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Any errors of interpretation or understanding remain the authors' responsibility. This Vade mecum is not a legal text and therefore cannot bind the European Commission in its application of the Stability and Growth Pact or any related legislation.

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0. INTRODUCTION

Enhancing clarity of the strengthened fiscal (and economic) governance toolbox is among the actions set out in the 21 October 2015 Communication by the Commission *On steps towards Completing Economic and Monetary Union.*[1] This document is the second issue of the Vade mecum, published for the first time in May 2013 with the aim of improving transparency of the way the Commission applies the rules of the Stability and Growth Pact (SGP). Its annual update was called for by the Communication *On steps towards Completing Economic and Monetary Union* with a view to further increasing transparency and explaining rules in a structured and hopeful pedagogical way. It is a manual prepared by, and under the responsibility of, the Directorate-General for Economic and Financial Affairs (ECFIN) of the European Commission. It presents the relevant procedures and methodologies designed for implementing the SGP. These are either enshrined in the EU legislations (Treaty, SGP regulations, delegated acts) or stemming from the interpretation of general provisions of the legislation by the Commission and Member States, in the context of the work of the Economic and Financial Committee (EFC) of the Council, or specific interpretative Communication by the Commission. This technical document is primarily aimed at experts and organisations working on public finance issues in European Union (EU) countries, but should be of interest for anyone wanting an in depth understanding of the SGP's functioning or searching for details on its implementation.

The Vade mecum is a compiled-style document that brings together all the elements relevant to the implementation of the SGP. The reader should see it as a compendious encyclopaedia with stand-alone articles digging into specific dimensions. Therefore, given the necessary repetitions entailed by this format, it is not meant for linear reading. While each Section strives for a comprehensive presentation of relevant technical and legal aspects, the main text aims to remain broadly accessible for non-specialists. In this respect, the relevant economic concepts and historical background underlying the procedure have been systematically recapped, while a load of technical details was put in annexes (17 in total). The Vade mecum describes the working of the SGP step by step at the time of writing (with 15 February 2016 as a cut-off date). It should not be considered to be definitive, since it presents in several parts the currently agreed or historic interpretation of a feature of the SGP, which might evolve as the need arises. The Vade mecum will be updated annually to timely reflect any significant change in the evolution of the rules and surveillance practice.

With respect to the previous (and first) issue of May 2013, the current version has been updated to reflect requests of clarification received since the first publication, and i) the changes to the surveillance procedures resulting from the entry into force of the legislative package known as the Two Pack on 30 May 2013,[2] ii) the current operationalization of the preventive arm also in light of the "Commonly agreed position on Flexibility", endorsed by the ECOFIN Council of 12 February 2016,[3] which builds on the interpretative Commission's Communication on *Flexibility within the SGP* of January 2015,[4] iii) the improvements to the methodology for assessing effective action under the corrective arm of the SGP as endorsed by the ECOFIN Council on 20 June 2014,[5] as well as iv) the introduction of

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(1) Communication from the Commission *On steps towards Completing Economic and Monetary Union*, COM(2015) 600 final of 21.10.2015: http://ec.europa.eu/priorities/economic-monetary-union/docs/single-market-strategy/communication-emu-steps_en.pdf
(2) For a non-technical overview of the changes, see Part II of Report on Public Finances in EMU 2013, European Economy 4/2013: http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee-2013-4.pdf.
(3) http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf
(4) Communication from the Commission *Making the best use of the flexibility within the existing rules of the Stability and Growth Pact*, COM(2015) 12 of 13.01.2015: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/2015-01-13_communication_sgp_flexibility_guidelines_en.pdf
(5) Economic and Financial Affairs Council conclusions of the meeting of 20 June 2014: http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/143293.pdf

macroeconomic conditionality linked to the economic surveillance procedures to all the European Structural and Investment Funds (ESIF).

The SGP is rooted in the Treaty on the Functioning of European Union (TFEU), in particular articles 121 and 126, and the Protocol 12 annexed to the TFEU (Box 1.1, 2.1 and 2.2). Article 136 indicates measures specific to those Member States whose currency is the euro (Box 1.2). The SGP is implemented through secondary legislation in the form of *Regulation (EC) 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies* and *Regulation (EC) 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure*. These two regulations respectively specify the so-called preventive arm and corrective arm of the SGP (with the latter being also known as the Excessive Deficit Procedure). Further details for the SGP's implementation are published in a Code of Conduct on the SGP([6]), entitled "*Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence programmes*", agreed by the ECOFIN Council. The SGP has evolved over the years through amendments to the legislation. Box 0.1 and Graph 0.1 present a short overview of its history.

This Vade mecum covers the preventive and the corrective arms of the Pact in Parts I and II respectively. Part III presents the institutional context – both European and national – in which European budgetary surveillance operates.

Part I focuses on the preventive arm of the Pact and contains four Sections. Section 1.1 provides the necessary background and is followed by Section 1.2 that elaborates on the role and assessment of the medium-term budgetary objectives (MTOs). Section 1.3 sets out how the assessment of the Stability and Convergence Programmes and, more in general, of compliance with the preventive arm should be undertaken and Section 1.4 describes the conditions and procedures linked to the observation of a significant deviation (from the requirements of the preventive arm) and the introduction of sanctions for euro area Member States.

Part II, on the corrective arm of the Pact, is structured on the basis of the successive steps under the Excessive Deficit Procedure (EDP). Section 2.1 provides the background. Section 2.2 explains how an EDP is launched and Section 2.3 considers the actions to be taken after a Council recommendation to put an end to excessive deficit is issued. Section 2.4 explains the actions to be taken after a non-effective action following a Council EDP recommendation or decision to give notice, respectively. Section 2.5 explains how an EDP is abrogated.

Part III, on the institutional context is divided into two Sections. Section 3.1 considers the institutional dimension of the European side of budgetary surveillance, placing the SGP in the context of not just budgetary but also wider economic surveillance. Section 3.2 discusses the obligations on Member States in terms of their own budgetary processes, stemming from the Six Pack, the Two Pack, and the Fiscal Compact established by the inter-governmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG).

Box 0.1: *The Stability and Growth Pact since its inception*

The secondary legislation governing the SGP was adopted in 1997, as the budgetary pillar of the Economic and Monetary Union, applying for the whole EU without exception. The first amendment of the SGP occurred in 2005 and involved changes to both the preventive and the corrective arms. The main aim was to take economic circumstances and country-specific characteristics better into account.

([6]) http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf.

In the preventive arm, the horizontal requirement of achieving a budgetary position of close to balance or surplus in nominal terms was replaced by a country-specific objective set in structural terms (net of cyclically-driven expenditure and revenue and of one-offs). These objectives take Member States' gross government debt level and the magnitude of the fiscal challenge posed by population ageing into account. In the corrective arm, the possibility of extending the Excessive Deficit Procedure (EDP) deadline was introduced for countries that had taken effective action but were faced with unexpected adverse economic circumstances with a significant impact on their public finances – a principle labelled “conditional compliance”. For both arms, the legislation indicated a benchmark adjustment for the size of the correction to be made for countries either not at their medium-term budgetary objective - MTO (preventive arm) or with an excessive deficit (corrective arm). Furthermore, in order to enhance the growth-oriented dimension of the Pact, the adjustment path to the MTO could take the implementation of major structural reforms into account, provided that they have a verifiable impact on long-term public finance sustainability, either directly (such as for pension reforms) or by raising the growth potential (and thereby lowering the level of public debt as a percentage of GDP).

Following the onset of the economic and financial crisis in 2008 and the further experience with the concrete implementation of the Pact, the SGP was amended for a second time in 2011, as part of a package of legislation known as the Six Pack. A schematic overview of these reforms is presented in Tables 0.1 and 0.2. The package amended both Regulations and added a system of graduated enforcement mechanisms (financial sanctions), to address the weaknesses in the surveillance framework that the crisis exposed. In particular, the changes strengthened the preventive arm of the Pact to ensure that good economic times were used to pursue policies leading to healthy public finances. A new expenditure benchmark was added, involving an analysis of government expenditure net of discretionary revenue measures, as a complement to the change in the structural balance. Moreover, a key innovation was the specification of when deviations from the adjustment path to the MTO are deemed to be significant, making them a trigger for a corrective mechanism (within the preventive arm) which could lead to sanctions. The corrective arm was changed by putting the debt requirement on an equal footing to the deficit one, in light of the damaging impact of sovereign sustainability concerns during the crisis. The sanctions for the euro area Member States were strengthened and frontloaded (and also extended to the preventive arm in case of significant deviation, as mentioned above). Complementing the SGP Regulations, the Six Pack also contained a Directive on requirements for budgetary frameworks in the Member States, imposing certain institutional requirements on domestic budgetary arrangements, procedures, rules and institutions, to better ensure that national budgetary positions are in line with the EU fiscal framework.

The amendments to the key regulations have increased both the economic credibility and the flexibility within the rules of the Pact. At the same time, these have led to make the rules more complex and introduced some necessary room for judgement, so as to adapt to ever-changing and complex economic reality, while avoiding an ex ante over-specification. This inevitable need for discretion within the rules calls, as a necessary counterpart, for further transparency. In this respect, the "Commonly agreed position on flexibility", endorsed by the ECOFIN Council (February 2016), building on the interpretative Communication on flexibility within the SGP (January 2015), has provided guidance for implementing the flexibility of the revised framework.

In March 2012, twenty-five EU countries([7]) signed the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), which contains the fiscal

([7]) All except the Czech Republic and the United Kingdom. Croatia, which was not member of the European Union at the time, is also not a signatory of the TSCG.

compact([8]). Building on the directive for national budgetary frameworks, it includes provisions to ensure that the national processes are able to fulfil European obligations and that national policy is in line with the requirements of the SGP. Its main features are also set out in Table 0.1.

Table 0.1: **Changes to the preventive arm of the SGP from the Six Pack 2011 reforms (in *bold) and the specifics of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union** ***(TSCG – in italics)***

Objective	Specification	Adjustment path	Enforcement specification
Requirement of a close to balance or in surplus position	Country specific Medium-Term Objective in structural terms: - Provide a safety margin with respect to the 3% deficit limit - Ensure rapid progress towards sustainability - Allow room for budgetary manoeuvre For euro area and ERMII MS: limits of -1% of GDP *(TSCG: limit is -0.5%, unless debt <<60% and low risks to sustainability)* ***Expenditure benchmark: expenditure net of discretionary measures should grow ≤ medium-term potential GDP**	0.5% of GDP as a benchmark: - More in good times - Less in bad times Possible temporary deviations from the MTO or the adjustment path towards it: - Implementation of major structural reforms which have a verifiable impact on the long-term sustainability of public finances – emphasis on pension reform **- *Unusual event outside the control of the MS concerned which has a major impact on its financial position** **- *Periods of severe economic downturn for the euro area or the Union as a whole provided this does not endanger fiscal sustainability in the medium term**	***Procedure for correcting significant deviation (0.5% in one year or cumulatively over two years from the MTO or the adjustment path towards it)** *(TSCG: Automatic correction mechanism in national legal order monitored by independent national institution)* ***For euro area: financial sanctions in case of repeated non-compliance (interest-bearing deposit of 0.2% of GDP)**

([8]) Beside euro area signatory countries, Denmark, Bulgaria and Romania declared themselves bound by the provisions of the fiscal compact.

Table 0.2: Changes to the corrective arm of the SGP from the Six Pack 2011 reforms (in *bold) and the specifics of 2013 Regulation on the European Structural and Investment Funds *(ESIF – in italics)*

Objective	Specification	Adjustment path	Enforcement specification
Correct gross policy errors	Sets limits: - Deficit of 3% of GDP - Debt of 60% of GDP or sufficiently diminishing ***Definition of sufficiently diminishing = respect of debt reduction benchmark** ***Debt reduction benchmark = reduction of 5% per year on average over 3 years of the gap to 60% taking the cycle into account or respect in the next two years.** ***Transition period for MS in EDP in Nov 2011 for three years after the correction of the deficit.**	Minimum annual improvement of at least 0.5% of GDP as a benchmark in structural terms Possible extension of the deadline: - If effective action has been taken and unexpected adverse economic events with major unfavourable consequences on its financial position - ***Periods of severe economic downturn in the euro area or in the Union as a whole provided this does not endanger fiscal sustainability in the medium-term**	***For the euro area: early and gradual sanction system to be activated at each stage of the EDP procedure** *ESIF: Suspension of commitments or payments under the European Structural and Investment Funds (UK excluded)*

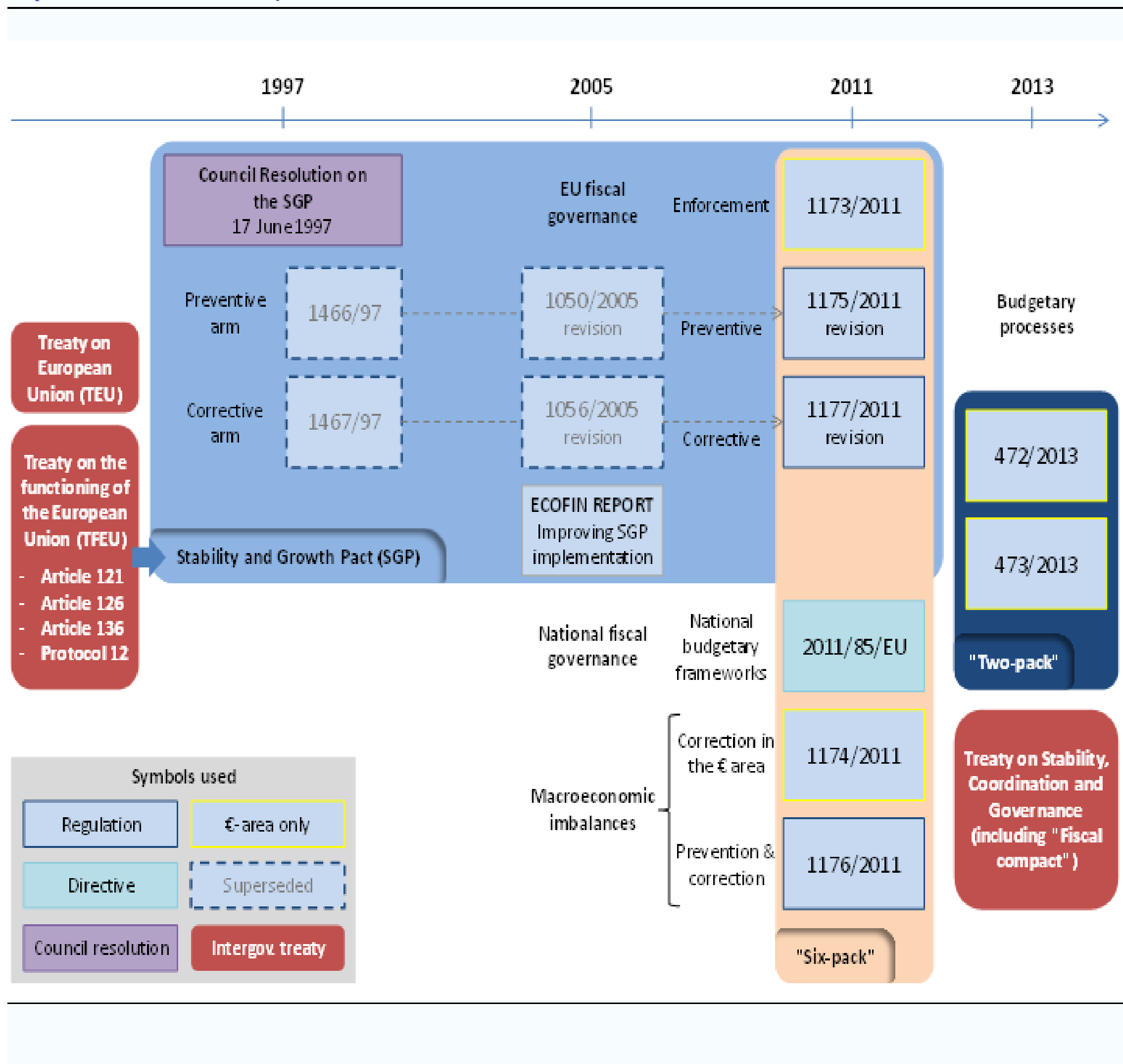
Two further regulations on enhanced surveillance and monitoring in the euro area – known as the Two Pack – were adopted and entered into force on 30 May 2013. Regulation 473/2013 of the Two-Pack includes common provisions for monitoring and assessing draft budgetary plans and for ensuring a timely and effective correction of excessive deficits for the Member States of the euro area. Regulation 472/2013 streamlines the requirements placed on financially fragile countries and embeds these provisions in the Union framework for policy co-ordination and surveillance, suspending the reporting requirements under the SGP for countries under a macroeconomic adjustment programme. The Two Pack regulations do not change the budgetary policy requirements for euro area Member States. A schematic overview of the Two- Pack is presented in Table 0.3.

Table 0.3: **The main features of the Two Pack**

	Regulation on enhanced monitoring (473/2013)	Regulation on enhanced surveillance (472/2013)
Applies to	All euro area Member States, with special provisions for those in EDP	Euro area Member States experiencing severe difficulties with regard to their financial stability (defined by a Commission decision), receiving financial assistance on a precautionary basis or subject to a full macroeconomic programme
Main provisions	Member State provide draft budgetary plans to the Commission by 15 October. Commission issues an opinion on the plan to inform the national debate. Commission can request a revised draft if particularly serious breach of SGP. National independent bodies monitor national fiscal rules, including a rule to implement the MTO at national level. They provide assessments linked to an automatic correction mechanism. Closer monitoring for countries under EDP: countries submit Economic Partnership Programmes with details of their programme to correct their EDP, regular reporting on budgetary execution and associated measures. Commission can request any information it requires.	Enhanced surveillance means countries must adopt measures to address their weaknesses, in cooperation with the Commission (and ECB). The Commission implements a closer fiscal monitoring and may request stress tests, detailed data on the financial institutions and an assessment of the supervisory capacities. Council can recommend (on a Commission recommendation) that a country adopt a precautionary programme or prepare a draft programme. Streamlining of reporting requirements for countries under programme. Special provisions for the post-programme period, when countries remain under enhanced surveillance until 75% of funds repaid.

Finally, in 2013 Regulation 1303/2013 on the European Structural and Investment Funds (ESIF) extended the possibility of sanctions following a decision on a lack of effective action under the corrective arm of the SGP to all Member States except the United Kingdom. The spirit was to reinforce the economic conditionality for granting the benefits of these funds to Member States, by checking if they comply with their fiscal obligations at EU level, in order to ensure that the effectiveness of ESIF is not undermined by unsound macroeconomic and fiscal policies. The provisions of this regulation apply under the 2014-2020 programming period and increase both the automaticity and the scope of suspensions, relative to the provisions that applied during the 2007–2013 period.

Graph 0.1: **The SGP over the years**



1. THE PREVENTIVE ARM OF THE STABILITY AND GROWTH PACT (SGP)

This Part focuses on the preventive arm of the Pact and contains four Sections. Section 1.1 provides the necessary background and is followed by Section 1.2 that elaborates on the role and assessment of the medium-term budgetary objectives (MTOs). Section 1.3 sets out how the assessment of the Stability and Convergence Programmes and, more in general, of compliance with the preventive arm should be undertaken and Section 1.4 describes the conditions and procedures linked to the observation of significant deviation (from the requirements of the preventive arm) and the introduction of sanctions for euro area Member States.

1.1. LEGAL BASIS, RATIONALE AND MONITORING

The objective of the preventive arm of the SGP is to promote sound public finances and to ensure the sustainability of public finances of the Member States. Compliance with the preventive arm should lead to sound budgetary positions so as to avoid the occurrence of excessive budget deficits (and debts). The preventive arm is based primarily on Article 121 of the Treaty on the Functioning of the European Union (TFEU) on multilateral surveillance and its operation is set out in Regulation (EC) 1466/97 and its subsequent amendments.

At the core of the preventive arm is the country-specific medium-term objective (MTO) which corresponds to the structural budgetary position that Member States should achieve, and maintain, over the cycle, in order to ensure sustainable public finances and provide a safety margin to safeguard respect of the Treaty reference values for the deficit and the debt at times of negative output gaps. The SGP sets out certain rules that Member States have to respect when drawing up their multi-annual budgetary plans, in order to progressively reach their MTO. These rules were strengthened with the 2011 reform of the SGP – commonly referred to as the Six Pack – by the introduction of an expenditure benchmark, which sets an upper limit for the net growth of government expenditure([9]) thereby providing more operational guidance, and by the possibility of financial sanctions for euro area Member States in the case of a repeated failure to comply with the recommendations under the preventive arm, namely when the steps set out in article 121(4) TFEU and articles 6(2) and 10(2) of Regulation 1466/97 (hereafter Significant Deviation Procedure) have been launched.

In order to enable the Commission and the Council to assess budgetary plans and outcomes against these rules, regular reporting obligations apply to all Member States as part of a multilateral surveillance framework. Member States provide information on their plans for the coming years to attain their MTO (in the form of Stability or Convergence Programmes (SCPs) – see Section 1.3). The surveillance starts with the European Semester, which broadly corresponds to the first six months of every calendar year. In this time-period, compliance with the preventive arm is assessed on the basis of Member States' medium-term plans, in time to allow them to take on board the conclusions of the European Semester, in the form of Country-Specific Recommendations, when preparing the budgets for the next year during the second half of the year.

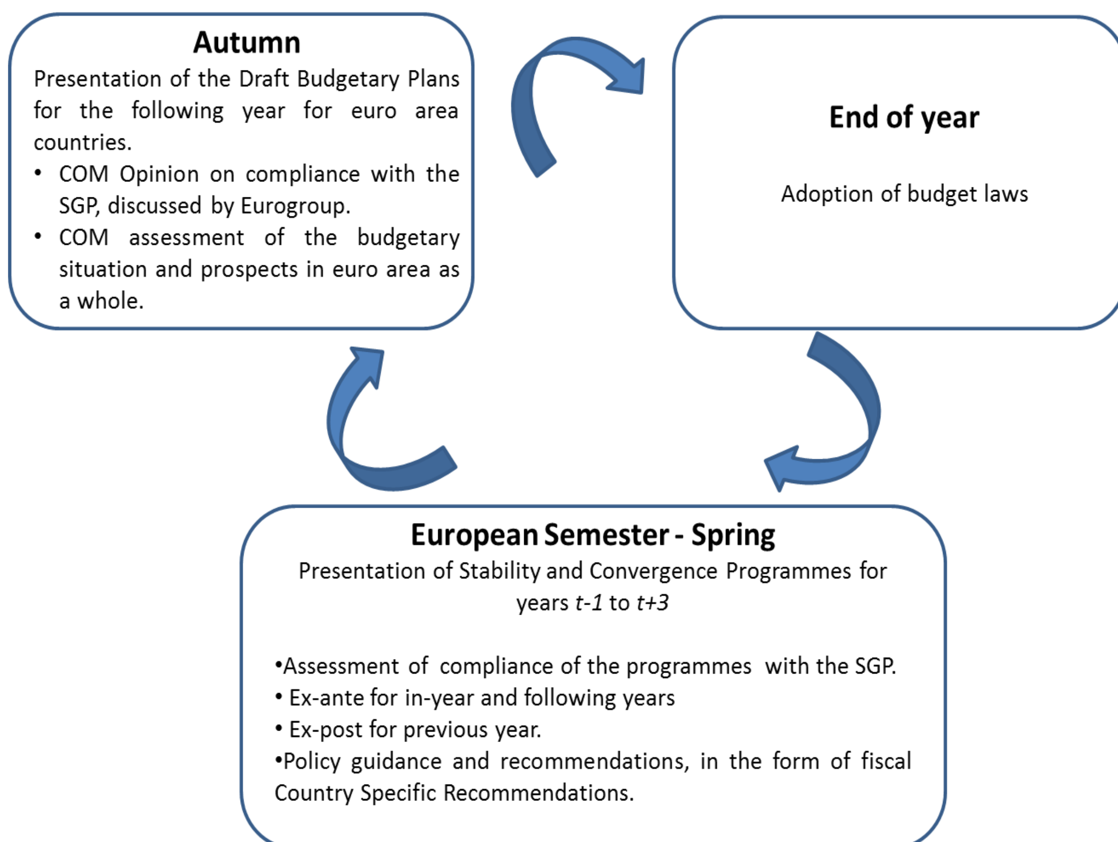
The assessments of the SCPs cover both the preventive and the corrective arms of the Pact depending on the circumstances of each Member State. Nevertheless, according to Regulation (EC) 1466/97, the SCPs

([9]) The growth of government expenditure which is not financed by corresponding changes to revenue measures.

play a specific role under the preventive arm, as they serve as the means for assessing ex ante compliance with the preventive arm.

Since the entry into force of the Two Pack in 2013, the surveillance cycle is completed in autumn with an assessment of euro area Member States' Draft Budgetary Plans (DBPs) for the next year (see Section 3.1).([10]) The Commission adopts an Opinion on each DBP which focuses on the (ex ante) assessment of compliance with the respective obligations under the SGP. In this way, guidance is provided to the Member States throughout the whole budgetary cycle. At the same time, the Commission also presents an overall assessment of the budgetary situation and prospects in the euro area as a whole, based on the plans submitted.([11]) Graph 1.1 gives an overview of the annual cycle of surveillance.

Graph 1.1: **The annual cycle of surveillance**



Note: All euro area Member States are bound by a common budgetary timeline introduced by the Two Pack, and should adopt their budgets for the forthcoming year before 31December, unless for reasons beyond the control of the government.

([10]) Euro area Member States under a macroeconomic adjustment programme are subject to a regular monitoring in the terms of Regulation (EU) 472/2013 and, therefore, exempted from the requirement to submit a Stability Programme or a Draft Budgetary Plan.
([11]) See http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2014/communication_to_euro_area_member_states_2014_dbp_en.pdf

1.1.1. Legal basis of the preventive arm

Article 121 TFEU (see Box 1.1) is the primary legal basis of the preventive arm of the SGP. This Article states that Member States shall regard their economic policies as a matter of common concern and that they shall coordinate them. It establishes a multilateral surveillance procedure based on the broad economic policy guidelines – discussed at European Council level and adopted by the Council – which set out the overall context against which Member States' policies will be assessed. The Council monitors the developments in the Member States, based on reports prepared by the Commission. Economic policies that are assessed as inconsistent with the broad guidelines or which risk jeopardising the proper functioning of Economic and Monetary Union can lead to steps set out under art. 121(4) TFEU – hereafter Significant Deviation Procedure. Detailed rules governing this multilateral procedure may be adopted by the European Parliament and the Council, using ordinary legislative procedure. The secondary legislation, which implements the preventive arm of the Pact, has been adopted on this basis – as per Article 121(6) of TFEU.

Box 1.1: **ARTICLE 121 OF TFEU**

1. Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council, in accordance with the provisions of Article 120.

2. The Council shall, on a recommendation from the Commission, formulate a draft for the broad guidelines of the economic policies of the Member States and of the Union, and shall report its findings to the European Council.

