerable impact on the financial situation of public administrations, or follows on from a serious economic recession". **Comprehensive, balanced assessment of all the relevant factors**, and in particular of their impact, whether as aggravating or as attenuating circumstances, on the assessment of the compliance with the deficit and/or debt criterion. For these relevant factors to be taken into consideration, the public deficit must remain close to the reference value and the overshooting of that value must be temporary.	**The occurrence of negative and unexpected economic events** having major unfavourable consequences for public finances, on condition that the member state has begun to adopt "effective action" to correct its excessive deficit. **"Relevant factors"** must be taken into account, whether as aggravating or attenuating circumstances, on condition that the member state has begun to adopt "effective action" to correct its excessive deficit. **Serious economic recession** in the euro area or the EU, on condition that the member state has begun to adopt "effective action" to correct its excessive deficit.
Consequence	**No early warning (thus no demand to establish an interest-bearing deposit)**	**No excessive deficit procedure is set in motion (thus no demand to establish a non-interest-bearing deposit)**	**Extension of the deadline for correcting the excessive deficit (thus no notice given and no fine levied)**
Legal basis	Article 5.1 in Regulation 1466/97 amended by Regulations 1055/2005 and 1175/2011	Article 126.2 in the TFEU and Articles 2.1, 2.3 and 2.4 in Regulation 1467/97 amended by Regulations 1056/2005 andt 1177/2011	Articles 3.5 and 5.2 in Regulation 1467/97 amended by Regulations 1056/2005 and 1177/2011

4. Budgetary discipline in the euro area since the adoption of the Stability and Growth Pact

"ONLY 4 COUNTRIES OUT OF 28 HAVE NEVER HAVE AN EXCESSIVE DEFICIT"

While the European fiscal rules fuel the image of a Europe narrowing the field of action for national sovereignty, it is necessary to point out that **compliance with these rules has been limited** since the adoption of the Stability Pact in 1997. In 17 years, only four countries out of 28 have never allowed their deficits to shoot above 3% of their national wealth (Estonia, Finland, Luxembourg and Sweden) *(see Appendix 1)*. For some countries, compliance with that threshold has been the exception rather than the rule (France, for instance, has met the criterion only seven times in 17 years, while Portugal and Greece have never met it yet). Even if there have been numerous breaches of the public deficit rule, **no financial sanction has ever been levied**.

As things stand today**, eleven EU countries (eight of which are members of the euro area) are subject to an EDP** *(see Table 4)*. As we can see in Table 4, according to the Commission's forecasts, in 2014, **only two countries in the euro area will achieve their MTO** (Germany and Luxembourg). Even though Greece has not established an MTO (Greece, being subject to a macro-economic adjustment programme, is not subject to the fiscal surveillance procedure, just like Cyprus), we should highlight the fact that it will record the largest structural fiscal surplus in the euro area in 2014, amounting to 2.8% of its GDP.

Now that the new fiscal rules require member states failing to achieve their MTO to reduce their structural deficit by 0.5% of GDP per year, only five countries will manage to comply with this adjustment path in 2014 (Ireland, Greece, Spain, Cyprus, Slovenia). **Regarding the nominal balance, all of the countries in the euro area under excessive deficit procedure have shown a drop in the public deficit in 2014 over 2013** apart from Cyprus, which has been subject to a macro-economic adjustment programme since last year. Greece and Slovenia showed public deficits at 12.7% and 14.1% of GDP respectively in 2013 due to exceptional expenditure to support their banking industries[17].

Of the eight countries subject to an EDP in the euro area, four have to bring their public deficit back to below the 3% threshold in 2015 (Ireland, France, Portugal and Slovenia). Only one of those countries will be able to honour its commitment, according to the Commission's forecasts, and that is Portugal. Yet the situation in Slovenia is less serious, because the country is going to make an effort to reduce its structural deficit by 0.8% of GDP, while France and Ireland do not comply, so far, with the structural deficit reduction path of 0.5% of GDP per year. Spain is also in bad shape because it has to return to below the 3% threshold in 2016 when its nominal deficit for 2015 is going to stand at 6% of GDP and its structural deficit is likely to increase by 1.5% of GDP between 2014 and 2015, according to the Commission's forecasts.