The European Council shall, acting on the basis of the report from the Council, discuss a conclusion on the broad guidelines of the economic policies of the Member States and of the Union.

On the basis of this conclusion, the Council shall adopt a recommendation setting out these broad guidelines. The Council shall inform the European Parliament of its recommendation.

3. In order to ensure closer coordination of economic policies and sustained convergence of the economic performances of the Member States, the Council shall, on the basis of reports submitted by the Commission, monitor economic developments in each of the Member States and in the Union as well as the consistency of economic policies with the broad guidelines referred to in paragraph 2, and regularly carry out an overall assessment.

For the purpose of this multilateral surveillance, Member States shall forward information to the Commission about important measures taken by them in the field of their economic policy and such other information as they deem necessary.

4. Where it is established, under the procedure referred to in paragraph 3, that the economic policies of a Member State are not consistent with the broad guidelines referred to in paragraph 2 or that they risk jeopardising the proper functioning of Economic and Monetary Union, the Commission may address a warning to the Member State concerned. The Council, on a recommendation from the Commission, may address the necessary recommendations to the Member State concerned. The Council may, on a proposal from the Commission, decide to make its recommendations public.

Within the scope of this paragraph, the Council shall act without taking into account the vote of the member of the Council representing the Member State concerned.

A qualified majority of the other members of the Council shall be defined in accordance with Article

238(3)(a).

5. The President of the Council and the Commission shall report to the European Parliament on the results of multilateral surveillance. The President of the Council may be invited to appear before the competent committee of the European Parliament if the Council has made its recommendations public.

6. The European Parliament and the Council, acting by means of Regulations in accordance with the ordinary legislative procedure, may adopt detailed rules for the multilateral surveillance procedure referred to in paragraphs 3 and 4.

The actual implementation of the preventive arm of the Pact is governed by secondary legislation in the form of Council Regulation (EC) 1466/97 of 7 July 1997 *on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies*, as amended by Council Regulation (EC) 1055/2005 of 27 June 2005 and Regulation (EU) 1175/2011 of the European Parliament and of the Council of 16 November 2011.([12])([13])

Regulation (EC) 1466/97 states that "The exact nature of the information [to be provided by Member States under the preventive arm of the Pact] shall be set out in a harmonised framework established by the Commission in cooperation with the Member States". This harmonised framework is part of the Code of Conduct on the SGP,([14]) whose Section 2 presents the specifications of how the information requirements under the SGP Regulations should be fulfilled by the Member States.

In addition, Regulation (EU) 1173/2011 of the European Parliament and of the Council of 16 November 2011 *on the effective enforcement of budgetary surveillance in the euro area* added a system of graduated enforcement mechanisms to the Pact for euro area Member States. This Regulation governs procedures under both the preventive and the corrective arms of the Pact, including the introduction of sanctions in the preventive arm on the basis of Article 136 (see Box 1.2) for euro area countries only.

Box 1.2: **Article 136 of TFEU**

1. In order to ensure the proper functioning of Economic and Monetary Union, and in accordance with the relevant provisions of the Treaties, the Council shall, in accordance with the relevant procedure from among those referred to in Articles 121 and 126, with the exception of the procedure set out in Article 126(14), adopt measures specific to those Member States whose currency is the euro:

(a) to strengthen the coordination and surveillance of their budgetary discipline;

(b) to set out economic policy guidelines for them, while ensuring that they are compatible with those adopted for the whole of the Union and are kept under surveillance.

([12]) Annex 1 contains links to all relevant legislation. The consolidated text is available under: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1466:20111213:EN:PDF.
([13]) The Amsterdam European Council Resolution on the SGP of 17 June 1997 and the Report of the Economic and Financial Affairs Council on "Improving the implementation of the Stability and Growth Pact", endorsed by the European Council in its conclusions of 22 March 2005, also form part of the preventive arm of the Pact, but do not contain additional operational requirements.
([14]) Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence programmes.
http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf

2. For those measures set out in paragraph 1, only members of the Council representing Member States whose currency is the euro shall take part in the vote.

A qualified majority of the said members shall be defined in accordance with Article 238(3)(a).

3. The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality.([15])

Moreover, as part of the November 2011 legislative package that amended the Stability and Growth Pact, the Council adopted Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, which had to be effectively incorporated into national budgetary processes following a two-year transposition period.([16]) This directive sets out essential requirements on national budgetary frameworks.([17])

The objective of ensuring that national decision-making processes are set up with a view to achieving budgetary positions in line with EU requirements is also at the heart of the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), signed by all EU countries, except the Czech Republic and the UK,([18]) in March 2012 and which entered into force on 1 January 2013. Euro area signatory countries have committed themselves to integrate the core principles of the preventive arm of the SGP straight into their national legal framework, through provisions of binding force and permanent character, preferably constitutional or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary process. The provisions specifically related to budgetary surveillance are also known as the "Fiscal Compact".([19]) These provisions include a national correction mechanism supervised by an independent monitoring body to ensure compliance with the budgetary targets. These ones, while being defined nationally, should be consistent with the targets set in the preventive arm of the Pact. Box 1.3 provides an overview of the key features of the TSCG, while Section 3.2.1 discusses provisions of the TSCG which affect the national decision-making processes in more detail.

Box 1.3: Key features of the TSCG

The TSCG commits the signatories to greater budgetary and economic coordination, and signals their commitment to abiding by the rules of the SGP. The provisions on the budgetary side are contained in the fiscal compact, which covers articles 3 to 8 of the TSCG. The fiscal compact (see Annex 8) aims to complement European budgetary surveillance through the following provisions:

• Contracting Parties commit to translating the MTO concept into their national law, through provisions of binding force and permanent character. If their debt level is significantly below 60% of

([15]) Paragraph 3 was added to Article 136 from 1 May 2013, following a Treaty amendment under Article 48(6) TFEU.
([16]) By virtue of Protocol 15 on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland annexed to the TFEU, chapter IV of the Directive, which concerns numerical fiscal rules, does not apply to the United Kingdom.
([17]) The 2012 Interim Progress Report on the implementation of this directive is available here: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0761:FIN:EN:PDF, the accompanying Staff Working Document here: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SWD:2012:0433:FIN:EN:PDF
([18]) Croatia is also not a signatory of the TSCG, as it was not a Member of the European Union in March 2012.
([19]) Non-euro area signatories may also declare themselves bound by the provisions of the fiscal compact. This is the case for Denmark, Bulgaria and Romania. On the other hand, Hungary, Poland and Sweden ratified the TSCG but did not opt in to the Fiscal Compact.
http://www.consilium.europa.eu/policies/agreements/search-the-agreements-database?command=details&lang=en&aid=2012008&doclang=EN

GDP and there are low risks to sustainability, their MTO should not be below a structural balance of -1% of GDP, otherwise a tighter constraint of -0.5% of GDP applies. A temporary deviation from the medium-term objective or the adjustment path towards it will only be possible in exceptional circumstances, as defined in the SGP. In case of significant observed deviations from the MTO or the adjustment path towards it – the SGP concept – correction mechanisms will be triggered automatically at the national level.

• In addition, independent bodies will be in charge of monitoring compliance with the balanced-budget rule – defined as a country attaining its MTO – at the national level.

• The contracting parties commit themselves to supporting Commission recommendations at all stages of deficit EDPs, unless a qualified majority of Member States is opposed. This mimics the so-called reversed qualified majority voting that applies to the imposition of sanctions under the sanctions regulation for the EDP.

• Finally, Contracting Parties subject to an EDP will have to present an economic partnership programme detailing the structural reforms that are deemed necessary to support an effective and durable correction of the excessive deficit.

• The Contracting Parties will report ex ante on their debt issuance plans to the Council of the EU and to the European Commission, to enhance the coordination of national debt issuance.

• Contracting parties that do not adequately enshrine these provisions in their national law may face financial sanctions of up to 0.1% of the Member State's GDP, imposed by the Court of Justice of the European Union.

In 2013, two Regulations based on Article 136 (see Box 1.2) applying only to the euro area entered into force. Although these Regulations – commonly referred to as the Two Pack –do not add to the SGP policy requirements, they bring about changes to the surveillance cycle. For this reason, a large part of their requirements has been incorporated seamlessly into the operation of the SGP.

Regulation (EU) 472/2013 of the European Parliament and of the Council of 21 May 2013 *on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability*([20]) streamlines the requirements placed on financially fragile countries and embeds these provisions in the EU framework for policy co-ordination and surveillance. In particular, for countries under a macroeconomic adjustment programme, it suspends the reporting requirements under the SGP and integrates the budgetary targets of the programme into the applicable recommendations and decisions under the SGP. Regulation (EU) 473/2013 of the European Parliament and of the Council of 21 May 2013 *on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit for the Member States of the euro area*([21]) complements the surveillance cycle for all euro area countries and increases the reporting and monitoring requirements for countries under EDP. Building on Directive 2011/85/EU, this Regulation also gives independent fiscal institutions a key role in preparing and monitoring macroeconomic forecasts and budgetary decisions and in supervising the operation of national fiscal rules.

Regulation 473/2013 states that "The specification of the content of the draft budgetary plans shall be set out in a harmonised framework established by the Commission in cooperation with the Member States".

([20]) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0001:0010:EN:PDF
([21]) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0011:0023:EN:PDF

This harmonised framework is the Code of Conduct on the Two Pack entitled "Specifications on the implementation of the Two Pack and guidelines on the format and content of draft budgetary plans, economic partnership programmes and debt issuance reports".([22])

1.1.2. Rationale behind the preventive arm

The fundamental idea behind Article 121 TFEU is that in an increasingly integrated EU, and particularly in the euro area, the interdependence between Member States means that their interests are best served through the co-ordination of their economic policies. Therefore, this Article constitutes the legal basis of both the preventive arm of the SGP, which deals with budgetary policy, and the macroeconomic imbalances procedure.([23])

The preventive arm of the SGP endeavours to ensure that fiscal policy is conducted so as to lead to healthy public finances over the short and longer terms. It requires that Member States attain a country-specific MTO for their budgetary position, which is set in structural terms. For Member States that are not at their MTO, an appropriate adjustment path towards it should be defined and adhered to. By setting a budgetary target in structural terms – i.e. cyclically adjusted and net of one-off and other temporary measures (see Box 1.4) – the preventive arm of the Pact aims to ensure that the underlying fiscal position of Member States is conducive to medium-term sustainability, while allowing for the free operation of the automatic stabilisers. The country-specific MTOs are set taking into account their respective debt levels, the country-specific sustainability challenge posed by the costs of ageing population and the specific dynamics of the automatic stabilisers. Section 1.2 presents a detailed guide to the MTO.

Since the Six-Pack reform of the SGP, compliance with the requirements of the preventive arm is assessed using a two-pillar approach. The assessment of the structural balance, which constitutes one pillar, is complemented by an analysis of the growth rate of an expenditure aggregate net of discretionary revenue measures (i.e. an assessment of compliance of the expenditure benchmark), which constitutes the other pillar. Compliance with the preventive arm is assessed through an overall assessment which takes both these elements into account.

The expenditure aggregate is comprised of overall government expenditure net of interest payments, spending on EU programmes paid for by EU funds and cyclical elements of unemployment benefits, while investment spending is smoothed over four years. The underlying rationale is to focus on government spending (i) that is independent of cyclical conditions (by netting out the cyclical elements of unemployment spending), (ii) within the government's control (by netting out interest expenditures) and (iii) has to be paid for out of tax revenues (by netting out spending on programmes directly funded by the European Union) (iv) without penalising peaks in investment (by averaging investment over a number of years).

Member States at their MTO must ensure that government expenditure grows at most in line with a medium-term rate of potential GDP growth – which is the rate which ensures adherence to the MTO over time – unless any excess growth is matched by discretionary revenue measures yielding additional revenues (see Section 1.3.2.6). Member States on the adjustment path to the MTO must ensure that their expenditure grows at a rate below this medium-term rate of potential GDP growth – the difference in growth rate is known as the convergence margin – unless the excess growth is matched by additional

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([22]) http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf
([23]) Regulation (EU) 1176/2011:
http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011R1176&from=EN

funds from discretionary revenue measures. This does not limit or in any way determine the size of government spending. All that is required is that any expenditure growth is funded by equivalent discretionary revenue measures.

Over the economic cycle, Member States at their MTO whose net government expenditure grows in line with potential GDP will remain at their MTO. Member States on the adjustment path will keep their net expenditure growing at rate below potential GDP, set according to a methodology agreed with the Member States and defined in the Code of Conduct on the SGP so that the difference – the convergence margin – brings a correction that is equivalent to that required by the appropriate adjustment path to the MTO. Graph 1.2 summarises the average dynamics over the cycle in terms of compliance with the MTO.

Graph 1.2: **The expenditure benchmark as an instrument to reach or stay at the MTO**

Member State at MTO	Member State not at MTO
Net expenditure growth in line with the reference potential growth rate	Net expenditure growth in line with a rate below the reference potential growth rate
% government expenditure in potential GDP constant in the absence of revenue measures	% government expenditure in potential GDP decreases in the absence of revenue measures
Structural balance constant over time	Structural balance strengthens
Remains at MTO	Gap with the MTO closes over time

1.1.3. Bringing the economic policy advice together – the European Semester

Since 2011, the preventive arm of the SGP is part of the European Semester for economic governance. The European Semester was introduced in 2010 and was revised and streamlined in 2015. It aims to ensure that the surveillance of budgetary and economic policies takes place in parallel so as to allow for consistent policy guidance at European level according to a timetable so that this guidance informs the national setting of policy in opportune time.

The European Semester is launched each year by the presentation of the Annual Growth Survey (AGS)([24]) by the Commission at the end of the previous year. In this document, the Commission presents its assessment of the economic situation in the European Union and sets out its priorities for the coming year in terms of the economic and budgetary policies and reforms to boost growth and employment. Since the European Semester 2016, the Commission produces the recommendations for the Euro area at the same time as the AGS. This common timing reflects common challenges of the Euro area ahead of country specific discussions. In addition, an Alert Mechanism Report (AMR) is published under the macroeconomic imbalances procedure (MIP). The AMR identifies which countries deserve closer attention. The start of the European Semester is therefore marked by the discussion of the AGS and the Euro area recommendations in the Council which then reports on its conclusions to the European Council. The March European Council subsequently issues general, policy guidance for Member States. At the end of February, the Commission releases Country Reports, for all Member States. These reports, in the form of Staff working documents, analyse Member States' economic and social developments. They identify

([24]) http://ec.europa.eu/europe2020/making-it-happen/annual-growth-surveys/index_en.htm

key macroeconomic and structural challenges and assess progress in advancing reforms. They also analyse more specifically the existence and the extent of possible macroeconomic imbalances for those Member States which have been selected as requiring an in-depth review based on the reading of the Alert mechanism Report, which is published in the context of the Macroeconomic Imbalance Procedure.

Following the publication of the Country Reports and the adoption of the European Council conclusions, Member States submit their Stability and Convergence Programmes (SCPs) in April – see Section 1.1.4. These outline the public finance plans of Member States and are submitted alongside the National Reform Programmes (NRPs) which outline economic plans and report on progress made over the past year. Based on the Country Reports and upon examining the NRPs and SCPs, the Commission proposes Country Specific Recommendations in the relevant policy areas. The Commission proposal includes its opinion for relevant Member States (all except Member States subject to a macroeconomic adjustment programme) on their Stability or Convergence Programme. At the same time, the scope of recommendations is larger than fiscal policy and shall provide guidance to Member States on how to increase growth and jobs, including by removing bottlenecks preventing growth and job creation, and to promote sustainable public finances.

Based on the Commission's proposals, the ECOFIN Council then adopts, for each Member State, the Country-Specific Recommendations. The Council opinions on the Stability or Convergence Programmes are usually reflected in the recitals and the recommendation n°1 of the Country-Specific Recommendations. The recommendations for each Member State are discussed and are endorsed by the European Council in June. In line with Article 2-ab of Regulation 1466/97 the Council is "expected to, as a rule, follow the recommendations and proposals of the Commission or explain its position publicly". This is known as the "comply or explain" principle and is not just confined to the European Semester. It creates a strong presumption in favour of the Council's opinion following the Commission's line, unless any divergence from it can be backed up by strong public explanations.

1.1.4. Monitoring under the preventive arm - the role of the Stability and Convergence Programmes

In accordance with Regulation (EC) 1466/97, Member States are required to submit annually Stability or Convergence Programmes (SCPs) to the Council and the Commission in April. Countries in the euro area submit Stability Programmes while countries outside the euro area submit Convergence Programmes.([25]) While the assessments of the SCPs cover both the preventive and the corrective arms of the Pact depending on the circumstances of each Member State, according to Regulation (EC) 1466/97, the SCPs play a specific role under the preventive arm, as they serve as the means for assessing ex ante compliance with the preventive arm.

The function of the SCPs is to allow the Commission and the Council to assess compliance with the MTO and the adjustment path towards it, including compliance with the expenditure benchmark. In order for this to be possible, a range of economic and budgetary data must be included in the SCPs, as set out in the tables annexed to the Code of Conduct on the SGP, which have been jointly agreed by the Member States and the Commission in Council committees. These tables are replicated in Annex 3.([26]) The forecasts contained in the SCPs must be prepared in a sound and realistic manner, consistent with the requirements of Council Directive 2011/85/EU on the requirements for budgetary frameworks of the Member States,

([25]) This requirement applies to all countries, except euro area countries under a macroeconomic adjustment programme as per Regulation (EU) 472/2013.
([26]) The annex includes also the additional table to be filled to request the structural reform clause (section 1.3.2.3).

and should therefore be based on the most likely macro-fiscal scenario or a more prudent one. With the Two Pack, euro area Member States have to base their Stability Programmes on macroeconomic forecasts produced or endorsed by an independent body. Section 3.2.2 discusses this in more detail. For all countries, as part of the SCPs, both the macroeconomic and budgetary forecasts must be compared with the most recent available Commission forecasts and, if appropriate, those of other independent bodies.

Member States' programmes must be consistent with the broad economic policy guidelines adopted at European Council level and with the National Reform Programmes, which focus on structural and employment policies. Section 3.1.2 discusses the interaction between the monitoring of budgetary policies with that of other aspects of economic policy.

The main economic and fiscal data presented in the SCPs should cover the year that just ended (year t-1), the current year (year t) as well as at least the following 3 years (year t+1 to t+3). Compliance with the MTO or the adjustment path towards it is the cornerstone of the budgetary analysis and this is assessed on an ex post basis for the past year, an in-year basis for the year that is underway and on an ex ante basis for the following three years. If the Council considers that the objectives and the content of the programme should be strengthened with particular reference to the adjustment path towards the MTO, it shall invite the Member State concerned to adjust its programme on the basis of a Commission recommendation (article 5(2) and 9(2) of Regulation 1466/97).

The ex ante (and in-year) examination of the programmes presented by the Member State is complemented by a risk assessment as embodied in the Commission forecasts, on which basis the fiscal Country-Specific Recommendations are built. On the other hand, the ex post assessment of the implementation of the plans is based on outturn data (as available in spring of year t+1) and centres on whether there have been significant divergences from the MTO, or the required adjustment path towards it, in the preceding year or in the last two years. If a significant deviation from the adjustment path towards the MTO (including the assessment of compliance with the expenditure benchmark) is observed, the Commission will address a warning to the Member State concerned, thereby launching the procedural steps under Article 121(4) of the Treaty (Significant Deviation Procedure -(see Section 1.4).

1.2. THE MEDIUM-TERM OBJECTIVE (MTO): CONCEPT AND ROLE

The country-specific MTOs are at the centre of the preventive arm of the SGP. The legal basis is Article 2a of Regulation (EC) 1466/97 which sets out how MTOs are to be defined, while the other Articles elaborate on the role of MTOs.

1.2.1. Defining the Medium-Term Objective

The MTOs are defined in structural terms, meaning that they represent the cyclically-adjusted general government budget position, net of one-off and other temporary measures (see Box 1.4 on the calculation of the structural balance).

According to Regulation (EC) 1466/97 the MTOs should be set so as to:

(i*) provide a safety margin with respect to the 3% of GDP deficit limit.* For each Member State, this safety margin is estimated in the form of a minimum benchmark (see Annex 2) which takes past output volatility and the budgetary sensitivity to output fluctuations into account.

(ii) *ensure sustainability or rapid progress towards sustainability.* This is assessed against the need to ensure the convergence of debt ratios towards prudent levels with due consideration to the economic and budgetary impact of ageing populations.

(iii) *in compliance with (i) and (ii), allow room for budgetary manoeuvre, in particular taking into account the needs for public investment.*

The Regulation further specifies that euro area and ERM2 Member States must have an MTO that corresponds to at least -1% of GDP. Signatories to the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), inter alia all euro area Member States, have further committed themselves to MTOs of at least -0.5% of GDP,([27]) unless their debt ratio is significantly below 60% of GDP and the risks in terms of the long-term sustainability of their public finances are low. In those cases, the lower limit for the balance remains at -1% of GDP.

The MTOs are updated every three years, taking into account the latest economic and budgetary costs of ageing as published in the triennial Ageing Report (see Section 1.2.1.2 for more details on the revision of the MTOs).

Box 1.4: Calculating the structural balance

The **structural balance** is defined as the cyclically-adjusted general government balance (CAB) net of one-off and other temporary measures.

In algebraic terms $CAB = (BAL/Y) - \varepsilon * OG$ where BAL stands for general government balance, Y for GDP and the cyclical component, $\varepsilon * OG$, for the product of the semi-elasticity of the budget balance to the cycle, ε, and the output gap, OG. The output gap, which measures the cyclical position of an economy, is defined as the difference between actual and potential output. The latter is estimated by the Commission using a production function method, endorsed by the ECOFIN Council on 12 July 2002, which allows identifying the different components of potential output.([28]) All methodological improvements are agreed by the Member States and discussed in a dedicated forum, the Output Gap Working Group (OGWG) within the EU's Economic Policy Committee.

The semi-elasticity of the budget balance to the cycle (ε) measures the effect of output movements on the general government balance, when assuming the economy is running at its potential (i.e. in the absence of the business cycle). This cyclical effect captures the impact of the output gap both on the numerator of the ratio (the budget balance per se) but also on the denominator of the ratio (GDP). This parameter is estimated on the basis of a methodology developed by the OECD and agreed by the OGWG.

The budgetary semi-elasticity is equal to the difference of the semi-elasticity of revenue and the semi-elasticity of expenditure. On the revenue side, the elasticities of individual revenue items are estimated by the OECD (personal income taxes, corporate income taxes, indirect taxes, social security contributions, non-tax revenue). They correspond to the percentage change in a particular type of revenue associated with a percentage change in output. They are then aggregated using the share of each in total revenue as weights, so as to derive the elasticity of the level of total revenues (in monetary terms) with respect to output. Subtracting one from the value of the revenue elasticity gives the value of the elasticity of the

([27]) This applies also to those non-euro area signatories that have declared themselves bound by the provisions of the Fiscal Compact (Denmark, Bulgaria and Romania).
([28]) For more details, see K. Havik, K. McMorrow, F. Orlandi, C. Planas, R. Raciborski, W. Röger, A. Rossi, A. Thum-Thysen and V. Vandermeulen, "The production function methodology for calculating potential growth rates and output gaps", European Economy, Economic Papers No. 535, November 2014

revenue-to-GDP ratio with respect to the output gap. Multiplying the latter with the size of total revenue as a share of GDP yields the value of the semi-elasticity of revenue. On the expenditure side, the OECD elasticity of unemployment-related expenditures is used and weighted with the share of unemployment-related expenditure in total expenditure (based on Eurostat data). Subtracting one from this value and then multiplying it by the size of total public spending as a share of GDP gives the semi-elasticity of expenditure.

The value of the semi-elasticities of the relevant taxes and expenditures have been recently updated by the Commission, using the individual elasticities updated by the OECD([29]) in the context of the Output Gap Working Group. The individual elasticities underlying the semi-elasticities will be revised every 9 years. The weights (tax and spending structure, revenue/expenditure-to-GDP ratio) are computed by the Commission services as an average over the period 2002-2011([30]) and are to be updated every 6 years to reflect changes in the government receipts and spending. The semi-elasticities and weights currently in use are shown in Annex 11.

The average budgetary semi-elasticity used for the EU is 0.5([31]) and ranges from 0.31 to 0.65 across Member States, suggesting significant differences in the cyclicality of the budget balance. The semi-elasticity for revenue is close to zero, since revenue is almost as cyclical as GDP, except for non-tax revenue. Therefore, the revenue-to-GDP ratio moves only slowly with the business cycle, especially in Member States where non-tax revenue is relatively low. In contrast, the semi-elasticity for expenditure ranges from -0.38 to -0.62, which accounts for the larger part of the disparity in the budgetary semi-elasticity across Member States. Its value broadly corresponds to the share of total expenditures in GDP. This mirrors the fact that the elasticity of the expenditure-to-GDP ratio to the output gap is close to minus one. Indeed, the cyclical effect of the denominator (GDP) largely dominates the low cyclicality of expenditure in level, given the small share of unemployment-related expenditure in total expenditure.

Once the cyclically adjusted balance has been estimated, one-off and other temporary measures (here referred to collectively as 'one-off measures') are removed in order to obtain an estimate of the structural balance, i.e. the underlying budgetary position.

The ability to correctly identify one-off measures is crucial for carrying out fiscal surveillance. The Commission has developed a set of guiding principles for classifying transactions as one-offs in order make the criteria used in fiscal surveillance more transparent. These guiding principles have been summarised below and are extensively explained in Chapter II.3 of the 2015 Report on Public Finances in EMU, ([32]) which also provides examples of frequently occurring one-offs and discusses a number of measures that have 'borderline' characteristics, but which ultimately have not been considered to be one-off measures.

Principle I: One-off measures are intrinsically non-recurrent. One-off measures are transactions that have, by their very nature, only a temporary, non-recurrent impact on general government revenue or expenditure. For this to be the case, a one-off measure must have an inherent characteristic that makes its impact temporary, i.e. a characteristic that means that it cannot have a sustained impact on the budgetary position.

([29]) For more details, see G. Mourre, C. Astarita and S. Princen, "Adjusting the budget balance for the business cycle: the EU methodology", *European Economy. Economic Papers*, November 2014, and Price, R. W, Dang T. and Guillemette Y. (2014), "New tax and expenditure elasticity estimates for EU budget surveillance", *OECD Economics Department Working Paper* No. 1174.
([30]) For more details, see G. Mourre, G-M. Isbasoiu, D. Paternoster and M. Salto, "The cyclically-adjusted budget balance used in the EU fiscal framework: a revised computation", *European Economy. Economic Papers*, March 2013.
([31]) This is a non-weighted average between all 28 EU Member States.
([32]) Report on Public Finances in EMU, December 2015: http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip014_en.pdf

Principle II: The one-off nature of a measure cannot be decreed by law or by an autonomous government decision. In order to ensure timely and effective policy surveillance, it should be possible to evaluate the one-off nature of a measure unambiguously upon its announcement. For that reason, the one off nature of a measure should not depend on whether the policymaker announces the measure as temporary or permanent.

Principle III: Volatile components of revenue or expenditure should not be considered one-off. It is clear that the cyclical part of revenue or expenditure should not be considered as a one-off, as its impact is already corrected for via the cyclical adjustment of the general government balance (as explained above). But even after this cyclical adjustment, revenue or expenditure components may still exhibit a significant degree of volatility. The concept of one-offs is not, however, primarily intended to smooth time series and should therefore not be used to correct for this kind of volatility.

Principle IV: Deliberate policy actions that increase the deficit do not, as a rule, qualify as one-offs. The provisions on one-offs are primarily meant to avoid policy measures that do not lead to a sustained improvement of the budget balance being treated as structural. In order to give policymakers the right incentive to fully recognise the permanent budgetary impact of their actions, there is therefore a strong presumption that deliberate policy actions that increase the deficit are of a structural nature.

Principle V: Only measures having a significant impact on the general government balance should be considered one-offs. As a rule, measures worth less than 0.1 % (rounded) of GDP should not be considered one-offs.

1.2.1.1 Calculating the appropriate Medium-Term Objective

The MTOs presented by the Member States in their SCPs need to comply with the requirements set out in Section 1.2.1. Compliance with these requirements is assessed by the Commission according to the methodology described in the Code of Conduct on the SGP. Using this methodology, the Commission estimates the country-specific lower bounds for the MTOs every 3 years. The Member States then present their MTOs in the forthcoming SCPs by adopting either an MTO in line with these lower bounds or a more ambitious one, if in their view circumstances are deemed to warrant it.

The methodology used to compute country specific lower bounds ensures that the requirements of the Pact are complied with in the following way:

(a) **The safety margin with respect to the 3% of GDP deficit limit**: For each Member State, the minimum value of the MTO that ensures this safety margin is assessed by taking into account past output volatility and the budgetary sensitivity to output fluctuations (i.e. the budgetary semi-elasticities as discussed in Box 1.4). The resulting value gives the minimum benchmark (MTO^{MB}). A country with a greater past output volatility and a larger budgetary sensitivity will need a more demanding MTO in order to ensure that the 3% limit is not breached during a normal economic cycle. By allowing sufficient margin with respect to the 3% limit, the operation of the automatic stabilisers is ensured.

The calculation of the minimum benchmark is based on the representative output gap (ROG), multiplied by the budgetary semi-elasticity ε: $MTO^{MB} = -3 - \varepsilon * ROG$. Annex 2 considers their calculation in more detail and gives the values of the minimum benchmark currently in use, as well as updated values to be used over 2017-2019.

(b) **Sustainability or rapid progress towards sustainability**: For each Member State a minimum value for the MTO that ensures sustainability or rapid progress to sustainability taking into account implicit liabilities and debt (MTO^{ILD}) is computed. This is the minimum value that ensures the convergence of debt ratios towards prudent levels with due consideration to the economic and budgetary impact of ageing populations, and is the sum of 3 components.

$$MTO^{ILD} = \underbrace{Balance_{debtstabilizing\,(60\%\,of GDP)}}_{(i)} + \underbrace{\alpha * AgeingCost}_{(ii)} + \underbrace{Effort_{debt-reduction}}_{(iii)}$$

Component (i) represents the budgetary balance that would stabilise the debt ratio at 60% of GDP. It corresponds to the product of 60% with the forecast average nominal growth until 2060 as calculated by the Ageing Working Group (AWG).([33])

Component (ii) represents the budgetary adjustment that would cover a fraction of the present value of the projected increase in age-related expenditure, where α=33% and the ageing cost corresponds to the discounted value of the increase in the cost of ageing, calculated up to an infinite horizon.

Component (iii) represents a supplementary debt-reduction effort, specific to countries with general government gross debt above 60% of GDP. It follows a continuous linear function:

$Effort_{debt\text{-}reduction}$= 0.024*debt - 1.24

which ensures a supplementary effort of 0.2% of GDP when debt reaches 60%, while requiring a supplementary effort of 1.4% of GDP when the debt ratio attains 110% of GDP.

The resulting value of the MTO (up to one decimal) is then rounded to the most favourable ¼ of a percentage point.

(c) **Compliance with the -1% lower bound for euro area and ERM2 Member States**: Euro area and ERM2 Member States have the additional bound captured by the $MTO^{Euro/ERM2}$ component, where $MTO^{Euro/ERM2} = -1\%$ of GDP.

The three bounds on the MTO are then combined to yield country specific greatest lower bound for the MTO, which corresponds to the lowest MTO that fulfils all the criteria defined above. This is known as the minimum MTO:([34])

$MTO^{min} = \max(MTO^{ILD}, MTO^{MB}, MTO^{Euro/ERM2})$

([33])The calculation is based on the real GDP forecast and an average inflation rate of 2%. Data sources are the latest available T+10 forecast and the AWG estimates beyond T+10. The Ageing Working Group in cooperation with the European Commission (DG ECFIN) revises their projections of GDP growth every three years. For the most recent projections see 2015 Ageing Report (Underlying Assumptions and Projection Methodologies),
http://ec.europa.eu/economy_finance/publications/european_economy/2015/pdf/ee3_en.pdf
([34]) At the time of the 2012 update of the MTO, the Commission proposed that if the MTO yielded by these formulae corresponds to an unrealistically tight primary balance, a Member State can ask to benefit from an exception clause. Indeed, as there is no precedent of a country maintaining a primary surplus significantly above 5.5% of GDP for a sustained period of time, countries would not be required to comply with a minimum value for their MTO implying a primary surplus significantly over this limit in the period to which the specific MTO applies. Instead, an exception can be made, which allows the concerned Member State to present a MTO corresponding to a primary surplus of 5.5% of GDP, as long as the -1% of GDP lower bound for euro area and ERM2 countries is adhered to.

When Member States present their MTOs in their SCPs, they can adopt either an MTO equal to the minimum MTO yielded by the formula above or a more ambitious one if they feel circumstances call for it.

1.2.1.2 Revising the Medium-Term Objective

In order to ensure a consistent application of the principles mentioned above for defining the country-specific minimum MTOs, regular methodological discussions take place in the Economic and Financial Committee.

Regulation (EC) 1466/97 requires that the MTOs are revised every 3 years or more frequently if a structural reform with a major impact on the sustainability of the public finances is implemented. The regular revision of the MTOs follows the publication of the Ageing Report which occurs every 3 years and provides up-to-date data on the ageing challenge facing the Member States.

In addition to the 3-yearly revisions of the minimum MTOs, countries undertaking structural reforms with a major impact on the sustainability of the public finances can also have their minimum MTOs revised on a case-by-case basis, in agreement with the Commission. In particular, the introduction of major pension reforms having an impact on long term fiscal sustainability could result in a revision of the minimum MTO.([35])

1.2.2. The Medium-Term Objective as an anchor

The MTO is the central concept of the preventive arm that serves to ensure sustainable public finances and compliance with the 3% of GDP deficit criterion in all but the most unusual adverse circumstances. According to the preventive arm of the SGP, countries must attain the MTO or be on an appropriate adjustment path towards it.

Compliance with the MTO, or with the required adjustment toward it, is evaluated on the basis of an overall assessment with the structural balance as the reference, and including an analysis of the expenditure aggregate net of discretionary revenue measures. Therefore:

(i) the structural balance is compared with the MTO to see whether the MTO has been attained, and if this is not the case the change in the structural balance is considered to see whether the country is on an appropriate adjustment path (Sections 1.3.2.1 and 1.3.2.2);

(ii) in parallel, compliance with the MTO requirement is assessed by looking at whether the evolution of net expenditure is in line with the expenditure benchmark (Section 1.3.2.6).

This assessment is conducted both on an ex ante and an ex post basis. The latter is of particular importance as it can lead to a Significant Deviation Procedure (i.e. the procedural steps set out under art. 121(4) TFEU and articles 6(2) and 10(2) of Regulation 1466/97), which itself can result in sanctions for euro area Member States. Section 1.3 discusses how both assessments of compliance are undertaken.

([35]) In case of major pension reforms, updated long-term budgetary projections need to be peer reviewed and endorsed by the Economic Policy Committee (Ageing Working Group) before updating the Ageing Report figures for MTO calculations.

1.3. ASSESSMENT OF THE STABILITY AND CONVERGENCE PROGRAMMES (SCPs)

The role of the SCPs is to elaborate on and communicate the Member States' medium-term budgetary plans, which are then examined by the Commission and Council following their submission. All Member States, except euro area Member States under a macroeconomic adjustment programme, are required to submit an SCP. The Commission publishes an assessment of each plan, which is transmitted to the Council along with a recommendation for the Council Opinion. The Council then adopts an Opinion on the programmes, which is usually reflected in the recitals and the recommendation n°1 of the Country-Specific Recommendations.

The Commission assesses the content of the programmes in terms of compliance of the Member State's policies with the broad economic policy guidelines endorsed by the European Council and with the requirement to attain or to be on the adjustment path towards the MTO, together with an assessment of compliance with the information requirements. Coherence with the economic policy guidelines and compliance with the information requirements are based on a qualitative assessment discussed in Section 1.3.1.

The assessment of compliance with the preventive arm is based on a numerical analysis of the data presented in the SCP and comprises the following:

- an *ex post assessment* of budgetary execution for the outcomes of year t–1 and the average of the outcomes of years t–1, t–2, on the basis of outturn data validated by Eurostat;

- an *in-year assessment* of the plans for year t, on the basis of in-year estimates, complemented by a risk assessment based on the Commission forecasts;

- an *ex ante evaluation* of the budgetary plans for t+1, complemented by a risk assessment based on the Commission forecasts, and

- a *qualitative assessment* covering years t+2 and t+3, which go beyond the horizon of available Commission forecasts at the time of the submission of the SCPs.

When on the basis of outturn data, the ex post assessment concludes for a significant deviation from the adjustment path to the MTO, a Significant Deviation Procedure (i.e. the procedural steps set out under art. 121(4) TFEU and articles 6(2) and 10(2) of Regulation 1466/97) would be launched (see Section 1.4). The in-year and ex ante assessments aim to inform the policy debate and provide guidance to countries, but cannot lead to a Significant Deviation Procedure, which is triggered by an observed significant deviation.([36]) Section 1.3.2 describes how the assessment under the preventive arm is undertaken.

Compliance with the MTO requirement is evaluated both ex ante, in year and ex post on the basis of an overall assessment with the structural balance as the reference, and including an analysis of the expenditure aggregate net of discretionary revenue measures. If, following an overall assessment, the ex post analysis concludes that a significant deviation from the adjustment path to the MTO (or the MTO itself)[37] has occurred, the Commission will address a warning under Article 121(4) of the Treaty to the Member State concerned, launching a Significant Deviation Procedure. The warning will be followed by a Council recommendation, based on a Commission recommendation, for necessary policy measures to

([36]) Art. 6.2 and Art. 10.2 of Regulation 1466/97.
([37]) For countries at their MTO, a significant deviation is assessed with respect to a requirement of 0% of GDP (see annex 14), which is usually reflected in the recommendation n°1 of the CSR as "ensure that the medium-term budgetary objective continues to be adhered to" or "avoid deviating from the medium-term budgetary objective"..

address the deviation. If the Member State then fails to take appropriate action within the given deadline a decision on no effective action and the imposition of sanctions for euro area countries, in the form of an interest-bearing deposit, are possible. Section 1.4 provides more details.

1.3.1. The reporting requirements

The content of the SCPs should comply with the requirements of Regulation (EC) 1466/97 and the Code of Conduct on the SGP, which sets out guidelines on their content and format. Member States are expected to follow these guidelines and to justify any departure from them. The standardisation of the format and content of the programmes should ensure equality of treatment. Overall, the SCPs should include data to enable a quantitative assessment of the Member State's fiscal outturns and plans, which conform to the requirements set out in the legislation, and should show that government policy is in line with the policy guidelines agreed on at European level. The tables to be supplied are replicated in Annex 3.([38])

Economic and budgetary forecasts and plans

In order to enable the Council and the Commission to assess compliance with the MTO requirement, including an assessment of the expenditure benchmark, the SCPs must present a fully-fledged multi-annual macroeconomic scenario, projections for the main fiscal variables as well as their relevant components, and a description and quantification of the envisaged budgetary strategy. The MTO being the overarching goal of the preventive arm to ensure a prudent and sustainable budgetary policy over the medium-term, Member States should report in their SCPs the MTO that they are aiming at as well as the planned adjustment path towards it. In addition, Member States have also to provide the following information: budgetary targets for the general government balance in relation to the MTO, and the projected path for the general government debt ratio; an update of the fiscal plans for the year of submission of the programme, based on the April notification of fiscal data,([39]) including a description and quantification of the policies and measures, with information on expenditure and revenue ratios and on their main components (including one-off and other temporary measures); the planned growth path of government expenditure, and of government revenue at unchanged policies (explaining the underlying assumptions, methodologies and relevant parameters), along with a quantification of the planned discretionary revenue measures. The budget balances should be broken down by subsector of general government and structural reforms should be specifically analysed when they are flagged as contributing to the achievement of the objectives of the programme.

The status of the programme and of the measures, with respect to national budgetary procedures and parliamentary processes, should be made explicit. After a new government has taken office, Member States are expected to show continuity with respect to the budgetary targets endorsed by the Council on the basis of the previous programmes. Stability and Convergence Programmes should show how developments have compared with the budgetary targets in the previous programme or update, including the Draft Budgetary Plan submitted each autumn by euro area Member States.

([38]) The same reporting requirements hold also for countries in the corrective arm. However, annex 3 includes also the additional table to request the structural reform clause, which is applicable only to Member States in the preventive arm interested in availing from the clause.
([39]) The requirement to report public finance data to the Commission in the context of the EDP stems from Council Regulation (EC) 479/2009 of 25 May 2009 *on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community*.

Macroeconomic forecasts

The figures presented must be based on realistic and cautious macroeconomic forecasts, with the main assumptions underlying them being presented in the programme. More precisely, Regulation (EC) 1466/97 requires that these projections are based on the most likely macro-fiscal scenario or on a more prudent scenario.

Since the entry into force of the Two Pack in May 2013 (Regulation 473/2013, Article 4.1), euro area Member States are obliged to publish their national medium-term fiscal plans at the same time as their Stability Programmes, i.e. no later than 30 April each year. These plans should be based on macroeconomic forecasts that have been produced or endorsed by an independent body and must include at least all the information contained in the Stability Programmes. In fact, national medium-term fiscal plans and stability programmes may be the same document. Should a Member States choose this option, it should clearly state in the Stability Programme that the latter is to be regarded as the national medium-term fiscal plan. It should also specify whether the macroeconomic forecasts underpinning the programme have been produced or endorsed by an independent body. As specified in the Code of Conduct on the Two-Pack,(40) it is understood that, while the endorsement would enable the use of the respective forecasts, a negative decision would typically trigger a review of the forecast in the light of the comments issued by the independent body and a revised forecast may be submitted for assessment to the independent body.(41) Regarding the annual Draft Budgetary Plans – to be submitted by 15 October -, Member States will also indicate whether the underlying macroeconomic forecast has been produced or endorsed by an independent body. Section 3.1.1.2 provides more details.

As part of the SCP, the macroeconomic and budgetary forecasts should be compared to the most recent available Commission forecasts and, if appropriate, those of other independent bodies. Significant differences between the chosen macro-fiscal scenario and the Commission forecast should be explained in detail, especially if the level or growth of external assumptions departs significantly from the Commission forecasts. In order to enhance cross-country comparability and to ensure high quality, the concepts used should be in line with the standards established at European level, in particular in the context of the European System of Accounts (ESA).(42) Moreover, the forecasts presented should be prepared in a manner that is consistent with the requirements of Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States, which relate primarily to the credibility of the forecasts and the transparency with which they are prepared and presented.

Consistency of policy measures

In addition to these data, the SCPs should provide information on the consistency of the budgetary objectives and the measures to achieve them, with the broad economic policy guidelines and the National Reform Programmes.(43) A description of the measures taken or envisaged to improve the quality of the public finances as well as information on existing or envisaged national budgetary rules (expenditure rules, etc.), and any other institutional features relative to the public finances should also be included in

(40) http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf
(41) Irrespective of the choice of having the forecasts produced or endorsed by an independent body, Member States should have specific mechanisms in place to cope with situations in which there are different views between the Ministry of Finance and the independent body in terms of the main variables of the forecasts. These could, for example, take the form of arrangements to reach an agreement.
(42) The revised European System of Accounts (ESA 2010), applied since September 2014, is set up by Regulation (EU) 549/2013 of the European Parliament and of the Council of 21 May 2013 *on the European system of national and regional accounts in the European Union*.
(43) Euro area Member States under EDP which have submitted an Economic Partnership Programme (EPP), should provide in their Stability Programmes information on the implementation of their EPP or any additional information requested in the Council opinion on their EPP. See Section 3.1.2.2.

the SCPs. Given the inevitability of forecasting errors, the SCPs should include a comprehensive sensitivity analysis and/or develop alternative scenarios in order to enable the Commission and the Council to consider the complete range of possible fiscal outcomes.

The Code of Conduct on SGP indicates that each Member State should appropriately define a scenario at unchanged policies and make the underlying assumptions, methodologies and relevant parameters public, so that it is clear from the plans in the SCPs what part of the Member States' plans are based on concrete enacted measures and what part requires additional policy choices. For future years, whose budget has not yet been adopted, the scenario at unchanged policies will imply the extrapolation of revenue and expenditure trends and the inclusion of measures that are known in sufficient detail. While there is no further guidance on what should be included in the SCPs scenario at unchanged policies, the no policy change assumption underpinning the Commission forecasts (Box 1.5) provides a useful benchmark for what is, and what is not, compatible with such a scenario.

1.3.2. The assessments of the SCPs

The analysis of budgetary policy in the SCPs aims to deliver, for each Member State, an overall assessment of compliance with the requirements of the preventive arm, in terms of being at or on the adjustment path towards the MTO, on an ex post, in-year and ex ante basis. In fact, the ex ante and in year assessment of compliance with the requirements of the preventive arm is undertaken both on the basis of the plans submitted every spring in the SCPs, which feeds the Country-Specific Recommendations concluding the European Semester, and again every autumn for euro area Member States on the basis of the Draft Budgetary Plans (DBPs) in the associated Commission Opinion. The methodology and the rationale used for the assessment of compliance is the same for both the SCPs and the DBPs.

The assessment of compliance contains three key elements:

- Is the MTO set at an appropriate level? This is discussed in Section 1.3.2.1
- Is the Member State at the MTO or on the adjustment path towards the MTO, by considering the position of the structural balance? This is discussed in Sections 1.3.2.2 to 1.3.2.5.
- Are expenditure plans in line with the expenditure benchmark? This is discussed in Section 1.3.2.6.

Section 1.3.2.7 describes how these three elements should be put together, to arrive at an overall assessment of compliance with the preventive arm of the SGP. At the outset, it is important to realise that the assessment is done in two stages: (i) taking the SCP([44]) targets at face value (after recalculating the structural balance based on the commonly agreed methodology([45]) and (ii) taking into account the risks attached to the SCP scenario, as embodied in, for instance, the most recent Commission forecasts. It is the latter that is then used to set each Member State's requirements in terms of structural adjustment under the preventive arm.

([44]) The same applies to DBP targets set by euro area Member States in autumn.
([45])This is implemented by the Commission services through the CONV simplified routine to recalculate the potential GDP/output gap submitted by the Member States in their plans. For more details, see "The production function methodology for calculating potential growth rates and output gaps", European Economy, Economic Papers No. 535, November 2014.

Box 1.5: **THE COMMISSION FORECASTS, THE "NO POLICY CHANGE" ASSUMPTION USED THEREIN, AND THE ROLE IN THE ASSESSMENT OF THE PLANS**

European Economic Forecasts are produced independently by Commission staff. At present, they are produced three times per year (winter, spring and autumn), with spring and autumn forecasts being produced after Eurostat validation of public finances data. The European Economic Forecasts concentrate on the Member States, the EU and the euro area, but also include the outlook for candidate countries as well as some major non-EU countries. They cover a medium-term forecast horizon of up to 2 years, with an additional year being added in each autumn round.

The forecasts are framed by a common set of 'external assumptions' for commodity prices, exchange rates and interest rates. Furthermore, European Economic Forecasts are produced under the assumption of "no policy change". In the autumn forecasts, the fiscal measures contained in euro area Member States' draft budgetary plans are fully reflected.

A forecast under the no-policy change assumption extrapolates past revenue and expenditure trends and relationships in a way that is consistent with past policy orientations, and includes all fiscal policy measures. A fiscal policy measure is an intervention by the government to change past policy orientations that is specified in sufficient detail, as well as adopted or at least credibly announced, and has a direct incremental budgetary impact.

The no policy-change assumption involves some judgement as it allows the incorporation of some measures that have not yet been legislated for. For example, measures which formally require a legal step (such as the adoption of a law in parliament) but which have been taken in the past quasi automatically (such as e.g. indexation of government salaries in certain countries) can be included in the no policy change scenario, even though they have not yet been formally approved, provided that it is reasonable to assume that the past practice will be continued. In addition, measures which have been announced, but not yet included in (draft) legislation, can still be incorporated, provided that these measures have been specified in sufficient detail and to which the government is credibly committed.

Commission forecasts are widely used as a basis for economic surveillance, and they are crucial to fiscal surveillance. In particular, when examining ex ante and in-year the SCPs (and for euro area Member States the DBPs, too), the assessment is done in two stages, i.e. first taking the programmes and plans at face value and then taking into account the risks attached to the programmes and plans, on the basis of the most recent Commission forecasts. Importantly, the SGP requirements are always set on the basis of the Commission forecasts.

The no-policy change assumption plays an important role at the various stages of fiscal surveillance, and especially so for the corrective arm of the SGP (Part II of this Vade mecum).

1.3.2.1 Is the MTO set at an appropriate level?

Member States' MTOs should be at least as demanding as the minimum MTOs (as set out in Section 1.2.1). The assessment determines whether the MTO is in line with the minimum MTOs emerging from the formula (Section 1.2.1.1). In accordance with Article 121(3) of the Treaty and Articles 5(2) and 9(2) of Regulation (EC) 1466/97, if the Council considers that the MTO presented in a Stability or Convergence Programme should be strengthened, it will indicate in its Country-Specific Recommendations that the Member State is invited to adjust its programme.

1.3.2.2 Is the Member State at its MTO or on an appropriate adjustment path towards it? The change in the structural balance

For the in-year and ex ante assessments the achievement of the MTO is assessed by seeing whether the Member State is planning and forecast to have a structural balance at least as tight as its MTO. As a matter of convention, from an ex post perspective, the Commission considers the structural balance to be in line with the MTO, if it is within ¼% of GDP of its value.([46]) If the Member State is not at its MTO([47]) in one of the years under consideration, it must nonetheless be on an appropriate adjustment path towards it. The adjustment delivered or set out for future years in the SCP (and, for euro area Member State also in the DBP) should be defined by an annual improvement in the structural balance, respecting the rules of the preventive arm of the SGP.

Regulation (EC) 1466/97 defines an appropriate annual improvement in the structural balance as follows:

- Euro area and ERM2 Member States should plan for an annual improvement in their structural balance of 0.5% of GDP as a benchmark.

- For Member States with debt in excess of 60% of GDP or with pronounced risks of overall debt sustainability([48]), a faster adjustment path, i.e. above 0.5% of GDP is expected (see Box 1.6, for detailed modulation). All Member States should undertake a greater adjustment in good economic times, while the effort may be more limited in bad economic times.

- In all cases, revenue windfalls and shortfalls should be taken into account.

- In addition, the regulation also provides for a "waiver" from any adjustment in case of an *"unusual event outside the control of the Member State […] which has a major impact on the financial position of the general government or in periods of severe economic downturn for the euro area or the Union as a whole"*.

Regulation (EC) 1466/97 does not, therefore, specify an appropriate annual adjustment for Member States outside the euro area and ERM2 with debt below 60% of GDP and at most moderate risks of debt sustainability. While these countries should pursue greater improvements in good and in bad times, the size of the adjustment is not defined in the regulation.

The "Commonly agreed position on flexibility within the SGP" endorsed by the ECOFIN Council of 12 February 2016([49]) gives a modulation of the required annual adjustment - the so-called matrix of requirements (see Box 1.6) – that was originally proposed by the Commission in its Communication on Flexibility([50]) within the SGP, to take the economic cycle as well as the debt level and sustainability

([46]) Still, such a deviation from the MTO of less than ¼% of GDP enters in the (corrected) required adjustment in the following year. See annex 14.
([47]) Even if the Member State plans to be at its MTO on the basis of the face value or/and recalculated structural balance, it is expected to make a structural effort if the Commission forecast shows that it is not at the MTO.
([48]) In this context, risks to overall debt sustainability are measured, among other information, by the S1 indicator. This indicator shows the adjustment effort required over five years, in terms of a steady improvement in the structural primary balance, to bring debt ratios to 60% of GDP in 2030, taking also into account the costs arising from an ageing population. For more information see the 2015 Fiscal Sustainability Report : http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip018_en.pdf
([49])http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf
([50]) Communication from the Commission *Making the best use of the flexibility within the existing rules of the Stability and Growth Pact*, COM(2015) 12 of 13.01.2015: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/2015-01-13_communication_sgp_flexibility_guidelines_en.pdf.

needs of each Member State more adequately into consideration. This interpretation is fully in line with the provisions under Articles 5 and 9 of Regulation (EC) 1466/97, which allow for modulation of the efforts and for no adjustment in case of an "unusual event outside the control of the Member State […] which has a major impact on the financial position of the general government". In the latter case, the requirements on the adjustment path to the MTO do not apply for the relevant years and no adjustment to the structural balance is required (see also Section 1.3.2.5).

Predictability of the assessment is key in a context where a significant deviation from the requirements will lead to procedural consequences, which eventually include financial sanctions for euro area Member States. In order to provide ex ante guidance and to ensure predictability of the assessment's outcome and certainty on what is expected from a Member State, the required adjustment for year *t* is frozen in the spring of year *t-1* (see Box 1.6 for a detailed explanation). However, in order to avoid situations where the freezing of the requirements could lead to unwarranted consequences, namely required adjustments that turn out to be either too large (should outturn data signal a worsening of the economic conditions so that the country is considered to be either in exceptionally or very bad times) or not necessary anymore to progress towards the MTO, the requirements based on the most recent data would prevail. Member States subject to a Significant Deviation Procedure which have not yet corrected the significant deviation with respect to their MTO, or the adjustment path towards it, should have an adjustment path that reflects their Council recommendation under art. 121(4) TFEU.

Box 1.6: DEFINING THE APPROPRIATE ADJUSTMENT PATH

The required annual fiscal effort is modulated so that Member States can adapt their fiscal adjustments over the economic cycle while taking into account their fiscal consolidation needs.