TABLE 4 ► Budgetary indicators for euro area member countries

	MEDIUM-TERM OBJECTIVE (2014)	PUBLIC STRUCTURAL BALANCE			PUBLIC NOMINAL BALANCE			DEADLINE FOR CORRECTING EXCESSIVE DEFICIT (NOMINAL DEFICIT)
		2013	2014	2015	2013	2014	2015	
Belgium	0.75	-1.7	-2.0	-2.5	-2.6	-2.6	-2.8	EDP closed in 2014
Germany	-0.5	0.6	0.4	0.0	0.0	0.0	-0.1	EDP closed in 2012
Estonia	0	-0.6	-0.7	-0.9	-0.2	-0.5	-0.6	No EDP
Ireland	0	-6.5	-4.3	-4.2	-7.2	-4.8	-4.2	2015
Greece	n/a	-6.7	2.8	0.9	-12.7	-1.6	-1.0	2016
Spain	0	-3.3	-2.4	-3.9	-7.1	-5.6	-6.1	2016
France	0	-2.8	-2.4	-2.1	-4.3	-3.9	-3.4	2015
Italy	0	-0.7	-0.7	-0.9	-3.0	-2.6	-2.2	EDP closed in 2013
Cyprus	n/a	-3.7	-2.9	-4.3	-5.4	-5.8	-6.0	2016
Latvia	-1.0	-1.0	-1.4	-1.9	-1.0	-1.0	-1.1	EDP closed in 2013
Luxembourg	0.5	1.4	0.6	-1.3	0.1	-0.2	-1.4	No EDP
Malta	0	-2.7	-2.6	-2.7	-2.8	-2.5	-2.5	2014
Netherlands	-0.5	-0.6	-1.3	-0.8	-2.5	-2.8	-1.8	EDP closed in 2014
Austria	-0.45	-1.0	-2.4	-1.3	-1.5	-2.8	-1.5	EDP closed in 2014
Portugal	-0.5	-2.3	-	-	-4.9	-4.0	-2.5	2015
Slovenia	0	-13.3	-3.2	-2.4	-14.7	-4.3	-3.1	2015
Slovakia	-0.5	-1.6	-1.7	-1.8	-2.8	-2.9	-2.8	EDP closed in 2014
Finland	-0.5	-0.7	-0.9	-0.3	-2.1	-2.3	-1.3	EDP closed in 2011

Source: Stability programmes submitted by the member states in 2014 for the Medium-term objectives; *European Economic Forecast – Statistical Annex*, Spring 2014 .

17. In 2013, Greece's budget deficit, excluding exceptional spending on recapitalising the bank system, stood at 2.1% of GDP, according to Eurostat. In Slovenia's case, the recapitalisation of its banking industry accounted for 10.3% of its GDP.

Where the public debt is concerned, in 2013 **only five countries in the euro area showed a debt below 60% of GDP** – Estonia, Finland, Latvia, Luxembourg and Slovakia – while the indebtment level in the euro area stands at over 90% of GDP. Six euro area countries have a public debt higher than their national wealth: Greece, Italy, Cyprus, Portugal, Ireland and Belgium *(see Appendix 1)*.

CONCLUSION

Is the EU doing too much or is it doing too little in the budgetary discipline that it imposes on its member states? If we consider only the measures in the Stability Pact and the way in which the Commission implements those measures, we can hardly accuse it of doing too stringent a job. The Commission uses the flexibility clauses provided for in the Pact, but at the same time it asks the countries not to let up on their budget consolidation efforts because, aside from the issue of an excessively high public deficit, most of the euro area countries subject to an EDP are also labouring under far too high a public debt.