All Member States are expected to accumulate savings in good times so as to be able to have sufficient latitude for the operation of the so-called automatic stabilisers (e.g. higher welfare spending and lower tax revenues) during the downturns. In good times, revenues of the state increase due to more vigorous economic activity and expenditure related to unemployment falls and usually multipliers are smaller than in bad times. More in general, the economy is expected to be more resilient, such that a bigger structural effort can be undertaken with limited impact on the economy and a larger adjustment can be attained. Thus, the larger the positive (negative) output gap, the greater (lower) the required adjustment effort. The matrix of requirements below also takes into account the direction into which he economy is moving, i.e. whether the economic situation is improving or deteriorating, by distinguishing whether the real GDP exceeds or falls short of a country-specific potential growth rate.

In addition, the required effort is also greater for Member States with unfavourable overall fiscal positions, i.e. whether fiscal sustainability is at risk or the debt-to-GDP ratio is above the 60% of GDP reference value of the Treaty.

Concretely, the matrix envisages a higher fiscal adjustment for the Member States identified as experiencing good times, i.e. when their output gap is estimated to be ≥ 1.5% of potential GDP. This is particularly important for the Member States with fiscal sustainability risks or debt-to-GDP ratios exceeding the 60% Treaty reference value and therefore such Member States would be required to provide a structural fiscal adjustment of at least 0.75% of GDP or at least 1% of GDP, depending on whether their good economic situation continues to improve further or not.

In normal times, interpreted as an output gap between -1.5% and +1.5% of potential GDP, all Member

States with a debt-to-GDP ratio below 60% would be required to make an effort of 0.5% of GDP, whereas the Member States with debt levels above 60% would need to make an adjustment greater than 0.5% of GDP. This is conventionally understood to be 0.6% of GDP at least.

In bad times, interpreted as an output gap between -3% and -1.5% of potential GDP, the required adjustment would be lower. All EU Member States with the debt-to-GDP ratio below 60% would be required to ensure a budgetary effort of 0.25% of GDP when their economies grow above potential, and a fiscal adjustment of zero would be temporarily allowed when their economies grow below the potential. In the same cyclical conditions, these requirements become 0.5% of GDP and 0.25% of GDP respectively for Member States with debt levels above 60%.

In very bad times, interpreted as an output gap between -4% and -3% of potential GDP, all Member States with the debt-to-GDP ratio below 60% would be temporarily allowed zero adjustment, meaning that no fiscal effort would be required, whereas Member States with debt-ratios exceeding 60% would need to provide an annual adjustment of 0.25% of GDP. In exceptionally bad times, interpreted as an output gap below 4% of potential GDP or when real GDP contracts, all Member States, irrespective of their debt levels, would be temporarily exempted from making any fiscal effort.

The output gap thresholds set at -3% and -4% of potential GDP are supported by past data: since the 1980s, output gaps in EU countries have been below -4% in only one year out of twenty, while they reached -3% in one year out of ten, hence these two values are considered indicating very bad and exceptionally bad times.

		Required annual fiscal adjustment (pp of GDP)	
	Condition	Debt ≤ 60% and low/medium sustainability risks	Debt > 60% or high sustainability risks
Exceptionally bad times	Real growth <0 or output gap < -4	No adjustment needed	
Very bad times	-4 ≤ output gap <-3	0	0.25
Bad times	-3 ≤ output gap <-1.5	0 if growth below potential, 0.25 if growth above potential	0.25 if growth below potential, 0.5 if growth above potential
Normal times	-1.5≤output gap <1.5	0.5	> 0.5
Good times	Output gap ≥1.5	>0.5 if growth below potential, ≥0.75 if growth above potential	≥0.75 if growth below potential, ≥1 if growth above potential

In order to ensure the predictability of the ex post assessment's outcome and that Member States are able to plan adequately and adopt the appropriate budgetary measures to ensure compliance with their obligations under the preventive arm of the Pact, the required adjustment path to the MTO for year *t* is frozen in the spring of year *t-1*. This means that for the purpose of defining the required adjustment:

- The initial structural balance level and its distance with respect to the MTO are those forecast for the year *t-1* in spring *t-1*. Thus, the extent of the adjustment required of a Member State in year t will be determined on the basis of the structural balance level as measured in spring of year *t-1*. The starting point also places an upper bound on the adjustment required as a Member State cannot be required to adjust to a structural position that lies above the MTO.
- The real GDP growth and output gap that apply in determining the adjustment are those forecast by the Commission for year *t* in the spring of *t-1*.
- The debt-to-GDP ratio and the sustainability risk indicator (S1) are those forecast by the Commission for year *t-1* in spring *t-1*.

The resulting adjustment requirement for year *t* should be set out in the assessment made in year *t-1*. This will then be the benchmark for assessing the appropriateness of the change in the structural balance for year *t* in the in-year assessment that occurs during year *t*, and in the ex post assessment that occurs in year *t+1*. In order to avoid unwarranted consequences of fluctuations in the output gap and the structural balance beyond the control of the governments, if the output gap turns out ex post to be larger than -3% of potential GDP (i.e. the Member State is found to be in very bad times or exceptionally bad times) or the Member State is found to have achieved the MTO, the conditions ex post prevail over the frozen requirements.

1.3.2.3 Taking into account the implementation of structural reforms

The Stability and Growth Pact provides the necessary flexibility within the rules to support structural reforms without compromising fiscal responsibility. Regulation (EC) 1466/97 allows Member States implementing major structural reforms to deviate temporarily from the MTO or the adjustment path towards it, if these reforms have positive budgetary effects in the long-term, including by raising potential growth. The deviation is allowed provided the Member State remains in the preventive arm, that an appropriate safety margin with respect to the 3% of GDP deficit reference value is preserved([51]) and that the budgetary position is expected to return to the MTO within the programme horizon (i.e. by the year t+4 at the latest, with t being the year of submission of the SCP). The Commission Communication on Flexibility within the SGP([52]) provided additional guidance on the best possible use of the flexibility embedded in the existing fiscal rules to strengthen the link between structural reforms and fiscal responsibility. On this basis, the Council decided on the implementation of the flexibility within the SGP, as reflected in the commonly agreed position endorsed by the ECOFIN Council of 12 February 2016.([53]) Box 1.8 describes the structural reform clause. The full text of the "Commonly agreed position on flexibility" is reported in Annex 17.

The so-called “structural reform clause” allows for a temporary deviation from the MTO or the adjustment path towards it under well-defined conditions. More specifically, structural reforms must (i)

([51]) The Code of Conduct of the SGP stipulates that this safety margin should take account of past output volatility and budgetary sensitivity to output fluctuations, which indicates that the structural balance should be equal or above the minimum benchmark, defined in Section 1.2.1.1.
([52]) COM (2015) 12 final provisional.
([53])http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf

have a verifiable positive impact on the long-term sustainability of public finances, (ii) be major and (iii) be fully implemented.

Arguably, assessing the impact of structural reforms on the long-term sustainability of public finances is amongst the most challenging conditions of the structural reform clause. It is neither possible nor probably desirable to set up a *numerus clausus* list of structural reforms that could qualify for the temporary deviation. However, some guidance can be provided to delimit the kind of eligible reforms.

There are two possible channels through which reforms can affect public finances in the long-run. First, some structural reforms may generate a direct positive budgetary impact as for instance is the case of pension reforms, health care reforms or reforms to the public administration. Second, some structural reforms may have an indirect sustainability-enhancing effect, in cases where they result in higher potential output and, therefore, lead to higher future revenues. However, some structural reforms may also generate budgetary costs, particularly in the short-run. Consequently, a qualitative assessment of the sustainability-enhancing nature of a reform should encompass all these possible budgetary effects.

According to the stipulations in the Code of Conduct on the SGP, the effects of the reforms over time “are to be assessed by the Commission and the Council in a prudent way, making due allowance of the margin of uncertainties associated to such an exercise.”

In operational terms, this assessment by the Commission should build on the input provided by the concerned Member State regarding both the costs and savings which are direct consequence of the reform, and the indirect budgetary impact linked to potential output effects of the reform. In fact, Annex 1 to the Code of Conduct on the SGP – which details the structure of the Stability and Convergence Programmes – establishes that the growth and budgetary implications of 'major' structural reforms should be detailed by Member States when submitting their economic and budgetary projections. Based on the information provided([54]) by the Member State, the Commission will pass an informed judgement, which may include a plausibility assessment, on whether the reform meets the sustainability-enhancing condition to qualify for application of the clause. This plausibility analysis could draw upon the methodology outlined in Annex 16, while having in mind uncertainties and risks associated with quantitative estimations of impacts of structural reforms.

The reforms must be major. While, there are some individual reforms with a major positive impact on growth and the long-term sustainability of public finances, such as pension reforms (see Box 1.7), well-designed and comprehensive packages of reforms addressing structural weaknesses may also have a major positive impact. This is notably the case when the reforms are mutually reinforcing through an appropriate policy mix and sequencing of implementation.

All the reforms must be fully implemented before being considered as eligible for the clause. The reforms must be adopted by the national authorities through provisions of binding force, whether legislative or not, in accordance with the applicable domestic laws and procedures. However, the effective implementation of adopted reform may take time and may be subject to delays and setbacks. This raises the question of introducing strong safeguards against the risk of implementation failures. While the SGP does not provide the tools for monitoring the enforcement of structural reforms, the legal framework in which the SGP operates – notably the European Semester process and the Excessive Imbalances

([54]) According to the Code of Conduct of the SGP, sufficient, detailed information is to be provided in the Stability and Convergence Programmes. Therefore, since 2015, Member State applying for the use of the structural reform clause are requested to include in both the SCP and the NRP a table with detailed description (including the budgetary impact) of each structural reform (see annex 3).

Procedure (EIP)([55]) – allows the Commission and the Council to assess the challenges and imbalances requiring structural reforms, and for monitoring action taken by the Member States.

In case the structural reform is not yet fully implemented, in order to assess ex ante whether the abovementioned eligibility criteria are met, the Member State should also submit a dedicated structural reform plan – subsumed, as relevant, in the National Reform Programme (NRP) or Corrective Action Plan (CAP).([56]) The plan will include well-specified measures and set credible timelines for their adoption and delivery. The implementation of the reforms will be closely monitored in the context of the European Semester. If the Member State is under an Excessive Imbalances Procedure (EIP) and has submitted a Corrective Action Plan (CAP) with the necessary information, the implementation of the reforms will then be monitored through the EIP. In both cases, Member States will be expected to provide in-depth and transparent documentation quantifying the short-term costs – if any – of the reforms and both the medium-term budgetary and potential growth impact of the reforms, as well as providing details on the timetable of their implementation. Concurrently, Member States will provide an independent evaluation of the information provided to support their application for the reform clause, including on the estimated short and medium-term impact on the budgetary position or a comprehensive independent information to support the estimated impact.

Box 1.7: The pension reform clause

Sustainability-enhancing pension reforms have received specific consideration in the legislation (art. 5(1) of regulation 1466/97) and in the Code of Conduct on the SGP.

Pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar, constitute a specific case of structural reforms which also justify a temporary deviation from the MTO or the adjustment path towards it by the amount of the direct incremental impact of the reform on the general government balance, provided that an appropriate safety margin with respect to the 3% of GDP deficit reference value is preserved.([57]) This type of pension reforms has a direct deficit-increasing impact in the short term. The direct impact of a pension reform involves a transfer of pension obligations to or from the general government that is made up of two elements: i) the social contributions or other revenue collected by the pension scheme taking over the pension obligations and which is meant to cover for these obligations and ii) the pension and other social benefits paid by this pension scheme in connection to the obligations transferred. The direct impact of such pension reforms does not include interest expenditure that is linked to the higher accumulation of debt due to forgone social contributions or other revenues.

A Member State wishing to avail itself of the pension reform clause must liaise with Eurostat in order to verify the eligibility of the reforms envisaged and include the cost of the reform incurred on the first year, following the introduction of the reform and any annual incremental costs for subsequent years in its SCP.

The structural reform clause is granted in the context of the assessment of the SCPs, specifically in the relevant Country Specific Recommendation (CSR). In case a Member State applies for the clause in

([55]) Regulation EU/1176/2011.
([56]) A plan announcing upcoming reforms as a simple manifestation of political intentions or of wishes would not fulfil the requirements for the application of Article 5(1) of Regulation 1466/97.
([57]) The Code of Conduct of the SGP stipulates that this safety margin should take account of past output volatility and budgetary sensitivity to output fluctuations, which indicates that the structural balance should be equal or above the minimum benchmark, defined in Section 1.2.1.1.

autumn, the structural reform clause may be granted provided it is endorsed by the Council in the autumn of the same year as an updated CSR. The "Commonly agreed position on flexibility within the SGP" – see Annex 17 – gives further details on the way the Commission and the Council will set the requirements (via the CSR) in case the structural reform is planned but not yet fully implemented.

In case a Member State fails to implement or reverses the agreed reforms, the temporary deviation from the MTO, or from the adjustment path towards it, will no longer be considered as warranted. If such failure results in an observed significant deviation (Section 1.3.2.7) from the MTO or the path towards it, the Commission will launch a Significant Deviation Procedure, according to the steps set out under article 121(4) TFEU and articles 6(2) and 10(2) of Regulation 1466/97.

Box 1.8: **THE OPERATIONALIZATION OF THE "STRUCTURAL REFORM CLAUSE"**

The structural reform clause allows Member States to temporarily deviate from the MTO or the appropriate adjustment path towards it. However, the deviation should not lead to a breach of the 3% of GDP deficit threshold and a safety margin to this threshold should be continuously preserved. As indicated in Box 1.6, the requirements in terms of change in the structural balance (and expenditure benchmark) for each year are set and kept unchanged on the basis of the spring forecast of the year before. Therefore, the temporary deviation linked to structural reforms submitted in the SCPs in year t will be allowed from year t+1 onwards.

Regarding the amount of the allowed deviation linked to structural reforms, the Council agreement – based on Regulation (EC) 1466/97 – establishes a difference between pension reforms and other kind of structural reforms.

- In case of an eligible pension reform (see Box 1.7), the allowed deviation from the adjustment path towards the MTO or from the MTO itself would amount to the direct incremental impact of the reform on the general government balance. There is no cap for the amount of allowed deviation in this case, provided that an appropriate safety margin with respect to the 3% of GDP deficit reference value is preserved.

- In case of other structural reforms, the Council agreement establishes that the allowed deviation from the MTO, or the adjustment path towards it, will not exceed 0.5% of GDP, thereby establishing a cap to the maximum allowed deviation.

The need to cap the deviation in respect of the structural reform clause is explained by the acknowledged significant uncertainty which attaches to estimating the costs and benefits of such reforms. By contrast, the costs of pension reforms are directly measurable and verified by Eurostat.

Beside the capping, two other safeguards ensure the integrity of the MTO as the central target of the preventive arm of the SGP, namely:

- the application of the structural reform clause is restricted to one single time per period of adjustment towards the MTO;

- the maximum initial distance, which the structural balance can be from the MTO, is 1.5% of GDP in year t. This condition is meant to ensure that - in the benchmark case of an annual adjustment of 0.5% of GDP - the Member State can achieve its MTO within the four year horizon of the SCP.Moreover, according to the commonly agreed position on flexibility within the SGP endorsed

by the ECOFIN Council of 12 February 2016,([58]) in case the same Member State is granted also the investment clause (see Section 1.3.2.4), the cumulative temporary deviation allowed under the two clauses will not exceed 0.75% of GDP.

The allowance is modulated according to the Member State position with respect to its MTO so as to ensure an equivalent impact on the debt levels. Thus, a Member State which is at the MTO is allowed to depart from it for three years. Whereas a Member State which is not initially at the MTO, but would reach it before the end of the period would adjust on a trajectory that is parallel to their original path and halt that adjustment if, while being entitled to the deviation, they reach the point where they are within 0.5% of GDP of their MTO (i.e. their MTO minus the temporary deviation). In the fourth year of the adjustment period covered by the structural reform clause, the deviation is no longer applied and the Member State is then required to adjust according to the matrix. In the benchmark case, this will return the Member State to their MTO.

Algebraically, with t being the year of submission of the SCPs and assuming t+1 is the year for which the temporary deviation is granted, the new adjustment path towards the MTO for a Member State benefitting from the structural reform clause will be:

$$SB_{t+1} = SB_t + \min[adj_matrix_{t+1} - deviation, \{(MTO - deviation) - SB_t\}]$$

$$SB_{t+2} = SB_{t+1} + \min[adj_matrix_{t+2}, \{(MTO - deviation) - SB_{t+1}\}]$$

$$SB_{t+3} = SB_{t+2} + \min[adj_matrix_{t+3}, \{(MTO - deviation) - SB_{t+2}\}]$$

$$SB_{t+4} = SB_{t+3} + \min[adj_matrix_{t+4}, \{MTO - SB_{t+3}\}]$$

Where:

- SB_{t+1} denotes the structural balance in % of GDP in year t+1
- adj_matrix_{t+1} denotes the appropriate adjustment towards the MTO in year t+1 resulting from the matrix in Box 1.6
- deviation denotes the temporary allowed deviation
- $\{(MTO - deviation) - SB_t\}$ denotes the distance between the MTO minus the temporary allowed deviation and the structural balance prevailing the previous year.

Expressing the above in terms of the adjustment required in year t+1, gives:

$$reform_adj_{t+1} = \min\{adj_matrix_{t+1} - deviation, [(MTO - deviation) - SB_t)]\}$$

1.3.2.4 Taking into account investment

Under the preventive arm of the SGP, some investments aiming at, ancillary to, and economically equivalent to major structural reforms, may under certain conditions justify a temporary deviation from the MTO or from the adjustment path towards it. The Commission provided its first guidance in 2013 on

[58] http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf

the application of these provisions following Article 5(1) of Regulation (EC) 1466/97, i.e. as a specific application of the "structural reform clause". This guidance, commonly referred to as the "investment clause" was further specified through the Commission Communication on Flexibility within the SGP.([59]) On this basis, the Council decided on the implementation of the flexibility within the SGP, as reflected in the commonly agreed position endorsed by the ECOFIN Council of 12 February 2016.([60]) The investment clause is described in Box 1.9. The full text of the "Commonly agreed position on flexibility" is reported in Annex 17.

A temporary deviation from the MTO, or the adjustment path towards it, may be granted for the financing of certain specific investments with positive, direct and verifiable long-term budgetary effects on growth and on the sustainability of public finances under certain conditions. In particular, the Member State's GDP growth is forecast to be negative or to remain well below its potential (resulting in negative output gap greater than 1.5% of potential GDP), the Member State remains in the preventive arm and an appropriate safety margin with respect to the 3% of GDP deficit reference value is preserved.([61])

The deviation allowed must be linked to the national expenditure on projects co-funded by the EU under the Structural and Investment Funds,([62]) Trans-European-Network (TEN) and Connecting Europe Facility (CEF) and to national co-financing of investment projects also co-financed by the EFSI, with positive, direct and verifiable long-term budgetary effects. Moreover, co-financed expenditure should not substitute for nationally financed investments, so that total public investments are not decreased.

The investment clause is activated ex ante upon request from Member States in their SCPs one year ahead of the application of the clause. The process for Member States to request the flexibility and for the Council to grant this flexibility is the same as for the "structural reform clause" (Section 1.3.2.3), When requesting the application of the investment clause, Member States should include in their SCPs in particular the following information: i) the forecast path of national co-financing expenditure (as a % of GDP), ii) detailed information on the positive, direct and verifiable long-term budgetary effect of the expenditure covered by the clause, iii) the corrected path of the structural balance resulting from the application of the clause, iv) an independent evaluation of the information provided to support the application for the investment clause, including the estimated long-term impact on the budgetary position, or independent information to support the estimated impact. Member State should present information by main category of projects co-financed by the EU (including the EFSI), the size of the expenditure involved, the key features and objectives of the investment project and specifying how it will contribute to boost potential growth and the long-term sustainability of public finances.

The temporary deviation from the medium-term objective, or the adjustment path towards it, is granted by the Commission and the Council based on an overall assessment of the situation of the concerned Member State. Namely, the temporary deviation for investment expenditure listed above will be subject to a plausibility assessment by the Commission and the Council, where consideration is given to whether the project in question aims at, is ancillary to, and economically equivalent to the implementation of structural reforms. In its assessment the Commission will consider whether the eligible investment occurs against the background of structural actions aiming at improving the productive capacity of the economy. In this sense, investment is considered as aiming at, ancillary to, and economically equivalent to major

([59]) Communication from the Commission *Making the best use of the flexibility within the existing rules of the Stability and Growth Pact*, COM(2015) 12 of 13.01.2015: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/2015-01-13_communication_sgp_flexibility_guidelines_en.pdf
([60]) http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf
([61]) The Code of Conduct on the SGP stipulates that this safety margin should take account of past output volatility and budgetary sensitivity to output fluctuations, which indicates that the structural balance should be equal or above the minimum benchmark (defined in Section 1.2.1.1)..
([62]) See Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013.

structural reforms. However, the granting of the temporary deviation under the investment clause will not be conditional on a specific assessment of structural reforms comparable to the assessment undertaken for the application of the structural reform clause.

The investment clause is granted in the context of the assessment of the SCPs, specifically in the relevant Country Specific Recommendation. In case a Member State applies for the clause in autumn, the investment clause may be granted provided it is endorsed by the Council in the autumn of the same year as an updated Country Specific Recommendation. Ex-ante, the potential deviation will depend on the commitments of the EU structural funds towards each Member State as well as on the level of planned co-financing. Ex post, the allowed deviation will depend on the effective payments of EU structural funds and on the correspondent effective co-financing. The allowance will be reviewed reflecting the actual co-financing of the Member States. The (downward) revision of this temporary deviation shall not imply that a Member State implements an effort superior to the one necessary to reach its MTO.

Box 1.9: The operationalization of the "investment clause"

As for the "structural reform clause" (Box 1.8):

- the application of the investment clause is restricted to one single time per period of adjustment towards the MTO;

- the maximum initial distance, which the structural balance can be from the MTO, is 1.5% of GDP in year t.

Moreover, according to the commonly agreed position on flexibility within the SGP endorsed by the ECOFIN Council of 12 February 2016,([63])

- the full allowed deviation (i.e. the initial deviation and the following incremental deviations, if any) from the MTO, or the adjustment path towards it, corresponds to the total amount of the national part of eligible co-financed expenditure, but will not exceed 0.5% of GDP; and in case the same Member State is granted also the Structural Reform Clause (see Section 1.3.2.3), the cumulative temporary deviation allowed under the two clauses will not exceed 0.75% of GDP.

As for the "structural reform clause", the allowed deviation is adjusted according to the Member State distance to its MTO so as to equalise the impact on the debt level. A Member State at its MTO is allowed to depart from it for three years. For countries, not yet at the MTO but likely to reach it before the end of the period, an adjustment parallel to the original trajectory is required until they find themselves at the distance of the temporary deviation allowed to the MTO.

Effectively, this means that a Member State benefiting from the clause when at MTO or sufficiently close to MTO would be able to remain at either the distance of one temporary deviation, or of one initial temporary deviation complemented with following incremental temporary deviations, to the MTO, until t+3. From t+4 onwards, the Member State will lose the benefit of the temporary deviation granted in the first year. For the incremental temporary deviation, the logic is kept unchanged: if a Member State asks for an incremental temporary deviation in year t for year t+1, it will lose the benefit of the temporary deviation from year t+4 and onwards.

([63]) http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf

Algebraically, with t being the year of submission of the SCPs and assuming t+1 is the year for which the temporary deviation is granted, the new adjustment path towards the MTO for a Member State benefitting from the investment clause will be: ([64])

$SB_{t+1} = SB_t + \min[adj_matrix_{t+1} - deviation, \{(MTO - deviation) - SB_t\}]$
$SB_{t+2} = SB_{t+1} + \min[adj_matrix_{t+2} - Incr.\ dev._{t+2}, \{(MTO - (deviation + Incr.\ dev._{t+2}) - SB_{t+1}\}]$
$SB_{t+3} = SB_{t+2} + \min[adj_matrix_{t+3} - Incr.\ dev._{t+3}, \{(MTO - (deviation + Incr.\ dev._{t+2} + Incr.\ dev._{t+3}) - SB_{t+2}\}]$
$SB_{t+4} = SB_{t+3} + \min[adj_matrix_{t+4} - Incr.\ dev._{t+4}, \{MTO - (Incr.\ dev._{t+2} + Incr.\ dev._{t+3}) - SB_{t+3}\}]$

Where:

- SBt+1 denotes the structural balance in % of GDP in year t+1
- adj_matrixt+1 denotes the appropriate adjustment towards the MTO in year t+1 resulting from the matrix in Box 1.6
- deviation denotes the temporary allowed deviation
- Incr.dev. t+i denotes the positive incremental change with respect to the temporary deviation allowed in the previous year,
- {(MTO – deviation) - SBt+i} denotes the distance between the MTO minus the temporary allowed deviation and the structural balance prevailing the previous year.

Expressing the above in terms of the adjustment required in year t+1, gives:

$reform_adj_{t+1} = \min\{adj_matrix_{t+1} - deviation, [(MTO - deviation) - SB_t)]\}$

1.3.2.5 Considering the impact of adverse economic events

Since the Six-Pack reform of the Stability and Growth Pact in 2011, the pace of fiscal consolidation may be adapted for all Member States, as long as this does not endanger fiscal sustainability in the medium-run, in cases of a severe economic downturn in the euro area or in the EU as a whole. Parallel provisions apply to countries in the preventive arm and in the corrective arm (see Section 2.3.3.1)

Article 5(1) of Regulation (EC) 1466/97 states that: “In the case of an unusual event outside the control of the Member State concerned which has a major impact on the financial position of the general government or in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective referred to in the third subparagraph, provided that this does not endanger fiscal sustainability in the medium term.”

The activation of this provision would not mean putting on hold indiscriminately the fiscal adjustment, but rather re-designing the adjustment path on country-specific basis, to take into account the exceptional circumstances of the severe economic downturn in the euro area or in the EU as a whole.

([64]) It has to be noted that for countries benefitting from the clause while they are above the MTO, this formula displays a ceiling and not a compulsory adjustment path.

Beside a severe economic downturn for the euro area or the Union as a whole, the article refers to *an unusual event outside the control of the Member State*. Together with article 6(3), these provisions envisage that temporary deviations with respect to the required fiscal adjustment towards the MTO can either be allowed ex-ante (art. 5.1) or can be left out of consideration ex post (art. 6.3), provided that they result from i) an unusual event, ii) outside the control of the Member State, iii) with a major impact on the financial position of the general government and iv) not endangering fiscal sustainability in the medium term.

1.3.2.6 Is the Member State compliant with the requirements of the expenditure benchmark?

The assessment of the appropriateness of the path towards the MTO includes an assessment of respect of the expenditure benchmark. The expenditure benchmark acts as a guide for Member States to ensure that their policies are consistent with either remaining at the MTO or being on an appropriate adjustment path towards it. This Section considers how the expenditure benchmark is treated.

Applying the expenditure benchmark

According to Regulation (EC) 1466/97, for Member States that have attained their MTOs:

- Annual expenditure growth should not exceed a reference medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures. Thus, allowing the Member State to remain at its MTO. Countries that have exceeded their MTO do not need to be assessed for compliance with the expenditure benchmark.

For Member States that have not attained their MTO:

- Annual expenditure growth should not exceed a specific lower rate, which is set below the reference medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures. The difference between the appropriate growth rate for net expenditure and the reference medium-term rate of potential GDP growth is referred to as the convergence margin and is set so as to ensure the appropriate adjustment towards the MTO (i.e. in line with the required change in the structural balance). As a default the convergence margin is calculated to be consistent with a tightening of the structural balance of 0.5% of GDP. In cases where a higher or lower tightening of the structural balance is required, the convergence margin is recalibrated to reflect the tighter or looser adjustment path.

- Any discretionary reductions of government revenue items must be matched by either expenditure reductions or by discretionary increases in other revenue items or both.

In addition, whether at the MTO or not, excess expenditure growth over the medium-term reference is not counted as a breach of the benchmark if it is fully offset by revenue increases mandated by law. This provision is applicable to situations where Member States have revenue sources that are linked by law to certain expenditure items, so that when expenditure increases, the revenues automatically also increase to fund the higher expenditure. More precisely, a revenue (change) mandated by law is a change in a specific tax or contribution rate which is – in principle – triggered automatically (i.e. through a specific piece of pre-existing legislation) by a change in a well-specified and clearly linked expenditure category, with the intention of ensuring sufficient financing for this expenditure category. An example of this is the case where health/medical expenses are funded by a hypothecated tax which is automatically adjusted to cover these expenses when they increase (or decrease). Use of this exception should be based on detailed

understanding and explanation of why a particular feature of a Member State's tax and spending system complies with this situation.

The expenditure benchmark applies to an expenditure aggregate that excludes interest spending, expenditure on EU programmes fully matched by EU funds revenue and cyclical elements of unemployment benefit expenditure. In addition, investment spending is averaged over a four year period to smooth the impact of any large investment projects.

Computing the expenditure benchmark

In order to compute the expenditure benchmark, the following variables are needed:

- the medium-term rate of potential GDP growth

- the convergence margin which is subtracted from the medium-term rate of potential GDP growth to obtain the reference rate for countries not at their MTO

- the expenditure aggregate which will be used to assess compliance with the expenditure benchmark

- a measure of inflation (GDP deflator) to convert the benchmark growth rate, which is given in real terms, into nominal terms so that it can be compared to the change in the expenditure aggregate.

The medium-term rate of potential GDP growth used to define compliance with the expenditure benchmark is set on a country-by-country basis. It aims to link the changes in net expenditure growth with the growth of the economy, so that compliance with the expenditure benchmark is linked either to a stable deficit over the medium-term (for Member States at or above their MTOs) or to a tightening of the budgetary position (for Member States on the adjustment path to their MTOs). It is defined as an average over time and in terms of potential – rather than actual – growth to ensure that the application of the expenditure benchmark does not lead to pro-cyclicality.

The medium-term rate of potential GDP growth is calculated by a 10-year average of potential GDP, comprising 5 years of outturn data (as provided by Eurostat), the year underway and four years of forward-looking data. These figures build on the Commission forecasts, which follow the commonly agreed methodology set out by the Output Gap Working Group for the years beyond the scope of the Commission forecast. As from spring 2015 the medium-term rate of potential GDP growth applied in year t is set on the basis of the Commission spring forecast in t-1. Annex 4 gives the medium-term rates used for the assessments of the 2015 and 2016 budgetary figures.([65])

The convergence margin is country-specific and is subtracted from the medium-term rate of potential GDP growth to obtain the reference rate for countries not at their MTO. As a default this is set so that the lower increase in net expenditure relative to GDP is consistent with a tightening of the budget balance of 0.5% of GDP, when GDP grows at its potential rate. It is calculated based on the assumption that any decrease in the share of public expenditure not financed by additional revenue measures in the economy (which would occur if net expenditure grows more slowly than GDP) would then translate into an exactly proportional improvement of the structural balance (the coefficient being equal to the share of public

([65]) The reference rates in use for the budgetary figures of 2015 were computed on the basis of the Commission winter forecast 2013. Following the introduction of yearly update of the reference rate (in spring 2015), a transitional arrangement was put in place, only for the assessment of 2016, according to which the less demanding reference rate between the old and the updated one is used.

expenditure in GDP times the shortfall of expenditure growth). The size of the convergence margin therefore depends on the size of the general government sector, with larger public sectors requiring less expenditure restraint in percentage terms to yield a particular tightening of the structural budget. As with the medium-term rate of potential GDP growth, the convergence margin for year t is set in spring t-1, according to the methodology set out in Box 1.10.

Box 1.10: The convergence margin

The convergence margin is country-specific. It is applied to the medium-term rate of potential GDP growth to obtain the reference rate for countries not at their MTO. It serves to support the annual improvement of the structural balance towards the MTO, as required under the preventive arm of the SGP.

By default, the convergence margin is calibrated to be consistent with a 0.5% of GDP improvement in the structural balance. Its size depends on the share of government primary expenditure in GDP (P, in % of GDP).The higher P, the larger the improvement of the structural balance when the growth rate of net public spending (numerator) is limited below GDP (denominator) growth.([66])

Thus, the convergence margin (expressed in percentage points) is given by:

$$C=50/P$$

where the value of P comes from the same Commission forecast vintage on which the medium-term rate (10-year average) of potential GDP growth is centred. For example, the 2015 share of government primary expenditure in GDP (as per the spring forecast 2015) is used to calculate the convergence margin for 2016.

The reference rate L is then derived from the medium-term rate R (both expressed in percentage points) by the deduction of the convergence margin, as follows:

$$L = R - C.$$

As discussed in Box 1.6, Member States' required annual fiscal adjustment is modulated so as to take into account the economic cycle as well as their debt levels and sustainability risks: it can be therefore lower or higher than 0.5% of GDP. In those cases, the convergence margin is recalibrated to reflect this greater or lower adjustment need. The recalibrated convergence margin (C^{rec}) is given by:

$$C^{rec}= C * adjustment/0.5$$

where the “adjustment” term corresponds to the required tightening expressed in percentage points of GDP. This gives the recalibrated reference rate (L^{rec}) = R – C^{rec}.

Member States' required annual fiscal adjustment is modulated so as to take into account the economic cycle as well as their debt levels and sustainability risks (see Box 1.6). This requirement is then used to

([66]) For example, for a country with a primary expenditure of 40% of GDP the convergence margin is 1.25 percentage points of GDP. If the primary expenditure-to-GDP ratio increases to 41%, this reduces the convergence margin to 1.22 p.p., i.e. the lower rate will be 0.03 p.p. higher. Assuming real GDP growth of 2%, the 1 p.p. increase in primary expenditure in fact corresponds to a lower rate 4% higher (0.78 compared to 0.75).

calculate an applicable convergence margin and a corresponding recalibrated reference rate, as explained in Box 1.10. For a country with an adjustment above 0.5%, the recalculated applicable convergence margin will be greater, leading to tighter reference rate which constrains net expenditure growth more. For a country with a lower adjustment requirement, the recalculated applicable convergence margin will be smaller, leading to a loosening of the constraint on net expenditure growth.

In order to ensure the predictability of the ex post assessment's outcome and that Member States are able to take the appropriate measures in the forthcoming budget plan, the applicable convergence margin and the resulting reference rate is communicated in the spring of year *t-1* for year *t* and is kept fixed – unless the required adjustment is reset - for all the assessments (ex ante, in-year and ex post) of the budgetary figures of year *t* (see Box 1.6 for further details on the implementation of the so-called freezing of the requirements).

While potential GDP is measured in real terms, expenditure plans are typically set in nominal terms. Therefore, to convert the expenditure figures into real terms to allow for the comparison the GDP deflator is used as a measure of inflation.([67]) When the Commission assesses Member States plans for year t depicted in the SCP (or the DBP) of the same year, the average GDP deflator from the Commission's spring forecast and that of autumn of the preceding year will be used. The ex post assessment of outturn data of year *t* undertaken in year *t+1* will be based on the average GDP deflator forecast for *t* from the Commission's spring and in autumn forecasts of *t-1* (see Table 1.1).

Table 1.1: **Use of deflators for the in-year and ex post assessment of the expenditure benchmark**

Budget and year of in year assessment	Year of ex post assessment (during European Semester)	Deflators to use
2015	2016	Average of 2014 spring and autumn Commission forecasts
2016	2017	Average of 2015 spring and autumn Commission forecasts
2017	2018	Average of 2016 spring and autumn Commission forecasts
t	t+1	Average of t-1 spring and autumn Commission forecasts

[67]The GDP deflator fulfils two criteria: First, it is conceptually sound and coherent with the aim of the preventive arm. Since the expenditure benchmark is based on a potential rate of GDP growth, aligning growth rates of both net expenditure and revenues (where growth rate is proxied by GDP growth) and using a common deflator ensures a constant differential and allows the Member State respecting the expenditure benchmark to remain at its MTO. Second, on a practical level, the GDP deflator typically displays less volatility than other measures of inflation and is therefore more conducive to supporting transparent and stable policy-making.

Compliance with the expenditure benchmark requires that planned expenditure growth be compared with the appropriate benchmark growth rate (see Box 1.11).

Box 1.11: How the net expenditure growth rate for year t is computed?

Step 1 – The first step in the calculation requires the computation of *modified* expenditure aggregates for years t([68]) and t-1, referred to as G_t and $G_{t-1,}$ respectively.

	Variable (for t unless otherwise mentioned, in nominal terms)	Source
+	Government expenditure aggregate	SCPs (table 2a, ESA code TE)
–	Interest expenditure	SCPs (table 2a, ESA code D.41)
–	Government expenditure on EU programmes which is fully matched by EU funds revenue	SCPs (table 2c, row 1)
–	Gross fixed capital formation (for year t)	SCPS (table 2a, ESA code P.51g)
+	Gross fixed capital formation averaged over t-3 to t	SCPs (table 2a, ESA code P.51g) + ESTAT for past data
–	Cyclical unemployment benefit expenditure	SCPs (table 2c, row 2)
=	*modified* expenditure aggregate E_t	

Step 2 – Expenditure *net of discretionary revenue measures* is obtained by subtracting from E_t the estimated impact for year t of revenue measures having an incremental effect on revenues collected in t with respect to t-1. To this purpose, it is necessary to estimate the *incremental impact for year t* (ΔR_t) of discretionary revenue measures having an incremental effect on revenues collected in t, including the revenue increase mandated by law – both revenue increasing *and* decreasing measures are to be taken into account. Member States should provide the estimate of this impact in their SCPs: it is the sum of "discretionary revenue measures" (table 2c, row 3) and of "revenue increases mandated by law" (table 2c, row 4).

Step 3 – Compute the net expenditure growth rate for year t: $g_t = (G_t - \Delta R_t - G_{t-1})/ G_{t-1}$

Step 4 – Deflate to obtain the net expenditure growth in real terms, using the annual percentage change of the GDP deflator.

Annex 9 provides a numerical example of how the net expenditure growth rate is calculated and applied.

Concluding the assessment on the expenditure benchmark

([68]) Year t is the year of budgetary execution being assessed (either *ex ante*, *in-year* or *ex post*).

Countries that have exceeded their MTO do not need to be assessed for compliance with the expenditure benchmark, as long as the MTO is maintained (see Section 1.3.2.6). In all other cases, the conclusion of the assessment should focus on whether the growth rate of government expenditure, net of discretionary revenue measures, contributes to the appropriate adjustment towards the MTO or whether it is in line with the medium-term rate of potential GDP growth for countries at their MTO.

Compliance with the expenditure benchamark in Member States' SCPs (or DBPs) is assessed against both the plans' own and the Commission forecasts, with the latter being the basis for the risk assessment of the plans. The ex post assessment of compliance is based on outturn data, with the exception of deflator values.

1.3.2.7 The assessment of compliance with the preventive arm

Regulation (EC) 1466/97 specifies how a deviation from the MTO or the adjustment path towards it will be measured. More specifically, the Regulation states that: "A deviation from the medium-term objective or from the appropriate path towards it shall be evaluated on the basis of an overall assessment with the structural balance as the reference, including an analysis of the expenditure net of discretionary revenue measures […]".

The assessment of the SCPs([69]) (and also of DBPs for euro area Member States), therefore, evaluates the overall compliance of the Member State with the requirements of the preventive arm and can reach a conclusion of compliance, (some) deviation([70]) or significant deviation. For the ex ante assessment, the latter refers to a risk of a significant deviation based on the Member State plans and the Commission forecast; for the ex post assessment (which is based on observed data as available in spring of year t+1), it triggers the procedural steps set out under art 121(4) TFEU (hereafter Significant Deviation Procedure - SDP), as outlined in Section 1.4. The assessment should also include a discussion of the figures underlying the two indicators, i.e. structural balance and expenditure benchmark, to enable a clear understanding of the basis of the overall conclusion.

As defined in Articles 6(3) and 10(3) of Regulation (EC) 1466/97, the assessment of whether the deviation is significant shall, in particular, include the following criteria:

(a) for a Member State that has not reached the MTO,([71]) when assessing the change in the structural balance, whether the deviation is at least 0.5% of GDP in a single year or at least 0.25% of GDP on average per year in 2 consecutive years;

(b) when assessing expenditure developments net of discretionary revenue measures, whether the deviation has a total impact on the government balance of at least 0.5% of GDP in a single year or cumulatively in 2 consecutive years.

The Articles further specify that "The deviation of expenditure developments shall not be considered significant if the Member State concerned has overachieved the medium-term budgetary objective, taking into account the possibility of significant revenue windfalls and the budgetary plans laid out in the stability/convergence programme do not jeopardise that objective over the programme period. Similarly,

([69]) Taking the plans at face value (after recalculating the structural balance based on the commonly agreed methodology, implemented through the CONV simplified routine), and then taking into account the risks attached to the SCP/DBP scenario, as embodied in, for instance, the most recent Commission forecasts.
([70]) "Some" deviation refers to any deviation which is not significant – in the sense of article 6(3) and 10(3) of Regulation 1466/97.
([71])In case a Member State has reached its MTO, a deviation from it of at least 0.5% of GDP still results in a significant deviation.

the deviation may be left out of consideration when it results from an unusual event outside the control of the Member State concerned and which has a major impact on the financial position of the general government or in the case of a severe economic downturn for the euro area or the Union as a whole, provided that this does not endanger the fiscal sustainability in the medium-term."

In considering compliance with the preventive arm, the analysis will therefore be different depending on the position of the Member State with respect to its MTO. If the Member State has exceeded the MTO, compliance with the expenditure benchmark is only necessary in order to assess any two year deviation, should the Member State plan to depart from its MTO in the next year. As a convention, the Commission considers a country to be at its MTO if it is within ¼ percentage points of GDP from its MTO. This convention has been applied over time, and aims to account for the inevitable uncertainty in judging the precise position of the structural balance.

The starting point for the analysis of any year t (whether assessed ex ante or ex post), is to look at the structural balance in that year to see whether the Member State in question achieved its MTO. Based on the Commission forecasts, the following outcomes are possible:

(i) The Member State exceeded its MTO in t.

(ii) The Member State achieved its MTO in t.

(iii) The Member State did not achieve its MTO in t.

A Member State that did not achieve its MTO in t will need to have been or plan to be on an appropriate adjustment path to the MTO in that year. This will require comparing the actual change in the structural balance to the appropriate adjustment path and to assess compliance with the expenditure benchmark, with respect to the requirements frozen in spring of the year t-1 (see Box 1.6).([72]) The frozen requirements do not apply if the economic conditions have deteriorated to very bad or exceptionally bad times or if the Member State has achieved its MTO.

The ex ante and in year assessment of a (risk of) significant deviation on each indicator will look at whether the difference between the two is forecast/planned to be equal to or more than 0.5% of GDP for the year under consideration, or will result in an average deviation of 0.25% of GDP over two years. The ex post assessments of a significant deviation on each indicator will look at whether the observed difference between the two equal to or more than 0.5% of GDP for the year under consideration, or resulted in an average deviation of 0.25% of GDP over two years.

In addition, Member States that exceeded their MTO in t-1 can deviate from the requirements of the expenditure benchmark without it being considered significant, as long as the MTO is maintained.([73])

As part of the incorporation of the MTO objective into the national legal order, those countries that are signatories of the TSCG and bound by the Fiscal Compact have committed themselves to implement automatic correction mechanisms at the national levels which will operate in the event of significant observed deviations. The Commission's Communication on *Common principles for the national correction mechanisms*([74]) gives the principles underlying the design of the requested corrective

([72]) For a Member State under a Significant Deviation Procedure which has not corrected its significant deviation, the adjustment path should reflect the requirements of its Council recommendation requesting the correction of the significant deviation.
[73] However, in that context, the ex post assessment of these countries should consider whether revenue windfalls are in part responsible for the overachievement of the MTO.
[74] (COM/2012/0342 final).

mechanisms.([75]) Moreover, the Two Pack requires that euro area Member States have in place independent bodies to oversee the operation of these mechanisms. Section 3.2.1 goes over these requirements in more detail.

Table 1.2 presents an overview of how the assessment of the two different indicators can lead to the following overall conclusions:

- If the Member State is compliant with both indicators, the overall conclusion will be one of compliance with the preventive arm. On an ex ante basis, this means that if the plans turn out as forecast, the Member State will be compliant with the preventive arm while on an ex post basis it indicates compliance in the previous year.

- In all other cases, in line with Art. 6(3) of Regulation 1466/97, the conclusion will depend on the 'overall assessment', which should include an in-depth analysis based on the two indicators. Within this, the risk of or the conclusion of an ex post significant deviation requires at least one indicator to be in significant deviation, in line with the specification in the Code of Conduct on the SGP. In case the Member State is in significant deviation on both indicators, this gives a strong presumption of a (risk of or observed) significant deviation, but an overall assessment is still needed before reaching the conclusion, as there is no element of automaticity in the Regulation in reaching the conclusion of a significant deviation.([76]) On an ex ante basis, this means that if the plans turn out as forecast, the Member State will be in significant deviation with respect to the preventive arm and would have a Significant Deviation Procedure (SDP, (i.e. the procedural steps set out under art. 121(4) TFEU and articles 6(2) and 10(2) of Regulation 1466/97) launched once the outturn figures are confirmed. On an ex post basis, it acts as the trigger for a SDP.

In the overall assessment, particularly when only one indicator points to a significant deviation, the Commission analyses the factors which lead to the discrepancy between the two indicators. It informs the Council about this analysis, explaining the discrepancy between both indicators and the reasons behind the conclusion of the overall assessment. The conclusion of the assessment of Member States' plans should consider whether the resulting change in the structural balance, including the analysis of the expenditure net discretionary revenue measures, appears to be appropriate or whether a significant deviation from the adjustment path can be expected – either on a one year or on a two-year basis (see Annex 14). Where a conclusion of overall significant deviation is reached on an ex post basis on outturn data, this triggers a SDP, which starts with a Commission warning to the Member State in question and can lead to an interest-bearing deposit being required, for euro area Member States. Section 1.4 presents it in more details.

[75] See Box 3.2 in Section 3.2.1

([76]) Articles 6(3) and 10(3): "A deviation from the medium-term budgetary objective or from the appropriate adjustment path towards it shall be evaluated *on the basis of an overall assessment* […]. The assessment of whether the deviation is significant shall, in particular, *include* the following criteria […]".

Table 1.2: **The overall assessment under the preventive arm**

ΔSBal / Dev. from the EB	Adjustment delivered	Deviation	Breach of the threshold of significance
Benchmark Respected	Compliance	*Need an overall assessment* (cannot lead to a significant deviation procedure)	*Need an overall assessment* (can lead to a significant deviation procedure)
Deviation	*Need an overall assessment* (cannot lead to a significant deviation procedure)	*Need an overall assessment* (cannot lead to a significant deviation procedure)	*Need an overall assessment* (can lead to a significant deviation procedure)
Breach of the threshold of significance	*Need an overall assessment* (can lead to a significant deviation procedure)	*Need an overall assessment* (can lead to a significant deviation procedure)	*Need an overall assessment, but strong presumption of* significant deviation (can lead to a significant deviation procedure)

1.4. THE PROCEDURE IN CASE OF OBSERVED SIGNIFICANT DEVIATION, INCLUDING THE INTRODUCTION OF SANCTIONS FOR THE EURO AREA MEMBER STATES

The ex post assessment of the preventive arm is of particular importance as in the event where a significant deviation from adjustment path to the MTO is found, the Commission will launch a SDP. It is based on outturn data. Graph 1.3 sets out the various steps to be followed, while Annex 7 provides details on the voting modalities.

The first step in the procedure is for the Commission to address a warning under Article 121(4) of the Treaty to the Member State in question. Within one month of the warning, the Council will examine the situation in the Member State and adopt a recommendation under Article 121(4) on necessary policy measures, including a new adjustment path towards the MTO. This recommendation will be based on a Commission recommendation and will set a deadline of no more than 5 months for the Member State to address the deviation. If the Commission judged that the situation was particularly serious and warranted urgent action, the deadline can be reduced to 3 months. On a proposal from the Commission, the Council shall make the recommendations it issues public.

Following the Council recommendation, the Member State in question must report to the Council on action taken, within the deadline set. If the Member State fails to take appropriate action within this deadline, the Commission will immediately recommend that the Council adopt, by qualified majority, a decision establishing that no effective action has been taken. The Commission may recommend that the Council adopt a revised recommendation under 121(4) on the appropriate measures to be taken.

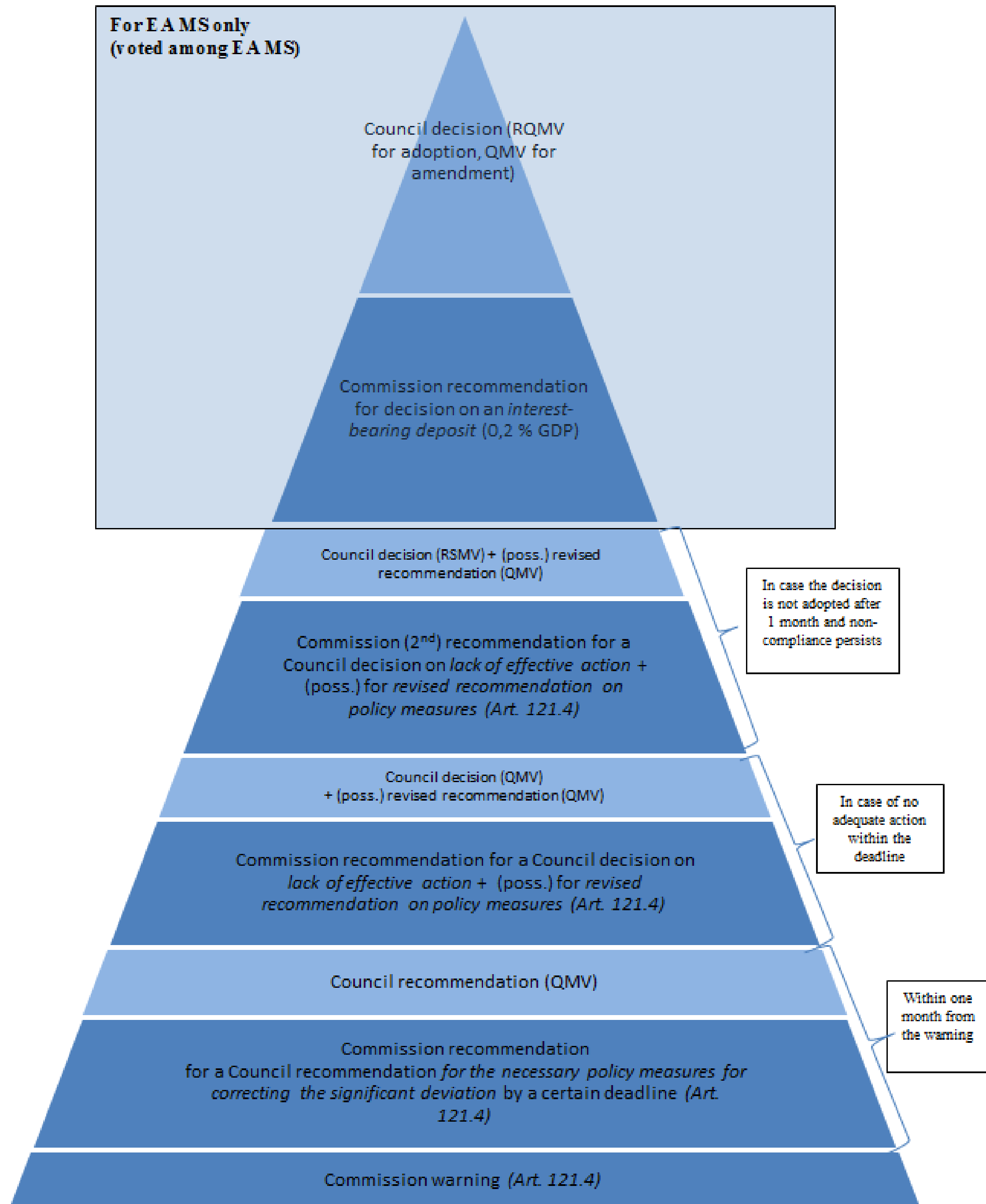
If the Council does not adopt the decision on no effective action and the lack of appropriate action by the Member State in question persists, the Commission will make a new recommendation for a Council decision on no effective action within one month of the previous one. This new recommendation will be subject to reverse simple majority voting in the Council, meaning that a majority of Member States must vote against its adoption in order for it not to be adopted. If there is no majority against the Commission recommendation, the Council decision is adopted. In all Council legal acts in the context of the significant deviation procedure, only euro area Member States vote on decisions concerning other euro participants, and the vote of the Member State concerned is not taken into account in any case. The Council submits a report to the European Council on all decisions taken.

The adoption of a Council decision on no effective action is the start of the sanctions procedure for euro area Member States. These sanctions are covered by Regulation (EU) 1173/2011 of the Parliament and the Council, which is based on Article 136 of the TFEU. Within 20 days from the adoption of a Council decision on no effective action, the Commission shall issue a recommendation for a new Council decision, requiring that the Member State in question lodge an interest-bearing deposit with the Commission. The deposit will equal 0.2% of the previous year's GDP. The Council will vote on the adoption of this decision with reverse qualified majority voting. Any such vote must occur within 10 days of the Commission's recommendation. In addition, the Council may also vote to amend the Commission's recommendation and adopt the amended text as a Council decision, by qualified majority voting.

While the default is for the deposit to equal 0.2% of GDP, the amount may be modulated. In order for this to occur, the Member State in question must issue a reasoned request to the Commission within 10 days of the Council decision on non-effective action. Following the receipt of this request, the Commission may recommend that the Council reduce the amount or cancel the interest-bearing deposit.