Yet if we factor in the economic climate, the picture may become more nuanced. For instance, recent budget consolidation efforts are partly cancelled out by lower growth and inflation rates than forecast. Also, while most of the countries in the euro area need to put their public finances back on track, their main priority today must be to impart a fresh boost to growth. But cutting back excessively on public spending and/or raising taxes in the name of budget consolidation cannot help but have a negative impact on domestic demand (consumption and investment) and, by extension, on potential and real growth. Weak growth, in its turn, reduces public revenue and makes a new budgetary effort necessary. This vicious circle needs to be broken. If the member states rediscover growth, it will be easier for them to reduce their deficit. A virtuous circle needs to be triggered. Europe has a role to play not only in stimulating growth (particularly via the 300 billion euro investment programme announced by Jean-Claude Juncker) but also in guaranteeing a balance at the national level between fiscal consolidation efforts and efforts designed to impart a fresh boost to growth and to bolster the economy's competitiveness (thanks, in particular, to the implementation of structural reforms).

Those countries that have made tremendous budget consolidation efforts in recent years must not focus on the issue of differentiated treatment at the hands of the Commission if, as Jean-Claude Juncker appears to want to do, the Commission accords priority to growth and employment and adopts a softer approach than the approach based on budget stringency and austerity that has been characteristic of Europe over the past few years. The policy of austerity is still present in those countries; so they too would be on a winning streak if the Commission were to head in a new direction. Also, we should not underestimate the fact that if countries benefiting from aid programmes have had to implement very painful austerity policies, as indeed so have Spain and Italy, it is primarily because they have been under pressure from the markets, which have been demanding interest rates of over 6% to finance their debt. In France's case, however, no such pressure has been seen, and indeed France today is borrowing at all-time low rates.

Having said that, even though the Juncker Commission wishes to guarantee full usage of the flexibility clauses and to assign full priority to growth, that does not necessarily mean that it is going to turn a blind eye to countries falling short of their objectives. Member states subject to an EDP, regardless of whatever attenuating circumstances or relevant factors the Commission may take into consideration, have to prove that they are adopting effective action to bring their deficits back down to below the 3% of GDP mark. This "effective action" notion is fairly broad and leaves plenty of room for the Commission to interpret it in a discretionary manner. A key issue for such countries as France is to know the degree of importance that must be assigned to the implementation of structural reforms. Whatever the answer, if the Commission harbours doubts regarding a member state's commitment, it will be able to step up the pressure. The economic climate must be seen as an attenuating circumstance for those countries that are making efforts yet failing to achieve their expected results, but it cannot become an excuse for postponing necessary action.

Nevertheless this increase in pressure on the Commission's part is not synonymous with the levying of financial sanctions. It is hard to imagine the Juncker Commission, whose buzz word is "a new start for Europe" based on growth and employment, being eager to kick off its mandate by levying financial sanctions for failure to comply with fiscal rules, when no such thing has ever been done in the past 17 years.

France today is the country with the most fragile budgetary situation in terms of its failure to meet its commitments. Not only is it going to fail to meet the goal of bringing its public deficit back down to below the 3% of GDP threshold in 2015; but it is also going to fail to comply with the path for reducing its structural deficit to the mandatory tune of 0.5% of GDP per year. Yet those who address the debate in terms that argue that the Commission can choose between doing nothing – and some would then judge its attitude to be too laissez-faire – or imposing a financial sanction on France, are wrong. If the Commission considers that France has failed to adopt the "effective action" required to correct its budgetary imbalance, it will recommend to the Council that it gives notice to France to correct its deficit, as provided for in Article 126.9 in the TFEU. This warning can (but need not necessarily) be accompanied by the levying of a fine. The Commission will have four months after the warning has been issued to judge whether or not France has adopted the necessary action to respond to its notice and, if necessary, to levy a fine on it. France would not be the first country in this situation. Belgium was given notice in June 2013 to correct its excessive deficit, but the step was not accompanied by financial sanctions, and a year later Belgium exited its excessive deficit procedure.

APPENDIX 1. Public deficit and debt dynamic (% of GDP) in euro area countries – 1997-2013

		1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Euro area (UE 18)	Deficit	-2.8	-2.3	-1.5	-0.1	-1.9	-2.7	-3.1	-2.9	-2.5	-1.3	-0.7	-2.1	-6.4	-6.2	-4.1	-3.7	-3.0
	Debt	73.1	72.8	71.6	69.2	68.1	68.0	69.1	69.6	70.2	68.5	66.2	70.1	80.0	85.5	87.4	90.7	92.6
Belgium	Deficit	-2.2	-0.9	-0.6	0.0	0.4	-0.1	-0.1	-0.1	-2.5	0.4	-0.1	-1.0	-5.6	-3.8	-3.8	-4.1	-2.6
	Debt	122.5	117.2	113.6	107.8	106.5	103.4	98.4	94.0	92.0	87.9	84.0	89.2	96.6	96.6	99.2	101.1	101.5
Germany	Deficit	-2.8	-2.3	-1.6	1.1	-3.1	-3.8	-4.2	-3.8	-3.3	-1.6	0.2	-0.1	-3.1	-4.2	-0.8	0.1	0.0
	Debt	59.8	60.5	61.3	60.2	59.1	60.7	64.4	66.2	68.6	68.0	65.2	66.8	74.6	82.5	80.0	81.0	78.4
Estonia	Deficit	2.2	-0.7	-3.5	-0.2	-0.1	0.3	1.7	1.6	1.6	2.5	2.4	-3.0	-2.0	0.2	1.1	-0.2	-0.2
	Debt	7.0	6.0	6.5	5.1	4.8	5.7	5.6	5.0	4.6	4.4	3.7	4.5	7.1	6.7	6.1	9.8	10.0
Ireland	Deficit	1.0	2.2	2.6	4.9	0.9	-0.4	0.4	1.4	1.6	2.9	0.2	-7.4	-13.7	-30.6	-13.1	-8.2	-7.2
	Debt	63.6	53.0	47.0	37.0	34.5	31.8	31.0	29.4	27.2	24.6	24.9	44.2	64.4	91.2	104.1	117.4	123.7
Greece	Deficit	-6.2*	-4.0*	-3.2*	-3.7	-4.5	-4.8	-5.6	-7.5	-5.2	-5.7	-6.5	-9.8	-15.7	-10.9	-9.6	-8.9	-12.7
	Debt	96.6	94.5	94.0	103.4	103.7	101.7	97.4	98.6	100.0	106.1	107.4	112.9	129.7	148.3	170.3	157.2	175.1
Spain	Deficit	-4.0	-3.0	-1.3	-0.9	-0.5	-0.3	-0.3	-0.1	1.3	2.4	2.0	-4.5	-11.1	-9.6	-9.6	-10.6	-7.1
	Debt	66.1	64.1	62.4	59.4	55.6	52.6	48.8	46.3	43.2	39.7	36.3	40.2	54.0	61.7	70.5	86.0	93.9
France	Deficit	-3.3	-2.6	-1.8	-1.5	-1.5	-3.1	-4.1	-3.6	-2.9	-2.3	-2.7	-3.3	-7.5	-7.0	-5.2	-4.9	-4.3
	Debt	59.2	59.4	58.9	57.3	56.9	58.8	62.9	64.9	66.4	63.7	64.2	68.2	79.2	82.7	86.2	90.6	93.5
Italy	Deficit	-2.7	-2.7	-1.9	-0.8	-3.1	-3.1	-3.6	-3.5	-4.4	-3.4	-1.6	-2.7	-5.5	-4.5	-3.7	-3.0	-3.0
	Debt	117.5	114.3	113.1	108.6	108.3	105.4	104.1	103.7	105.7	106.3	103.3	106.1	116.4	119.3	120.7	127.0	132.6
Cyprus	Deficit	-5.1	-4.2	-4.3	-2.3	-2.2	-4.4	-6.6	-4.1	-2.4	-1.2	3.5	0.9	-6.1	-5.3	-6.3	-6.4	-5.4
	Debt	57.4	59.2	59.3	59.6	61.2	65.1	69.7	70.9	69.4	64.7	58.8	48.9	58.5	61.3	71.5	86.6	111.7
Latvia	Deficit	1.5	0.0	-3.8	-2.8	-2.0	-2.3	-1.6	-1.1	-0.4	-0.6	-0.7	-4.4	-9.2	-8.2	-3.5	-1.3	-1.0
	Debt	11.1	9.3	12.4	12.4	14.1	13.6	14.7	15.0	12.5	10.7	9.0	19.8	36.9	44.5	42.0	40.8	38.1
Luxembourg	Deficit	3.7	3.4	3.4	6.0	6.1	2.1	0.5	-1.1	0.0	1.4	3.7	3.2	-0.7	-0.8	0.2	0.0	0.1
	Debt	7.4	7.1	6.4	6.2	6.3	6.3	6.2	6.3	6.1	6.7	6.7	14.4	15.5	19.5	18.7	21.7	23.1