The interest-bearing deposit will bear a rate of interest which reflects the Commission's credit risk and the relevant investment period. It will be returned to the Member State with the interest accrued once the situation which led to a decision of non-effective action relative to the Council recommendations under Article 121(4) no longer exists. The Council decision to return the deposit and the accrued interest shall be taken on the basis of a Commission recommendation, although the Council may amend this Commission recommendation by qualified majority voting. In the case, however, where a country enters the Excessive Deficit Procedure having lodged an interest-bearing deposit, the default situation will be for this deposit to be turned into a non-interest-bearing deposit following the Council decision on the existence of an excessive deficit. Section 2.2.4 considers this in detail.

Graph 1.3: **Actions in the case of significant deviation from the adjustment path to the MTO**



2. THE CORRECTIVE ARM OF THE STABILITY AND GROWTH PACT

This Part focuses on the corrective arm of the Pact and is structured on the basis of the successive steps under the Excessive Deficit Procedure (EDP). Section 2.1 provides the background. Section 2.2 explains how an EDP is launched and Section 2.3 considers the actions to be taken after a Council recommendation to put an end to excessive deficit is issued. Section 2.4 explains the actions to be taken after a non-effective action following a Council EDP recommendation or decision to give notice, respectively. Section 2.5 explains how an EDP is abrogated.

2.1. LEGAL BASIS, RATIONALE AND PROCEDURAL STEPS

Compliance with the preventive arm of the Pact should ensure that countries are kept out of the corrective arm – also referred to as the Excessive Deficit Procedure (EDP) – under all except the most unusual of circumstances. Therefore the EDP ought not to be thought of as being part of the normal budgetary procedure in the Member States, but as being the end of the line where previous budgetary policy errors are rectified. This is in line with the notion of "gross errors" referred to in Article 126 TFEU.

The corrective arm of the Pact implements the steps set out under Article 126 TFEU and Protocol 12 on the Excessive Deficit Procedure. Its operation is set out in Council Regulation (EC) 1467/97 and its subsequent amendments, and details relating to its implementation are further specified in the Code of Conduct on the SGP.([77])

A peculiarity of the EDP is that the word “deficit” is used to refer both to a situation of excessive general government borrowing and to government debt that is greater than 60% of GDP and is not diminishing at a satisfactory pace. Where it is important to distinguish between the two concepts, the distinction is made explicitly in this manual. This occurs, for example, when defining how to judge a breach of the numerical limits set in the Treaty, which are given for both the general government deficit and general government gross debt. At other times though, where the procedure is the same whatever the cause of the breach, the word deficit is used to refer to both excesses of deficit and debt.

The corrective arm comprises the various steps that are taken when Member States' deficits or debt levels are judged to be excessive. In the case of the deficit, this corresponds to a value greater than 3% of GDP. In the case of the debt, it corresponds to a debt in excess of 60% of GDP and not sufficiently diminishing towards that level. In both cases, a breach of the numerical requirements does not necessarily lead to the Member State being placed in EDP, as other factors may be taken into account. Nevertheless, in case of breach of the deficit criterion, the presumption is that for countries with a debt-to-GDP ratio above 60% - unless the breach is small and temporary – which triggers the consideration of relevant factors see Section 2.2.2 – the Member State is placed in EDP to correct its budgetary excess.

The launch of an EDP brings with it Council recommendations for the Member State concerned to take action and correct its excessive deficit within a specific timeframe. The Commission and the Council regularly monitor the action taken by the Member State and conclude either that it is taking effective action or that the EDP is to be moved to the next stage, i.e. stepped up. Stepping up involves stricter requirements and possibly financial sanctions for euro area Member States, while the application of macroeconomic conditionality can also lead to a suspension of commitments or payments under the

([77]) http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf.

European Structural and Investment Funds for all Member States.([78]) The comprehensive sanctions toolbox and its functioning are described in greater detail in Section 2.4.

2.1.1. Legal basis of the corrective arm

The primary legal basis of the corrective arm of the SGP is Article 126 TFEU and Protocol 12 to the Treaty. Article 126 TFEU specifies that Member States shall avoid excessive deficits and defines budgetary discipline in terms of compliance with specific bounds for government deficit and debt levels (see Box 2.1).([79]) It sets out the steps to be taken when one or both of these conditions are not complied with. The actual reference values against which the deficit and debt criteria are based are defined in Protocol 12 (see Box 2.2).

Article 126 also includes the provision of sanctions under paragraph 126(11) for euro area Member States. Since the entry into force of the Six Pack, sanctions have become applicable much earlier in the EDP, with the first financial sanctions for euro area countries being possible from the decision launching the EDP. This is based on Article 136 TFEU which applies only to euro area Member States (see Box 1.2). Article 136 specifies that, to ensure the proper functioning of Economic and Monetary Union (EMU), the Council shall set out specific economic policy guidelines for the euro area and strengthen the coordination and surveillance of their budgetary discipline, in accordance with the relevant procedures described in Articles 121 (multilateral surveillance –preventive arm of the SGP) and 126 (the corrective arm of the SGP). Article 136 also serves as the legal basis for the Two Pack which introduces additional reporting requirements for euro area countries under EDP and arms the Commission with the possibility of issuing an autonomous recommendation to euro area Member States at risk of non-compliance with their EDP deadline.

([78]) All countries, except the United Kingdom, can be subject to a suspension of commitments or payments of the European Structural and Investment Funds under the macroeconomic conditionality provisions.
([79]) Protocol 15 on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland annexed to the TFEU states that the United Kingdom "shall endeavour to avoid an excessive deficit". As a result, the avoidance of excessive deficit and debt is not directly binding for the United Kingdom.

Box 2.1: **Article 126 of TFEU**

1. Member States shall avoid excessive government deficits.

2. The Commission shall monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors. In particular it shall examine compliance with budgetary discipline on the basis of the following two criteria:

(a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, 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;

(b) whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The reference values are specified in the Protocol on the excessive deficit procedure annexed to the Treaties.

3. If a Member State does not fulfil the requirements under one or both of these criteria, the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State.
The Commission may also prepare a report if, notwithstanding the fulfilment of the requirements under the criteria, it is of the opinion that there is a risk of an excessive deficit in a Member State.

4. The Economic and Financial Committee shall formulate an opinion on the report of the Commission.

5. If the Commission considers that an excessive deficit in a Member State exists or may occur, it shall address an opinion to the Member State concerned and shall inform the Council accordingly.

6. The Council shall, on a proposal from the Commission, and having considered any observations which the Member State concerned may wish to make, decide after an overall assessment whether an excessive deficit exists.

7. Where the Council decides, in accordance with paragraph 6, that an excessive deficit exists, it shall adopt, without undue delay, on a recommendation from the Commission, recommendations addressed to the Member State concerned with a view to bringing that situation to an end within a given period. Subject to the provisions of paragraph 8, these recommendations shall not be made public.

8. Where it establishes that there has been no effective action in response to its recommendations within the period laid down, the Council may make its recommendations public.

9. If a Member State persists in failing to put into practice the recommendations of the Council, the Council may decide to give notice to the Member State to take, within a specified time limit, measures for the deficit reduction which is judged necessary by the Council in order to remedy the situation.
In such a case, the Council may request the Member State concerned to submit reports in accordance with a specific timetable in order to examine the adjustment efforts of that Member State.

10. The rights to bring actions provided for in Articles 258 and 259 may not be exercised within the framework of paragraphs 1 to 9 of this Article.

11. As long as a Member State fails to comply with a decision taken in accordance with paragraph 9, the Council may decide to apply or, as the case may be, intensify one or more of the following measures:
— to require the Member State concerned to publish additional information, to be specified by the Council, before issuing bonds and securities,

(Continued on the next page)

Box (continued)

— to invite the European Investment Bank to reconsider its lending policy towards the Member State concerned,
— to require the Member State concerned to make a non-interest-bearing deposit of an appropriate size with the Union until the excessive deficit has, in the view of the Council, been corrected,
— to impose fines of an appropriate size.
The President of the Council shall inform the European Parliament of the decisions taken.

12. The Council shall abrogate some or all of its decisions or recommendations referred to in paragraphs 6 to 9 and 11 to the extent that the excessive deficit in the Member State concerned has, in the view of the Council, been corrected. If the Council has previously made public recommendations, it shall, as soon as the decision under paragraph 8 has been abrogated, make a public statement that an excessive deficit in the Member State concerned no longer exists.

13. When taking the decisions or recommendations referred to in paragraphs 8, 9, 11 and 12, the Council shall act on a recommendation from the Commission.
When the Council adopts the measures referred to in paragraphs 6 to 9, 11 and 12, it shall act without taking into account the vote of the member of the Council representing the Member State concerned.
A qualified majority of the other members of the Council shall be defined in accordance with Article 238(3)(a).

14. Further provisions relating to the implementation of the procedure described in this Article are set out in the Protocol on the excessive deficit procedure annexed to the Treaties.

The Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the European Central Bank, adopt the appropriate provisions which shall then replace the said Protocol.
Subject to the other provisions of this paragraph, the Council shall, on a proposal from the Commission and after consulting the European Parliament, lay down detailed rules and definitions for the application of the provisions of the said Protocol.

Box 2.2: Protocol 12 on the Excessive Deficit Procedure

THE HIGH CONTRACTING PARTIES,

DESIRING TO lay down the details of the excessive deficit procedure referred to in Article 126 of the Treaty on the Functioning of the European Union,

HAVE AGREED upon the following provisions, which shall be annexed to the Treaty on European Union and to the Treaty on the Functioning of the European Union:

Article 1
The reference values referred to in Article 126(2) of the Treaty on the Functioning of the European Union are:
— 3 % for the ratio of the planned or actual government deficit to gross domestic product at market prices;
— 60 % for the ratio of government debt to gross domestic product at market prices.

Article 2
In Article 126 of the said Treaty and in this Protocol:
— 'government' means general government, that is central government, regional or local government and social security funds, to the exclusion of commercial operations, as defined in the European System of Integrated Economic Accounts;
— 'deficit' means net borrowing as defined in the European System of Integrated Economic Accounts;
— 'investment' means gross fixed capital formation as defined in the European System of Integrated Economic Accounts;
— 'debt' means total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government as defined in the first indent.

Article 3
In order to ensure the effectiveness of the excessive deficit procedure, the governments of the Member States shall be responsible under this procedure for the deficits of general government as
defined in the first indent of Article 2. The Member States shall ensure that national procedures in the budgetary area enable them to meet their obligations in this area deriving from these Treaties. The Member States shall report their planned and actual deficits and the levels of their debt promptly and regularly to the Commission.

Article 4
The statistical data to be used for the application of this Protocol shall be provided by the Commission.

The actual implementation of the corrective arm of the Pact is governed by secondary legislation, based on Article 126(14) TFEU, in the form of Regulation (EC) 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, as amended by Regulation (EC) 1056/2005 of 27 June 2005 and Council Regulation (EU) 1177/2011 of 8 November 2011.([80])

In addition, Regulation (EU) 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area added a system of effective preventive and graduated enforcement mechanisms to the Pact. This Regulation complements the sanctions envisaged under Article 126(11) by an earlier and graduated system of sanctions on the basis of

([80]) Annex 1 contains links to all relevant legislation. The consolidated text is available under: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1467:20111213:EN:PDF.

Article 136 for euro area countries only. This is to ensure that sanctions are more effective by being applicable at a time when Member States are able to react. In fact, restricting them to Article 126(11) means that they would only be levied on Member States that would be, by definition, in a very difficult financial situation. All countries – except the United Kingdom – may also be subject to the suspension of commitments or payments under the European Structural and Investment Funds following a Council decision on a lack of effective action under the EDP.([81])

Together these two regulations set out the roles and procedures to be followed by the Member States, the Commission, the Council, the European Council and the European Parliament. As their application is intertwined, they are considered together in the present Vade mecum.

The Code of Conduct on the SGP foreseen under Regulation (EC) 1466/97 on the preventive arm has been complemented by specification on the implementation of the Excessive Deficit Procedure.([82])

Council Regulation (EC) 479/2009 of 25 May 2009 ([83]) on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community defines the statistical and reporting obligations on Member States, in terms of the data to be provided for the application of the EDP.

As described in Box 1.3, Member States which have adhered to the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) have committed themselves to voting through reverse qualified majority voting (RQMV – see Annex 7) on all votes concerning euro area Member States for deficit EDPs, and to presenting an economic partnership programme when subject to an EDP.([84])

In 2013 two Regulations based on Article 136 TFEU and applying only to the euro area entered into force. Although these Regulations – commonly referred to as the Two Pack –do not add to the SGP policy requirements, they bring about changes to the surveillance procedure. For this reason, a large part of their requirements has been incorporated seamlessly into the operation of the SGP.

Regulation (EU) 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability([85]) streamlines the requirements placed on financially fragile countries and embeds these provisions in the EU framework for policy co-ordination and surveillance, suspending the reporting requirements under the SGP for countries under a macroeconomic adjustment programme.

([81]) Regulation (EU) 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) 1083/2006:
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:347:0320:0469:EN:PDF
([82]) In addition, the Amsterdam European Council resolution on the SGP of 17 June 1997 and the Report of the Economic and Financial Affairs Council on "Improving the implementation of the Stability and Growth Pact", endorsed by the European Council in its conclusions of 22 March 2005, also form part of the corrective arm of the Pact, but do not introduce additional operational requirements.
([83]) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:145:0001:0009:EN:PDF
([84])The commitment to RQMV applies only to Contracting Parties whose currency is the euro. The commitment to present an economic and budgetary partnership programme applies also to DK, RO and BG.
([85]) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0001:0010:EN:PDF

Regulation (EU) 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit for the Member States of the euro area([86]) complements the surveillance cycle for all euro area countries and increases monitoring and reporting requirements for countries under EDP. As part of these, the Commission can request that countries under EDP be subject to closer monitoring, with the submission of regular reports all the way through their EDP.([87]) The Regulation also allows the Commission to issue an autonomous recommendation to Member States at risk of missing their deadline for correction (see Box 2.8). Moreover, with the launch of an EDP, euro area Member States must present an economic partnership programme (EPP), which sets out the fiscal structural reforms necessary to ensure an efficient and lasting correction of the excessive deficit.

The Code of Conduct on the Two Pack sets out the specifications on the implementation of the Two Pack and the guidelines on the format and content of draft budgetary plans, economic partnership programmes and debt issuance reports.([88])

2.1.2. Rationale behind the corrective arm of the SGP

The corrective arm of the SGP is centred on the Treaty requirement that Member States should avoid excessive deficit and debt levels. It implements a step by step EDP which is triggered by a general government deficit exceeding the 3% of GDP Treaty reference value, and/or a debt level above 60% of GDP and insufficiently diminishing towards that level.

Establishing a clear limit to a Member State's deficit and debt is necessary in a context of enhanced spillovers and interdependence between EU – especially euro area – countries, as emerged clearly in the recent crisis. The spillovers from unsound fiscal policy constrain monetary policy and render its role more difficult. High debt levels in some Member States may cause difficulties to other Member States especially in difficult times. Large deficits can have a destabilizing and inflationary impact especially in good economic times. By constraining the general government deficit to be at most 3% of GDP and requiring debt to sufficiently decrease towards 60% of GDP, the Treaty seeks to reduce such risks.

The limit on debt also stems from the fact that too high debt levels can have important adverse consequences. High public sector debt levels are in general associated with high interest payments in percentage of GDP, which could crowd out investments; moreover, high levels of debt impose constraints on the use of countercyclical fiscal policy in recessions and the ability to absorb the indebtedness of other sectors at times of stress, which could act as a drag on growth. Also, growing debt levels lead to higher interest payments not just because there is more debt, but also because growing debt also raises the risk of default and so governments face higher interest rates on the amount that they borrow. This can lead to the so-called snowball effect, where the effect of debt on interest rate drives debt levels up and these then drive interest rates higher resulting in a vicious spiral towards unsustainability.

The debt requirement was operationalized with the 2011 amendment of the SGP – commonly referred to as the Six Pack – through the so-called debt reduction benchmark. At that time, a number of Member States were already in EDP and, consequently, had their fiscal consolidation paths already defined. In order to ensure that these Member States have time to adapt their structural adjustments to comply with the new debt benchmark, a transition period of three years after the correction of their excessive deficit

([86]) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0011:0023:EN:PDF
([87]) The content and format of such reports is defined in Commission Delegated Regulation 877/2013 (see annex 13)
([88]) http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf

was introduced. During that period, these Member States have to make sufficient progress towards compliance with the debt benchmark rather than actually be compliant with the formula that applies outside the transition period (see Sections 2.2.1.2 and 2.2.1.3).

The operation of the corrective arm of the SGP is defined by a series of steps set out in Article 126 of TFEU, which are presented in more detail in the next subsections.

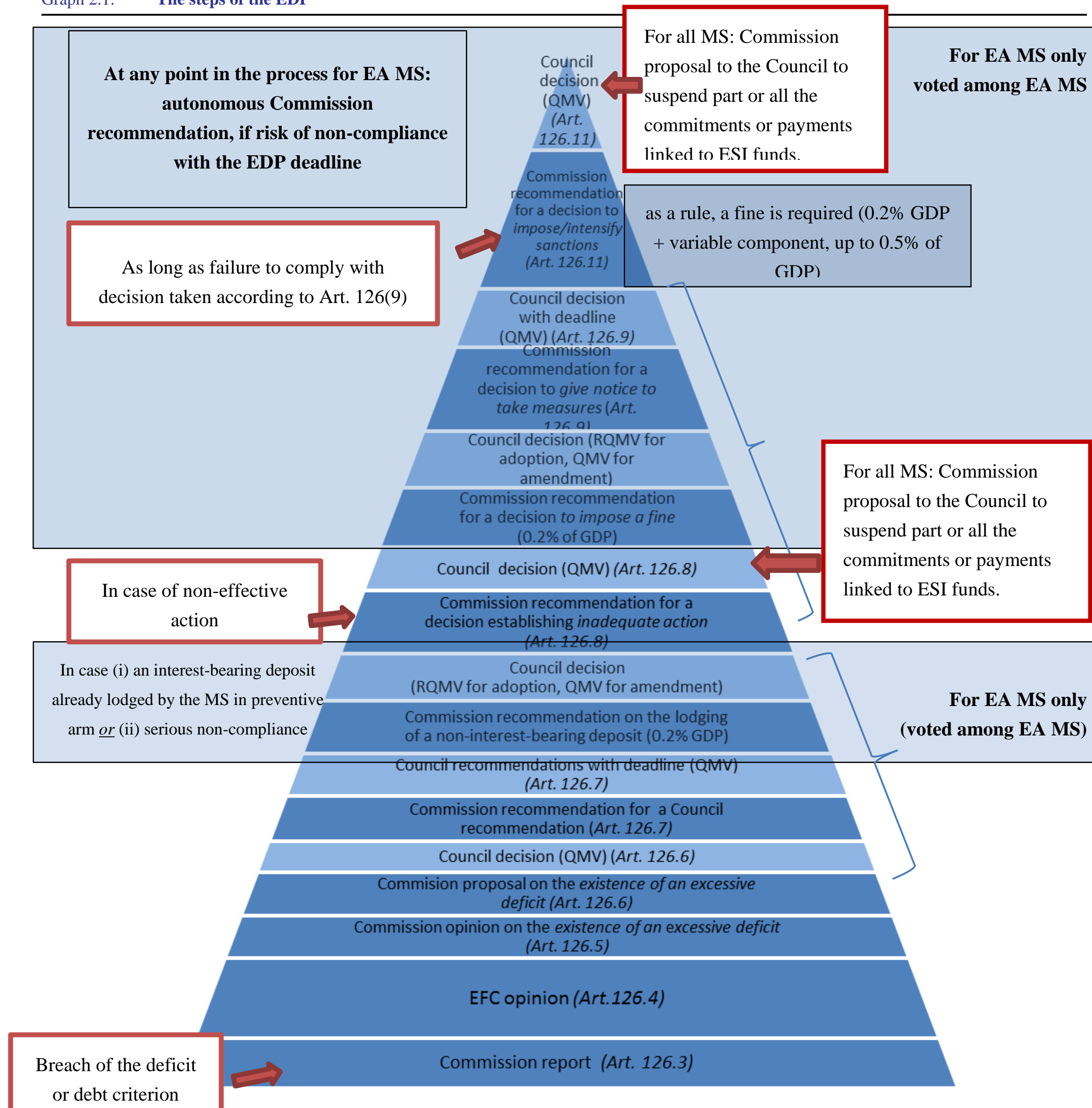
2.1.3. Overview of procedural steps under the corrective arm of the SGP

Following a breach of the deficit criterion, identified on the basis of outturns, plans or forecast data, or following a breach of the debt criterion, identified on the basis of outturn data, the Commission prepares a report according to Article 126(3) of the Treaty. In the report, the Commission assesses the case for launching an EDP, based on a consideration of all factors pertinent to such a decision. Then, Article 126(4) TFEU requires that the Economic and Financial Committee (EFC) formulates an opinion on the Commission report.

Following the Commission's report and the ensuing opinion from the Economic and Financial Committee, if the Commission considers that an excessive deficit exists or may occur, the Commission issues an opinion to the Member State concerned under Article 126(5); then, the Commission prepares a proposal for an Article 126(6) Council decision on the existence of an excessive deficit; and finally, the Commission prepares a so-called Article 126(7) recommendation to be adopted by the Council, which sets a time limit to correct the Member State's public finance imbalances and to be compliant with both the deficit and the debt requirements. The recommendation contains annual deficit targets both in nominal and in structural terms, which are linked by an underlying macroeconomic scenario set on the basis of the Commission forecasts. Moreover, a quantification of the policy response required to attain these targets, in terms of the total amount of measures to be taken, is also given.([89])

([89]) All the underlying data relevant to the definition of the EDP recommendation to bring an end to the situation of an excessive government deficit are publicly available through the Commission Staff Working Documents accompanying the recommendation.

Graph 2.1: **The steps of the EDP**



Note: EA: euro area, MS: Member States, QMV: qualified majority voting, RQMV: reverse qualified majority voting. Annex 7 sets out the voting modalities under the SGP in detail.

Following the Council decision under 126(6) and the adoption of the Article 126(7) recommendation, the Member State must show that it has taken action to address its excessive deficit within a deadline set in the recommendation. According to the Regulation this deadline should be within six months, or within three if the situation is judged to be particularly serious. For euro area Member States, the Commission may also recommend to set a sanction in the form of a non-interest bearing deposit if the Member State has already lodged an interest-bearing deposit under the preventive arm or in case of serious non-compliance with the budgetary policy obligations in the SGP.

The Commission undertakes a first assessment, which looks at whether the Member State is on track to correct its excessive deficit, i.e. if it has taken effective action, following the submission of the Member State's report on action taken. Depending on the outcome of this assessment, the procedure may be put/held in abeyance or stepped up. An EDP in abeyance is subject to continuous monitoring and may be activated again if this monitoring shows the Member State not to be on course to comply with the recommendation. With the Two Pack, for euro area Member States, the continuous monitoring is based – on a request by the Commission – on regular reports submitted by the country every six months. At any point in the EDP process euro area Member States may be issued an autonomous recommendation by the Commission if the latter perceives a risk of non-compliance with the deadline to correct the excessive deficit. Conversely, as long as a Member State is judged as having taken effective action, it may be issued with revised recommendations, including the possibility of extending the deadline for correction, if unexpected adverse economic events with a major impact on public finances impede its ability to correct its excessive deficit by the deadline initially recommended despite its action.

The stepping up of the EDP involves a Council decision following a Commission recommendation under Article 126(8) that effective action has not been taken. For euro area Member States, this is the next trigger for the imposition of sanctions in the form of a fine corresponding to 0.2% of GDP in the preceding year as a rule. Following a Council decision that effective action has not been taken, the Commission shall propose to suspend part or all of the commitments under the European Structural and Investment Funds (applicable to all countries except the United Kingdom). In the case where immediate action is sought, or where there has been significant non-compliance, the Commission may instead propose a suspension of part or all of the payments rather than commitments.([90])

Euro area Member States whose EDP has been stepped up are issued by the Council with a notice under Article 126(9). The notice mirrors the Article 126(7) recommendation in that it includes a time limit for correcting the excessive deficit as well as annual nominal and structural balance targets, which are linked by an underlying macroeconomic scenario. In addition, the notice also contains a series of measures – and the corresponding timetable for their implementation – that are conducive to the achievement of the nominal and structural targets. Non-euro area Member States are issued with revised Article 126(7) recommendations following an Article 126(8) decision that effective action has not been taken.

Following a notice under Article 126(9) or a revised Article 126(7) recommendation, an assessment of whether a Member State is on track to correct its excessive deficit, i.e. if it has taken effective action, can again lead to either maintaining/putting the procedure in abeyance or to a decision on a lack of effective action. With the Two Pack, the regularity of the reports to be submitted by euro area Member States increases to every three months when subject to a notice under Article 126(9). The possibility of revising the notice or the recommendation and extending the deadline also remains, as long as the Member State is found to have taken effective action, but has faced unexpected adverse economic circumstances with a major impact on its public finances.

Where the Commission concludes that effective action has not been taken to comply with the requirements of an Article 126(9) notice, the procedure is stepped up to Article 126(11) for euro area Member States with a Council decision to intensify sanctions. For as long as the Member State continues not to comply with its notice under Article 126(9) it can face an annual fine equal to 0.2% of its GDP in the preceding year plus a variable component determined by the magnitude of its excessive deficit, up to a maximum of 0.5% of GDP. For non-euro area Member States, a repeat of steps 126(8) followed by a new recommendation under Article 126(7) is undertaken for as long as the Member State is not on track to correct its excessive deficit and has not taken effective action. For all countries except the United Kingdom, each decision on a lack of effective action should be accompanied by a Commission proposal

([90]) For more details on the conditions for macroeconomic conditionality, see Box 2.9.

to either suspend (or increase the size of the suspension) of commitments under the European Structural and Investment Funds or suspend (or increase the size of the suspension) of payments.

The EDP is abrogated when the excessive deficit is corrected in a durable manner (according to the no-policy change Commission forecast) and the correction is confirmed by outturn data. In all cases, abrogation requires a correction of the deficit that is lasting and compliance with the debt rule on a forward-looking basis. The abrogation requires a Council decision under Article 126(12) TFEU adopted by a qualified majority vote in Council, based on a Commission recommendation.