		1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Malta	Deficit	-7.4	-9.7	-6.9	-5.7	-6.3	-5.7	-9.0	-4.6	-2.9	-2.7	-2.3	-4.6	-3.7	-3.5	-2.7	-3.3	-2.8
	Debt	46.7	51.8	55.2	53.9	58.9	57.9	66.0	69.8	68.0	62.5	60.7	30.9	66.5	66.0	68.8	70.8	73.0
Netherlands	Deficit	-1.2	-0.9	0.4	2.0	-0.2	-2.1	-3.1	-1.7	-0.3	0.5	0.2	0.5	-5.6	-5.1	-4.3	-4.1	-2.5
	Debt	68.2	65.7	61.1	53.8	50.7	50.5	52.0	52.4	51.8	47.4	45.3	58.5	60.8	63.4	65.7	71.3	73.5
Austria	Deficit	-1.8	-2.4	-2.3	-1.7	0.0	-0.7	-1.5	-4.4	-1.7	-1.5	-0.9	-0.9	-4.1	-4.5	-2.5	-2.6	-1.5
	Debt	64.1	64.4	66.8	66.2	66.8	66.2	65.3	64.7	64.2	62.3	60.2	63.8	69.2	72.5	73.1	74.4	74.5
Portugal	Deficit	-3.7	-3.9	-3.1	-3.3	-4.8	-3.4	-3.7	-4.0	-6.5	-4.6	-3.1	-3.6	-10.2	-9.8	-4.3	-6.4	-4.9
	Debt	55.5	51.8	51.4	50.7	53.8	56.8	59.4	61.9	67.7	69.4	68.4	71.7	83.7	94.0	108.2	124.1	129.0
Slovenia	Deficit	-2.3	-2.4	-3.0	-3.7	-4.0	-2.4	-2.7	-2.3	-1.5	-1.4	0.0	-1.9	-6.3	-5.9	-6.4	-4.0	-14.7
	Debt	22.4	23.1	24.1	26.3	26.5	27.8	27.2	27.3	26.7	26.4	23.1	22.0	35.2	38.7	47.1	54.5	71.7
Slovakia	Deficit	-6.3	-5.3	-7.4	-12.3	-6.5	-8.2	-2.8	-2.4	-2.8	-3.2	-1.8	-2.1	-8.0	-7.5	-4.8	-4.5	-2.8
	Debt	33.7	34.5	47.8	50.3	48.9	43.4	42.4	41.5	34.2	30.5	29.6	27.9	35.6	41.0	43.6	52.7	55.4
Finland	Deficit	-1.3	1.7	1.7	7.0	5.1	4.2	2.6	2.5	2.9	4.2	5.3	4.4	-2.5	-2.5	-0.7	-1.8	-2.1
	Debt	53.9	48.4	45.7	43.8	42.5	41.5	44.5	44.4	41.7	39.6	35.2	33.9	43.5	48.8	49.3	53.6	57.0

Source: Eurostat

* Data from the OECD (information non available on Eurostat)

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19 rue de Milan, F – 75009 Paris
Pariser Platz 6, D – 10117 Berlin
info@notre-europe.eu
www.notre-europe.eu