The Commission forecasts (and the no-policy change assumption used therein – see Box 1.5) play an important role at the various stages of the EDP. At the opening of the EDP the deficit is regarded as "temporary" if it moves back below the Treaty reference value following the end of the unusual event or the severe economic downturn according to the Commission forecast (Regulation 1467/97). The forward-looking part of the debt benchmark (Section 2.2.1.2) also relies on the Commission forecast (same text). The no-policy change assumption also plays a role in the formulation of EDP recommendations (Section 2.2.3). In particular, fiscal efforts in the recommendations need to be formulated such that, on a no-policy change basis, the forward-looking part of the debt rule would be complied with by the EDP deadline. The no-policy change assumption is also instrumental for the assessment of compliance with the EDP recommendation. In the assessment of effective action (Section 2.3.2.1), the "careful analysis" builds on the 'top-down' and 'bottom-up' measures of fiscal effort. The 'top-down' approach refers to the change in the structural balance corrected for the differences in growth and revenue outturns with respect to the no-policy change scenario at the time of the recommendation. The 'bottom-up' measure of fiscal effort, i.e. the budgetary impact of the fiscal consolidation measures implemented, is estimated on the expenditure side by comparison between expenditure outturns and the no-policy change scenario. Similar considerations apply to the EDP abrogation (Section 2.5). The relevant text here is the Code of Conduct, where it is explicit that the assessment of sustainability of the correction has to be performed based on the Commission forecast. This holds for both the deficit and for the forward-looking debt criterion.

2.2. LAUNCHING AN EXCESSIVE DEFICIT PROCEDURE

An EDP is launched by a Council decision based on a Commission proposal on the existence of an excessive deficit. The Commission proposal is based on a Commission report under Article 126(3) of the Treaty which assesses the case for the launch of an EDP. The production of the report is itself triggered by a breach of the numerical deficit and debt criteria in the Treaty.

Section 2.2.1 sets out the conditions for the deficit and debt triggering the production of an Article 126(3) report, the content of which is described in Section 2.2.2. Then, Section 2.2.3 zooms in on the content of Article 126(7) recommendations and Article 126(9) notices, while Section 2.2.4 describes the preparation of a recommendation for a non-interest bearing deposit following a Council decision that an excessive deficit exists.

2.2.1. Establishing the existence of an excessive deficit or debt

The start of an EDP is the identification by the Commission of a breach of either the deficit or debt criterion in a Member State. The breach in itself is just the first step; it triggers the production of a report under Article 126(3), which considers in detail a series of factors and assesses the case for launching an EDP.

The breach of the deficit criterion may be identified on the basis of outturns, plans or forecast data. The preparation of an Article 126(3) report on the basis of forecast data can be based on either the Member State's plans – as outlined in their SCPs, DBPs, or in other announcements made by the government – or the Commission forecasts. A planned breach of the debt criterion needs to be confirmed by outturn data in order to trigger the opening of an EDP.([91])

Although a breach of either the deficit or the debt criteria is sufficient to lead to the preparation of an Article 126(3) report, in some cases a Member State will be found to be in breach of both. In these cases, the Article 126(3) report will consider both criteria and an EDP may be launched on the basis of both criteria.([92])

It should be noted that special transitional arrangements apply to the debt rule for Member States that were in EDP in November 2011, when the latest amendments of the SGP – commonly known as the Six Pack – were adopted. Member States in this situation need to show compliance with the debt benchmark according to the special transition arrangements for the three years after the correction of their excessive deficit.([93]) This is covered in Section 2.2.1.3, below.

2.2.1.1 Establishing non-compliance with the deficit criterion

A Member State is non-compliant with the deficit requirement if its general government deficit is greater than 3% of GDP. No other considerations are taken into account before producing an Article 126(3) report on the basis of the deficit criterion. Indeed, the Commission has committed itself([94]) to prepare a report whenever there is the risk of an excessive deficit or whenever the planned or actual government deficit exceeds the reference value of 3% of GDP.

2.2.1.2 Establishing non-compliance with the debt criterion

A Member State is non-compliant with the debt requirement if its general government debt is greater than 60% of GDP and is not sufficiently diminishing and approaching 60% of GDP at a satisfactory pace. The concept of "sufficiently diminishing" and the "satisfactory pace" are defined in Regulation (EC) 1467/97 as being fulfilled if "*the differential [of the debt ratio] with respect to the reference value has decreased over the previous three years at an average rate of 1/20th per year as a benchmark*". The Regulation then specifies that "*the requirement under the debt criterion shall also be considered to be fulfilled if the budgetary forecasts of the Commission indicate that the required reduction in the differential will occur over the three-year period encompassing the two years following the final year for which data is available*". It further specifies that "*the influence of the cycle on the pace of debt reduction*" should be taken into account. These elements are translated into a debt reduction benchmark which has been agreed

([91]) Differently from the deficit criterion, there is no notion of planned breach of the debt criterion in the Treaty (Art. 126.2 and Art. 126.7).
([92]) This is the case, for example, of the EDP launched in June 2013 for Malta: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/2013-05-21_mt_126-3_en.pdf ; and in January 2014 for Croatia: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/2013-11-15_hr_126-3_en.pdf
([93]) Cyprus, Portugal, Slovenia, France, Ireland, Greece, Spain and the United Kingdom will enter the transition period when their EDPs are abrogated. Austria, Belgium, and the Netherlands are currently in their transition periods.
([94]) Resolution of the European Council on the Stability and Growth Pact Amsterdam, 17 June 1997: EUR-Lex - 31997Y0802(01) - EN - EUR-Lex

with the Member States in the Economic and Financial Committee of the Council and is set out in the Code of Conduct on the SGP.

When a Member State's debt exceeds 60% of GDP, compliance with the debt criterion should be examined. A breach of the 60% threshold from below automatically triggers the production of an Article 126(3) report, unless the debt-to-GDP ratio goes below the threshold reference value within the Commission forecast horizon.([95]) In all other cases, a breach of the debt criterion is judged by considering the debt reduction benchmark in three configurations: the backward looking version, by taking into account the impact of the cycle and the forward-looking version. The backward and forward looking benchmarks are computed over a three-year horizon to avoid treating debt peaks as normal factors, hence, catering for the volatility that would imply a one-year rule. Moreover, the length and depth of economic cycles are asymmetric and unknown and cannot, of course, be guaranteed to fit into a six year time period. This means that meeting the debt reference benchmark on either the backward or forward looking measures might at time require large fiscal efforts in bad times. As this is undesirable in itself, the debt reduction benchmark is also adjusted for the effect of the cycle. Only if a country is in breach of all these conditions, the Commission has the obligation to write an Article 126(3) report.([96]) More specifically, a breach of the debt criterion is judged according to the steps set out in Graph 2.2, namely:

1) The government debt ratio is above the reference value of 60% of GDP

and

2) The debt is too high on the backward-looking measures:

$$b_t > bb_t = 60\% + 0.95/3\ (b_{t-1} - 60\%) + 0.95^2/3\ (b_{t-2} - 60\%) + 0.95^3/3\ (b_{t-3} - 60\%)$$

where b_t equals the debt ratio in year t and bb_t is the backward-looking benchmark debt ratio in year t. If the Member States is being considered for an EDP on the basis of its outturn data, the year t applies to the year which has just ended.

and

3) (a) The debt is forecast to be too high on the forward-looking measures

$$b_{t+2} > bb_{t+2} = 60\% + 0.95/3\ (b_{t+1} - 60\%) + 0.95^2/3\ (b_t - 60\%) + 0.95^3/3\ (b_{t-1} - 60\%)$$

where bb_{t+2} stands for the forward-looking benchmark debt ratio; b_{t+1} and b_{t+2} stand for the debt forecast in year t+1 and t+2 as estimated by the Commission under the 'no-policy-change' assumption (see Box 1.5) on the basis of the fiscal outcome of year t. If the Member State is being considered for an EDP on the basis of its outturn data, the year t in the formula applies to the year that has just ended.

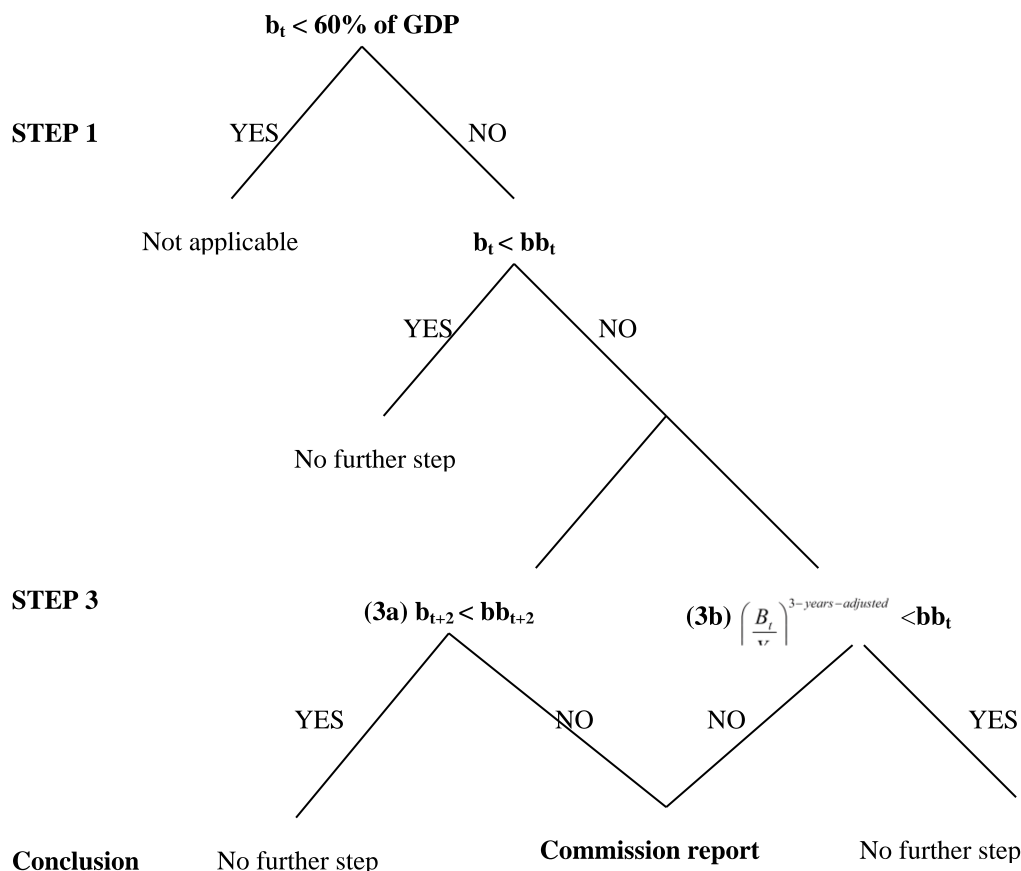
and

(b) the breach of the benchmark cannot be attributed to the influence of the cycle. The methodology for correcting for the cycle is described below.

([95]) This to ensure consistency of treatment with countries having debt-to-GDP ratio above 60% and meeting the forward-looking debt benchmark.

[96] As explained in Section 2.2.2.3, as long as the Commission considers that the Member State's situation has not changed since the last Article 126(3) report, it is not bound to produce another report.

Graph 2.2: **The steps to assess compliance with the debt criterion**



The steps set out in Graph 2.2 do not apply when there is a breach of the 60% threshold from below, as neither the backward- nor the forward-looking benchmark can be meaningfully computed in case a Member State goes above the 60% threshold for the first time in year t. In such a case, the identified breach of the debt criterion automatically triggers the production of an Article 126(3) report,([97]) in which due consideration is given to all the relevant factors (Section 2.2.2.2).

The correction of the cycle

The cyclical correction that forms part of the third step of the assessment aims to ensure that a Member State will not be subject to an EDP if the debt benchmark is not fulfilled purely as a direct consequence of the impact of the cycle. The actual debt ratio will be adjusted and then compared to the debt benchmark (step 3b of the decision tree above), to see whether an Article 126(3) report should be prepared.

Adjusting the debt for the cycle consists of a correction of both the numerator and the denominator of the debt-to-GDP ratio. To this end, the following cyclical adjustment of the debt ratio should be undertaken:

([97]) Unless the debt-to-GDP ratio goes below the threshold reference value within the Commission forecast horizon.

$$\left(\frac{B_t}{Y_t}\right)^{3-years-adjusted} = \left(\frac{B_t + \sum_{j=0}^{2}\left(C_{t-j}\right)}{Y_{t-3}\prod_{h=0}^{2}(1+y_{t-h}^{pot})(1+p_{t-h})}\right)$$

where B_t stands for debt, Y_t for GDP at current prices, y_t^{pot} for potential growth, p_t for the price deflator of GDP, C_t for the cyclical component of the budget balance. The cyclical components and potential growth are calculated according to agreed methodologies. ([98])

This methodology therefore:

- corrects the debt level for the cyclical component of the deficit over the past three years. This adjustment implies that if the output gap is positive, the adjusted debt level will be larger than the observed debt and vice versa; and

- corrects the GDP level for the output gap over the past three years, so that the corrected level of GDP in time *t* represents the level that GDP would have reached if it had evolved according to its potential from year *t*–3 on. The growth rate of the price deflator of GDP is used to convert real growth into nominal growth.

2.2.1.3 Establishing non-compliance with the debt criterion in the transition period

Member States that were in EDP on the date that the Six Pack amendments to the SGP were adopted (8 November 2011) are subject to transitional arrangements for the three years following the correction of their excessive deficit([99]) in order to ensure that they have time to adapt their structural adjustments to the level needed to comply with the debt reduction benchmark. During those three years, compliance with the debt criterion is judged according to whether the Member State makes sufficient progress towards compliance. Thus, the debt requirement still applies during the transition period as the Member States concerned need to be moving towards compliance during this period.

The concept of "sufficient progress towards compliance" is set out in the Code of Conduct on the SGP. It is defined as the Minimum Linear Structural Adjustment (MLSA) ensuring that – if followed – Member States will comply with the debt rule at the end of the transition period. This minimum linear structural adjustment path is constructed (see Annex 6) taking into account both the influence of the cycle and the forward-looking nature of the debt benchmark. In order to ensure continuous and realistic progress towards compliance during the transition period, Member States should simultaneously respect the two conditions below:

([98]) Following the ECOFIN Council meetings of July 2002/May 2004, the production function (PF) approach for the estimation of output gaps now constitutes the reference method. Cfr. footnote 30.
([99]) The transition period does not begin on the date of the abrogation of the existing EDP, but with the correction of the deficit, which will typically take place in the year before the EDP is actually abrogated since abrogation can only take place based on actual data.

- First, the annual structural adjustment should not deviate by more than ¼ % of GDP from the linear structural adjustment ensuring that the least stringent condition consistent with the respect of the debt benchmark is met by the end of the transition period (minimum linear structural adjustment);

- Second, at any time during the transition period, the remaining annual structural adjustment should not exceed ¾ % of GDP.([100])

These conditions should ensure that the path of deficit reduction chosen by the Member State is sustained over the three years of the transitional period (first condition) and realistic (second condition), while providing some room for manoeuvre during the transition period.

Whereas compliance is judged ex ante and ex post, only an observed breach of the MLSA can lead to the opening of a debt-based EDP. An ex ante assessment of compliance with the MLSA is undertaken both on the basis of the plans submitted in the SCPs, which feeds the Council-Specific Recommendations concluding the European Semester, and every autumn for euro area Member States on the basis of the Draft Budgetary Plans (DBPs) in the associated Commission Opinion. The process is the following:

- Year 1: First year of the transition period

Ex ante assessment: the consolidation path set out in the SCP in April, and in the DBP for euro area Member States in October, is compared in years 1, 2 and 3 to the minimum linear consolidation path consistent with sufficient progress towards compliance, as defined by the conditions 1) and 2) mentioned above.

Ex post assessment: based on fiscal notification for year 1 and the revised macroeconomic scenario, i.e. the latest Commission forecast, a report based under Article 126(3) will be prepared if one of the two conditions has been breached.

- Year 2: Second year of the transition period

Ex ante assessment: on the basis of the updated SCP in April of year 2, and on the DBP for euro area Member States in October, the consolidation path is compared in years 2 and 3 to the new minimum linear structural adjustment ensuring sufficient progress towards compliance as defined above, including the deficit and debt outcome of year 1 and the revised macroeconomic scenario, i.e. the latest Commission forecast.

Ex post assessment: based on fiscal notification for year 2 and the revised macroeconomic scenario, if one of the two conditions has been breached, a report based under Article 126(3) will be prepared.

- Year 3: Third (and last) year of the transition period

Ex ante assessment: on the basis of the updated SCP in April of year 3, and on the DBP for euro area Member States in October, the projected changes in the structural balance are compared to the new minimum linear structural adjustment which, by construction, is equivalent to assessing compliance with the debt reduction benchmark by the end of the transition period.

Ex post assessment: based on fiscal notification for year 3, if the minimum linear structural adjustment which, by construction, is equivalent to assessing compliance with the debt reduction benchmark by the end of the transition period, has not been respected, a report based under Article 126(3) will be prepared.

([100]) This condition does not apply in case the first condition implies an annual effort above ¾ % of GDP.

Hence, a negative assessment of the observed progress made towards compliance with the debt benchmark during the transition period leads to the preparation of a Commission report, based on Article 126(3).

2.2.2. Preparing an Article 126(3) report

The Article 126(3) report presents an assessment of the case for launching an EDP for a Member State on the basis of its deficit and/or debt position. The report is submitted to the Economic and Financial Committee which has 2 weeks following its adoption by the Commission to formulate an opinion under Article 126(4).

2.2.2.1 Assessing the breach of the deficit criterion in the Article 126(3) report

The deficit criterion is considered in detail in the Article 126(3) report in the case of a reported or planned deficit of above 3% of GDP. The Treaty – and by extension the SGP – provides two exception clauses with regard to the opening of an excessive deficit procedure on the basis of the deficit criterion. Member States are deemed to have complied with their deficit commitment if at least one of the two following conditions is met:

- the deficit has declined substantially and continuously and has reached a level close to 3% of GDP;
- the excess is only exceptional and temporary, and the deficit value is still close to 3% of GDP.

A deficit above 3% of GDP is considered exceptional when it results either (i) from an unusual event outside of the Member State's control and with a major impact on its public finances, or (ii) from a severe economic downturn. A severe economic downturn is defined([101]) as a negative real growth of GDP or as an accumulated loss of output during a protracted period of very low real growth of GDP relative to its potential. The excess over 3% is considered temporary if the Commission forecasts indicate that the deficit will fall below 3% following the end of the unusual event or the severe economic downturn.

The report presents an overall assessment of the deficit situation and the context in which it occurred. Article 126(3) specifies: “The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State.”

According to Regulation 1467/97 the relevant factors will be taken into account in the following way:

- For a Member State with debt below 60% of GDP: the relevant factors are considered in the overall assessment, whatever the level of the deficit.
- For a Member State with debt above 60% of GDP: the relevant factors are only considered if the deficit remains close to the reference value and its excess over the reference value is temporary.

Regulation 1467/97 gives further details on the relevant factors to be taken into account, presenting a list that falls under three headings: developments in the medium-term economic position, developments in the

([101]) Article 2(2) of Regulation 1467/97.

medium-term budgetary positions and developments in the medium-term government debt position. However, the regulation states that this list is not exhaustive and that “The Commission shall give due and express consideration to any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess compliance with deficit and debt criteria and which the Member State has put forward to the Council and the Commission. In that context, particular consideration shall be given to financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between Member States in the context of safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances” (see Box 2.3). The Regulation also includes as relevant factors “the implementation of policies in the context of the prevention and correction of excessive macroeconomic imbalances, the implementation of policies in the context of the common growth strategy of the Union”. Therefore, the Commission Communication on *Making the best use of flexibility within the existing rules of the Stability and Growth Pact*([102]) clarifies that Member States' contributions to the European Fund for Strategic Investments (EFSI)([103]) and the implementation of structural reforms (e.g. in the context of the European Semester, as well as within the Excessive Imbalances Procedure) fall under these categories and should be considered as relevant factors. Finally, Regulation 473/2013 of the Two Pack requires that the extent to which the Member State has taken into account the Commission's Opinion on the its Draft Budgetary Plan should also be considered as a relevant (mitigating or aggravating) factor.

Box 2.3: **THE TREATMENT OF FINANCIAL SUPPORT IN DETERMINING THE EXISTENCE OF AN EXCESSIVE DEFICIT**

Art. 2(3) of Regulation 1467/97 stipulates that in the context of an Article 126(3) report *"[...] particular consideration shall be given to financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between Member States in the context of safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances".*

On 26 November 2011, the Commission confirmed to the Eurogroup that financial support to other EU Member States would be subject to special treatment when assessing the public finances of creditor Member States in the context of the EDP.

In order to avoid that assistance provided to other EU Member States in the context of a coordinated, EU-wide policy, should result in a country being placed in EDP, debt-increasing operations are taken into account in the Article 126(3) report when considering a possible breach of the debt criterion. This is the case both for an apparent breach of the debt reduction benchmark, or the 'sufficient progress' benchmark towards it (applicable during the three-year transition period following the correction of the excessive deficit for the procedures under way at the time of the adoption of the Six Pack reform of the SGP). A Member State should therefore not be placed in EDP for breach of the debt criterion, including in the transitory period, if such breach would not have been registered in the absence of the solidarity operations.

When assessing 'sufficient progress towards compliance' through the Minimum Linear Structural Adjustment (MLSA) during the transition period, both the debt and the deficit figures are netted out from

([102]) COM(2015) 12: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/2015-01-13_communication_sgp_flexibility_guidelines_en.pdf
([103]) As reflected also in the "Commonly agreed position on flexibility within the SGP", endorsed by the ECOFIN Council on 12 February 2016. http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf

debt- and deficit-increasing operations, respectively. The same applies to the computation of the debt benchmarks (backward- and forward-looking), which are used to calculate the required annual MLSA.

The operations taken into account under the debt criterion are the bilateral loans to Greece under the Greek loan facility (GLF), EFSF disbursements, the impact of the paid-in capital under the ESM and the measures during the second financial assistance programme for Greece which have a budgetary impact on lenders through the reduction of future expected income. These measures are the reduction of the GLF margin and interest rates, the transfer to Greece's segregated account of the income equivalent to the Securities Market Programmes (SMP) profits and the cancelation of the EFSF guarantee fee. Payments made under the EFSM are not taken into account as the lending is not re-routed to EU Member States and therefore does not affect their debt.

Operations in the context of the Greek programme, with an impact on the deficit of the supporting Member States (reduction of GLF margin and interest rates, distribution of SMP profits, etc.), are also subject to special consideration. In order to avoid that they should lead to a Member State being placed in EDP on the basis of the deficit criterion, these operations are regarded as one-off and temporary measures, in line with the practice followed for other support operations in the context of the financial crisis, and as such netted out of the structural balance.

In the same vein, on 9 October 2013 Vice President Rehn clarified in a letter to finance ministers the treatment of recapitalisation of the banking sector under the EDP, namely that they are regarded as one-off or temporary measures and as relevant factors for financial stability, which means that they do not count against the Member State in the context of the excessive deficit procedure.

The treatment of capital injections requiring recourse to public backstops can be summarised as follows.

For a Member State in which the capital injection would lead to an apparent breach of the debt or deficit criterion of the Pact, financial stabilisation operations in the above context would be taken into account as a relevant factor in the Commission's assessment of compliance with the criteria, and thus an EDP would normally not be opened. Member States with debt above 60% of GDP however would be an exception and an EDP would be opened, unless the amount of capital transfers is limited, so that it allows them to keep the nominal deficit close to the 3% reference value, and temporary. The EDP recommendation in such a case would consider that such operations are usually of a one-off nature.

For a Member State that is already in EDP, a capital injection would not lead to a stepping-up of the procedure - provided that the recommended fiscal effort had been delivered- , as one-off and temporary measures are netted out of the fiscal effort recommended to correct the excessive deficit by the deadline.

For the abrogation of the EDP, the deficit has to be brought below 3% of GDP in a sustainable manner. A capital injection could thus lead to a delay in abrogating the procedure.

In addition, for countries whose deficit does not significantly exceed a level that can be considered close to the 3% of GDP reference value and whose debt ratio does not exceed the 60% of GDP reference value, special consideration should be given to pension reforms, on condition that overall fiscal sustainability is maintained. The pension reforms that are eligible for consideration are those introducing a multi-pillar system that includes a mandatory, fully funded pillar and publicly managed pillar with an associated cost to the public finances. Special consideration should be given to the features of the overall pension system created by the reform, namely whether it promotes long-term sustainability while not increasing risks for the medium-term budgetary position. In order to take the impact of any reforms into account, the net cost

of the reform is measured as its direct impact on the general government deficit.([104]) This impact stems from the fact that some revenue, which used to be recorded as government revenue, is diverted to a fully-funded pension fund classified in a sector other than general government. Moreover, some pensions and other social benefits, previously accounted for as government expenditure, will be paid by the pension scheme once the reform has been implemented. Thus, net costs do not include interest expenditure linked to the higher accumulation of debt due to forgone social contributions or other revenues. This consideration should be part of a broader assessment of the overall features of the pension system created by the reform, namely whether it promotes long-term sustainability while not increasing risks for the medium-term budgetary position. In this way, countries that reform their pensions systems in a way that improves the long-term sustainability of their public finances but introduces short and medium-term costs, are able to deviate slightly from the 3% of GDP limit without being placed in excessive deficit. Box 2.4 explains in detail how pension reforms are to be taken into account in the corrective arm of the Pact.

Box 2.4: RULES IN THE 2011 REFORM OF THE SGP FOR SYSTEMIC PENSION REFORMS

Systemic pension reforms have a special treatment in the fiscal rules. These structural reforms shift the responsibility of old-age insurance toward the private sector by setting up a mandatory fully funded pillar. The budgetary costs of such reforms can be large due to the fact that the government must redirect part of its revenue from social security contributions to the private pillar in exchange for lower pension expenditure in the (possibly distant) future.

The 2005 reform of the Pact included provisions for the impact of pension reforms to be considered in the Maastricht deficit criterion in the form of a gradually decreasing 5 year allowance for deviating from the deficit threshold. These provisions were changed by the 2011 reform of the SGP.

The Six Pack acknowledges the fact that the budgetary implications of systemic pension reforms can be drawn out over a longer period while taking better account of the government's capacity to absorb higher deficits over this protracted period. Hence, the revised rules make the allowance for maintaining a higher deficit permanent, provided that the government debt-to-GDP ratio remains below 60% of GDP and that deficit does not significantly exceed what can be considered to be close to the 3% of GDP reference value. The table below shows the various elements of these rules in detail.

([104]) As defined in Article 1 of Regulation (EU) 479/2009 amended by Commission Regulation (EU) 220/2014 of 7 March 2014.

Criteria for taking into account systemic pension reforms in the context of the EDP

		when launching EDP	when abrogating EDP
		net costs of systemic pension reforms	net costs of systemic pension reform
former rules	government debt	No restriction	No restriction
former rules	government deficit	Remains close to the reference value The excess is explained by reform costs	Has declined substantially and continuously Has come close to the reference value
former rules	other criteria	Degressive scale	Degressive scale
new rules	government debt	Less than 60% of GDP	Less than 60% of GDP
new rules	government deficit	Does not significantly exceed what can be considered close to the reference value Excess is explained by reform costs	Has declined substantially and continuously Has come close to the reference value
new rules	other criteria	Fiscal sustainability is maintained	

For ongoing excessive deficit procedures the new rules imply that an EDP may be abrogated even if the government deficit is above the 3% of GDP threshold only if its debt-to-GDP ratio is below 60% of GDP, the net costs of a systemic pension reform explain the excess in the deficit while staying close to the reference value. In addition to the above, the general rules for abrogation (detailed in Section 2.5) apply, i.e. the government deficit is reduced to below the reference value in a durable manner and the forward looking element of the debt benchmark is met.

Furthermore, the net costs of the systemic pension reform must be determined. Regulation (EC) 1467/97 is not explicit in what constitutes the net cost of such a reform, only referring to the 'net costs of the publicly managed pillar'. The Code of Conduct on the SGP defines these costs as direct costs stemming from the fact that some of the government's revenues has to be directed to the private pension pillar (adding to the costs of the reform), whereas some of the pension payments are, in fact, carried out by the private scheme instead of the public pillar (reduce the costs of the reform). Any lump-sum payments linked to the systemic pension reform should also be factored in the calculation of 'net costs'. Such a lump-sum payment might take place if the new mandatory, funded pension scheme does not only allow for the acquisition of new pension rights but also enables the government to transfer some of the rights already accumulated (in the public pillar) to the new scheme.

The government might encounter additional indirect costs if it uses government bonds to finance its increased deficits following the reform. However, these costs being indirect, the increase in the government's interest expenditure is not counted towards the direct net costs of implementing a multi-pillar pension system.

2.2.2.2 Assessing the breach of the debt criterion in the Article 126(3) report

The same factors that may be taken into account for the opening of a deficit-based EDP, are also borne in mind in the overall assessment for a country in breach of the debt requirements. In particular, adherence to the MTO, or the adjustment path towards it, is a relevant factor in assessing compliance with the debt criterion, as it is supposed, under normal macroeconomic circumstances, to ensure sustainability or rapid progress to sustainability in the medium term. In turn this factor needs to be evaluated in conjunction with an assessment of the overall economic environment (while considering that the debt reduction benchmark in itself already contains a correction for the impact of the cycle([105])), and other relevant factors, including implementation of structural reforms improving the sustainability of public finances, i.e. implying a downward shift in the path of the debt ratio at least in the medium term. Also the expected timeline for complying with the debt rule, under the assumption of a return to normal economic conditions, notably inflation, can provide a useful gauge when taking into account the relevant factors. Since the entry into force of the Two-Pack, the extent to which the Member State has taken into account the Commission's Opinion on its Draft Budgetary Plan (see Section 3.1.1.3) is also a relevant factor to be considered (Art. 12(1) of Reg. 473/2013).

Member States can also put forward other relevant factors deemed significant. The Commission then judges if the factor put forward by the Member State is encompassed by the definition given in Regulation 1467/97 and assesses whether it can be taken into account.

In the case of the debt, the relevant factors are taken into account in all cases, whatever the magnitude of the breach. Pension reforms are considered along with the other relevant factors, but the detailed treatment for systemic pension reforms as set out in Section 2.2.2.1 is not applicable. 'Stock-flow adjustments' (SFAs), which are all the changes in debt unexplained by the deficits/surpluses – including changes in the stock of financial assets such as the depletion of cash reserves –, are also explicitly considered as 'relevant factors' in Regulation (EC) 1467/97. Table 2.1 presents the components of the stock-flow adjustments.

([105]) For a country breaching the 60% reference value from below, the current practice is to consider the cyclically-adjusted debt-to-GDP ratio in the context of the relevant factors, as in this case the sole identification of the breach of the debt criterion automatically triggers the production of an Article 126(3) report (section 2.2.1.2) unless the debt-to-GDP ratio goes below the threshold reference value within the Commission forecast horizon.

Table 2.1: **Eurostat's breakdown of the change in government debt**

Change in debt			
Deficit	Stock-flow adjustments (SFAs)		
	Net acquisition of financial assets a) currency b) securities c) loans d) shares e) other financial assets	Adjustments a) financial derivatives b) other liabilities c) effects of face valuation d) appr./depr. of currency e) other volume changes	Statistical discrepancies

The contribution of SFAs to the evolution of gross government debt should be considered whenever an Article 126(3) report is prepared based on the debt criterion. This assessment will not be quantitative in the sense that it will not yield a recalculated debt benchmark. Nevertheless, an adjustment to the change in gross government debt should be applied to reveal whether developments in SFAs justify the failure to meet the numerical debt benchmark.([106]) In particular, gross debt should be 'netted out' by the net acquisition of currency and deposits to prevent that the government's cash management activity comes into conflict with its obligation to meet the debt criterion. This is further considered in Box 2.5.

Box 2.5: CONSIDERING 'STOCK-FLOW ADJUSTMENTS' FOR THE ASSESSMENT OF THE DEBT CRITERION

To prevent that transactions that are undertaken, for instance, for cash management purposes alter the assessment under the debt criterion some adjustments must be made to the measure of gross government debt.

Currency holdings

Cash holdings of the government are the most liquid assets, which could be used immediately to buy back government bonds. Thus, deducting the net acquisition of currencies and deposits from (the change in gross) government debt should not change the assessment of fiscal sustainability.

In the context of an Article 126(3) report, gross debt would be adjusted by the increase in the government's cash reserve. Such a situation may arise when the government decides to take advantage of favourable market conditions and raise more funds than it needs (pre finances itself). This would show up in both its financial liabilities and in its cash balance. In this case, netting out the so acquired funds would be appropriate. However, attention must also be paid to any increase in the 'accounts payable' of the government as in some cases less use of cash reflects the building up of arrears.

([106]) Recital 14 of the Council Regulation (EU)1177/2011 foresees that the assessment of the composition of the stock-flow adjustment on debt developments may be sufficient to exclude the establishment of an EDP on the basis of the debt criterion.

The government could equally decide to reduce its government debt (close to the end of the recording period with the intention to record a lower EDP debt) through the excessive use of its cash reserve. However, it can be assumed that a certain level of cash would have to be maintained for operational reasons, and thus it is likely that the government will have to issue bonds in the near future. Therefore, in this case, it would also be prudent to adjust (the change in) gross government debt with the (net acquisition of) currency and deposits line of SFA (and therefore the adjusted government debt would be higher than EDP debt).

Large swings in the government's currency position are not uncommon. In the October 2011 EDP notification, the net acquisition of 'currency and deposits' varied both across countries and over time. It exhibited variations over 5% of GDP (in absolute terms) in some countries (Denmark, Ireland, Luxembourg, Hungary and Slovenia), but in most cases it remained within the range of -3% and +3% of GDP.

Intergovernmental loans

A Member State should not be placed in EDP for breach of the debt criterion, including in the transition period, as a result of assistance provided to other EU Member States in the context of a coordinated, EU-wide policy. Box 2.3 describes how loans under the Greek loans facility, the EFSM, the ESM and operations under the second assistance programme to Greece should be taken into account in the Article 126(3) report.

Other adjustments

In spite of the fact that the net debt approach would, in theory, better reflect changes to the sustainability of fiscal policy, further adjustments to the gross debt figure are not recommended. The reason for this is that the more assets are netted out, the further one departs from the Maastricht original concept for the debt criterion. Also, the valuation of most assets is difficult or sometimes even arbitrary and, by taking them into account, the quality of the measurement of the EDP definition of government debt would suffer as well.

2.2.2.3 Concluding the Article 126(3) report

Once consideration has been taken of all relevant factors to assess the case for launching or not an EDP, the Article 126(3) report is sent to the Economic and Financial Committee of the Council which has 2 weeks to formulate an opinion, based on Article 126(4).

Following the Commission's report and the ensuing opinion from the Economic and Financial Committee, if the Commission considers that an excessive deficit exists or may occur, the Commission addresses an opinion to that effect to the Member State concerned and informs the Council accordingly, under Article 126(5). The Commission also prepares a proposal for a Council decision on the existence of an excessive deficit under Article 126(6) and a recommendation for a Council recommendation on the provisions to take to correct the excessive deficit under Article 126(7).

In case the launch of an EDP is not warranted, it should be noted that as long as the Commission considers that the Member State's situation has not changed significantly since the Article 126(3) report, it is not bound to produce another report. This refers to those situations where both the causes (breach of the deficit and/or debt criterion) triggering the preparation of the report and the relevant factors considered

therein have not undergone material changes since the latest report, so that the assessment of the case for not launching an EDP remains unchanged too.

2.2.3. Preparing an Article 126(7) recommendation or an Article 126(9) notice

The Commission recommendation for a Council recommendation under Article 126(7) to correct the excessive deficit contains an underlying analysis of the macro-fiscal situation of the Member State, a timeframe within which the excessive deficit should be corrected and annual targets for the nominal and structural deficit linked by an underlying macroeconomic scenario. Moreover, the amount of measures deemed needed to meet the structural deficit targets is also specified.

Once in EDP, the Commission will recommend the Council to issue a notice under Article 126(9) to euro area Member States which have been found by the Council in an Article 126(8) decision not to have taken effective action – on the basis of the methodology defined in Section 2.3.2 – to comply with an Article 126(7) recommendation or with a revised notice under Article 126(9).

Following the adoption by the Council of an Article 126(8) decision establishing a lack of effective action, Article 5(1) of Regulation 1467/97 requires that, for euro area Member States, a Council decision to give notice to take measures to correct the excessive deficit situation be taken within 2 months according to Article 126(9). In terms of content, the main difference between a notice under Article 126(9) and a recommendation under Article 126(7) is that the measures conducive to the achievement of the budgetary targets and the deadlines for their adoption are explicitly indicated in the notice. Otherwise, a notice under Article 126(9) follows the abovementioned specifications for the preparation of Article 126(7) recommendations, including due consideration to relevant factors.

Thus, both EDP recommendations under Article 126(7) and decisions to give notice under Article 126(9) contain the following quantitative budgetary objectives:

- A deadline for the correction of the excessive deficit. As a rule, when the EDP is launched in year t, following a Council decision on the existence of an excessive deficit, the latter should be corrected in year $t+1$. However, in case of special circumstances, a longer deadline could be set.

- A path towards the correction of the excessive deficit with intermediary annual targets for the general government balance. Even in the case of deadline set for the year ($t+1$) following the identification of an excessive deficit (in t), the EDP recommendation (or notice) would entail at least one intermediary nominal target (that of year t).

- An annual fiscal effort of at least 0.5% of GDP as a benchmark, defined in structural terms, consistent with the nominal path towards the correction of the excessive deficit.

In addition, a quantification of the amount of measures required to meet these annual targets should be included in the Article 126(7) recommendation and a more detailed specification of the measures with the corresponding deadlines for their adoption is explicit in the Article 126(9) notice. Box 2.6 explains the relationship between the structural adjustment and the required measures.

Setting a path for the deficit and a deadline for correction

The aim of Article 126(7) recommendations and Article 126(9) notices is to present a credible path for the timely correction of the excessive deficit. According to Article 3(4) of the Regulation (EC) 1467/97: *"[...] The Council recommendation shall also establish a deadline for the correction of the excessive deficit, which shall be completed in the year following its identification unless there are special circumstances. In its recommendation, the Council shall request that the Member State achieve annual budgetary targets which, on the basis of the forecast underpinning the recommendation, are consistent with a minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation."*

The Code of Conduct on the SGP specifies: *"As a rule, the initial deadline for correcting an excessive deficit should be the year after its identification and thus, normally, the second year after its occurrence unless there are special circumstances. This deadline should be set taking into account the effort that the Member State concerned can undertake, with a minimum of 0.5% of GDP, based on a balanced assessment of the relevant factors considered in the Commission report under Article 126(3). If this effort seems sufficient to correct the excessive deficit in the year following its identification, the initial deadline should not be set beyond the year following its identification.*

Longer deadlines could be set, in particular in the case of excessive deficit procedures based on the debt criterion, when the government balance requested to comply with the debt criterion is significantly higher than a 3% of GDP deficit."

Article 2(6) of Regulation (EC) 1467/97 further specifies that the deadline for correction will be set by taking into account the relevant factors: "*If the Council, acting under Article 126(6) TFEU, decides that an excessive deficit exists in a Member State, the Council and the Commission shall, in the subsequent procedural steps of that Article of the TFEU, take into account the relevant factors referred to in paragraph 3 of this Article, as they affect the situation of the Member State concerned, including as specified in Article 3(5) and Article 5(2) of this Regulation, in particular in establishing a deadline for the correction of the excessive deficit and eventually extending that deadline."*

Judging whether or not one year is sufficient to correct an excessive deficit requires a careful consideration of the magnitude of the necessary structural adjustment against both the urgency of the adjustment in terms of the fiscal risk borne by the Member State in question and the economic feasibility of such an effort. The Regulation also indicates that relevant factors are taken into account when setting the deadline for the correction of the excessive deficit. Thus, while the correction of an excessive deficit is expected to take place within the year following its identification, relevant factors including the implementation of major structural reforms shall be taken into account when considering instead a multiannual path for the correction of the excessive deficit either in a new EDP or when extending the original deadline.([107]) Any additional year should be considered taking into account again both the economic feasibility and the urgency for the Member State to correct its excessive deficit in that additional year.

Irrespective of whether an EDP is opened due to a breach of the deficit or of the debt criterion, both Article 126(7) recommendations as well as Article 126(9) notices present a correction path with annual

([107]) The Communication from the Commission on *Making the best use of the flexibility within the existing rules of the Stability and Growth Pact*, COM(2015) 12 of 13.01.2015 clarifies the role of structural reforms as a relevant factor to be considered, where relevant, in the EDP context. http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/2015-01-13_communication_sgp_flexibility_guidelines_en.pdf

targets for the nominal and structural deficits, which are defined on the basis of an underlying macroeconomic scenario, as per the Commission forecasts. For Member States with debt above 60% of GDP, the fiscal path has to take into account the need to comply with the debt benchmark so that the fiscal trajectory leads to the debt complying with at least the forward-looking element of the debt reduction benchmark at the end of the correction period, on a no-policy change basis (see Box 1.5). As a result, the level for the general government balance recommended for the final year may be above the Treaty reference value of a general government balance of -3% of GDP.

Following Article 10 of Regulation 472/2013 of the Two Pack, for euro area Member States under a macroeconomic adjustment programme, the programme's deficit targets should be integrated in the Article 126(7) recommendation or Article 126(9) notice, as relevant. In addition, the measures needed to achieve these budgetary targets as well as the deadlines for their implementation shall also be specified in the Article 126(9) notice.

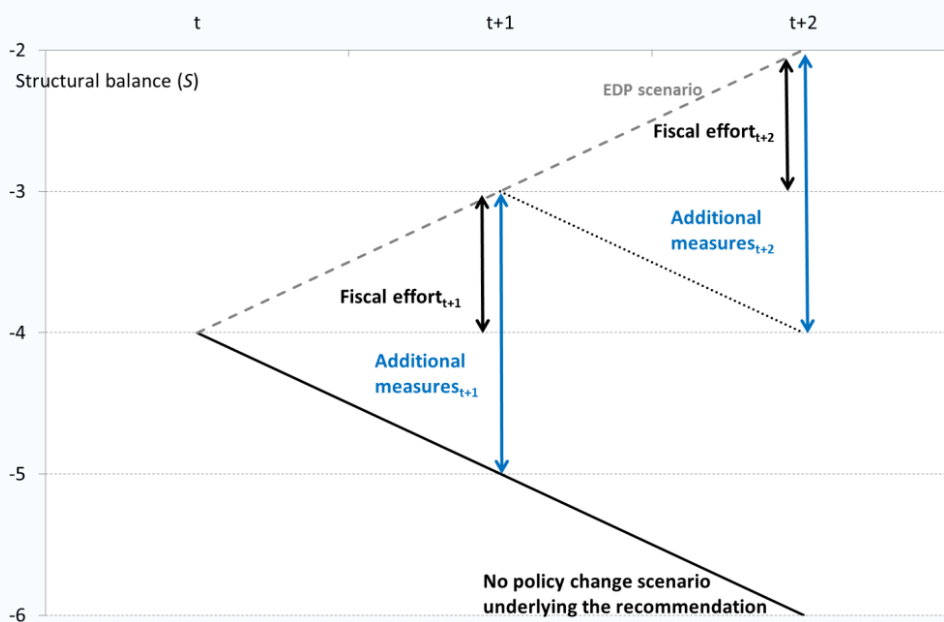
Specifying the measures

Along with the paths for both the nominal and structural deficits,([108]) and the underlying macroeconomic scenario that links them, a no-policy change trajectory of receipts and spending is given. This is because the change in the structural balance need not be equal to the magnitude of the measures that need to be taken by the Member State in question. In particular, the structural balance implicitly assumes that receipts and spending grow in line with potential GDP. In most countries, the no-policy change trajectory of receipts and spending will be different and in some cases significantly so. For example, a country with no automatic indexation of tax thresholds will have revenue trends that are above the change in potential growth and will therefore need to take fewer policy measures than a country with indexation linked to the GDP deflator to achieve the same tightening in the structural balance, other things being equal.

Therefore, a quantification of the measures required to meet the annual nominal and structural targets should be included in the Article 126(7) recommendations. As regards the Article 126(9) notices, they should clearly specify both the necessary measures as well as the deadlines for their adoption, which define a timetable which will also bind the Member State to submit reports to show compliance with these requirements (see Box 2.6).

([108])The structural balance is defined as the cyclically-adjusted general government balance net of one off and other temporary measures (see Box 1.4).

Box 2.6: **RECONCILING THE REQUIRED CHANGE IN THE STRUCTURAL BALANCE AND THE AMOUNT OF ADDITIONAL MEASURES**



The figure above represents a case in which the Excessive Deficit Procedure is launched on the basis of actual data of year *t* and with a deadline for correction set in year *t*+2. At time t, there is a structural balance of -4% of GDP and the target for the EDP is for a structural balance of -2% of GDP to be attained at t+2. Therefore, there needs to be an improvement in the structural balance of 2 percentage points of GDP, which, if implemented linearly requires that the structural balance improve by 1 percentage point of GDP between t and t+1 and between t+1 and t+2. These two steps are shown in the dashed line which is called the EDP scenario.

However, in order for this improvement in the structural balance to be obtained, the size of the additional measures that the Member State in question could be greater than the improvement in the structural balance. This is because in this example, the no-policy change scenario is for an annual deterioration in the structural balance of 1 percentage point per year, as indicated by the “no policy change scenario underlying the recommendation”. This might be due to commitments to increase spending at a faster rate than potential growth, for example. In order to meet the EDP targets, additional measures equal to 2 percentage points of GDP will need to be taken in both t+1 and t+2. These are shown by the blue lines. In t+1, taking the required additional measures equal to 2 percentage points of GDP will bring the structural balance from -5% of GDP to -3% of GDP and set the no policy change scenario on a new trajectory shown by the dashed black line. In order to reach the target of structural balance of -2 by t+2, additional measures shown by second blue line equal to 2 percentage points of GDP, would be required.

In calculating the additional measures that need to be introduced to reach a given change in the headline balance, the impact of the measures on growth must be taken into account. This is not shown in the graphic as the aim is to illustrate the difference between the change in the structural balance and the amount of measures needed to reach it.

The Commission assumptions underlying the recommendations (or notices) are published in the Staff Working Document that accompanies them, which include the necessary information to undertake the ex post assessment of effective action as explained in Section 2.3.2.

The Article 126(7) recommendation also establishes a maximum deadline of six months for effective action to be taken and reported on in order to correct the excessive deficit in a timely manner. However, when justified by the seriousness of the situation, the deadline may be shortened to three months. It is four months in case of an Article 126(9) notice.

Along with the Article 126(7) recommendations (or notices), the Commission can request that euro area Member States be subject to additional reporting requirements (see Annex 13), as set out in Regulation 473/2013 of the Two Pack. ([109]) This request may occur at any point in the EDP for euro area Member States that were not initially subject to it. In all cases, the Member States concerned will be required to submit the regular reports until the abrogation of their excessive deficit procedure. These reporting requirements include a comprehensive assessment of budgetary execution at the time of the first report after the launch of EDP and make it incumbent on the Member States to submit updates to the Commission every six months, while under an Article 126(7) recommendation and every three when under notice according to Article 126(9). The reports submitted should follow the specifications and templates of Commission Delegated Regulation (EU) 877/13 of 27 June 2013 supplementing Regulation (EU) 473/2013 of the European Parliament and of the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area.([110])

2.2.4. Sanctions: recommending a non-interest bearing deposit

For euro area Member States, following the Council's adoption of a decision under Article 126(6) establishing the existence of an excessive deficit, the Commission may issue a recommendation for a further Council decision requiring the Member State to lodge a non-interest bearing deposit.([111]) This will systematically happen if the Member State in question had lodged an interest-bearing deposit following non-compliance with the recommendations in the preventive arm after a Commission warning, or on a case-by-case basis if the Commission identifies particularly serious non-compliance with the budgetary policy obligations laid out in the SGP. When the Commission decides to issue a recommendation for a Council decision on sanctions, it will do so within 20 days of the Council's adoption of the Article 126(6) decision. The amount of the non-interest bearing deposit shall equal 0.2% of the previous year's GDP, as a default and maximum value. The deposit will be lodged with the Commission – if the country had already lodged an interest-bearing deposit, it will be turned into a non-interest bearing one and any difference in the applicable amount (taking into account the interest accrued) will be returned to the Member State or made up by it.

The Council decision on the lodging of a non-interest bearing deposit shall be considered adopted, unless the Council decides to reject the Commission's recommendation within 10 days, using qualified majority voting.

While the default position is for the Commission to ask for a deposit equal to 0.2% of the previous year's GDP, the Commission may recommend that the Council reduce the amount or cancel the non-interest bearing deposit altogether. This can happen on the grounds of exceptional economic circumstances or following the reasoned request by the Member State concerned, addressed to the Commission within 10

([109]) Euro area countries under enhanced surveillance according to Regulation 472/2013 are automatically made subject to this regular reporting, whether or not they are under EDP. Conversely, euro area countries under a macroeconomic adjustment programme may not be made subject to this regular reporting as their obligations under their macroeconomic adjustment programme are sufficient to ensure the closer monitoring that the regular reporting leads to.
([110]) http://eur-lex.europa.eu/JOHtml.do?uri=OJ:L:2013:244:SOM:EN:HTML.
([111]) Regulation EU/1173/2011

days of the Council's adoption of the Article 126(6) decision. The Council may also amend the Commission's recommendation for a deposit using qualified majority voting and adopt the amended text as a Council decision.

2.3. STEPS FOLLOWING A RECOMMENDATION UNDER 126(7) OR A NOTICE UNDER 126(9)

This Section considers the steps to be followed after the adoption of a Council recommendation under Article 126(7) or a Council decision to give notice under Article 126(9). Section 2.3.1 sets out the reporting requirements on Member States in EDP and Section 2.3.2 describes how compliance with the recommendations (or notices) is judged. Section 2.3.3 considers the cases in which the deadline for correction can be extended. Section 2.3.4 describes the continuous monitoring that takes place when EDPs are placed in abeyance and discusses the correction of the excessive deficit.

2.3.1. Member States' reporting on action taken and continuous monitoring of compliance

Article 126(7) recommendations and Article 126(9) notices contain a deadline for the Member State concerned to adopt the necessary measures to comply with the recommendation. Depending on whether the situation is deemed particularly serious or not, this deadline can be within three or six months in a recommendation and four months in a Council decision to give notice. Within this deadline, the Member State must report to the Council and the Commission on action taken in response to the Council's recommendation or notice. The report, which is made public by the Member State, includes the targets for government expenditure and revenue and for the discretionary measures on both the expenditure and the revenue side which should be consistent with the Council's requirements, as well as information on the measures already taken and on the nature of those envisaged to achieve the targets. These requirements do not apply to countries under a macroeconomic adjustment programme.

In addition, as per Regulation (EU) 473/2013, euro area Member States subject to additional reporting requirements will provide every six months when subject to a recommendation or every three months when subject to a notice, a comprehensive assessment of in-year budgetary execution for the general government and its subsectors including any financial risks stemming from contingent liabilities. This additional information should also be included in the first report on action taken. Annex 13 gives the tables that should be used for the regular reporting for euro area countries under these additional reporting requirements (see Section 2.3.4 for more details).

Regulation (EU) 473/2013 also requires euro area Member States to submit an Economic Partnership Programme (EPP) together with the report on the action taken following an Article 126(7) recommendation.([112])([113]) The EPP is a one-off document where Member States define a roadmap for the fiscal structural reforms which they consider necessary to ensure an efficient and lasting correction of their excessive deficit. Section 3.1.2.2 presents more details on the EPPs.

In addition, the Commission is allowed by Regulation 473/2013 to request a comprehensive independent audit of the public accounts and the provision of any available additional information for the purposes of monitoring progress towards to the correction of the excessive deficit from euro area countries, on an ad

([112]) Non-euro area signatories of the TSCG who have chosen to be bound by the fiscal compact prior to adopting the euro (Bulgaria, Denmark and Romania) have also committed themselves to submitting an EPP. However, this commitment falls outside of the Community framework.
([113]) Member States subject to a macroeconomic adjustment programme do not have to submit EPPs, which is substituted by the programme conditionality.

hoc basis, independent of the activation of the additional reporting requirements. Box 2.7 provides more details.

Box 2.7: **Additional ad hoc information requests from euro area countries**

According to Regulation 473/2013 the Commission may require that euro area Member States:

- Carry out and report on a comprehensive independent audit of the public accounts of all subsectors of general government with the aim to assess their reliability, completeness and accuracy for the purposes of the EDP. This should preferably be conducted in coordination with national supreme audit institutions;
- Provide available additional information for the purposes of monitoring progress towards the correction of the EDP.

This information must be provided to the Commission following a request, and within the deadline set by the Commission. The request can be issued at any point as many times as the Commission wishes in the EDP process. The ability to request this information is not predicated on the activation of the additional reporting requirements set out in Section 2.3.4 as these information requests occur on an ad hoc basis. The right to request this information does not apply to euro area Member States subject to a macroeconomic adjustment programme, as it is the terms of that programme that determine the information flow from the Member State to the Commission and the Council.

2.3.2. Assessing compliance with an Article 126(7) recommendation or an Article 126(9) notice

Following the submission by the Member State of the report on action taken along with any other information requested by the Commission when relevant, the Commission undertakes a first, formal assessment to evaluate compliance with the terms of the recommendation or notice according to an agreed methodology, as endorsed by the ECOFIN Council on 20 June 2014.([114]) This first assessment is done by assessing whether the Member State is forecast to meet the nominal and structural targets, according to the Member States' plans and Commission's forecasts (as it usually takes place at a time where no outturn data are available yet). Thus, the first assessment of compliance with the nominal targets and the structural adjustments is of a preliminary nature and focuses on the credibility of the Member States' plans. Indeed, according to the Code of Conduct on the SGP, this preliminary assessment should consider whether the Member State concerned has publicly announced or taken measures that seem sufficient to ensure adequate progress towards the correction of the excessive deficit within the time limits set by the Council.

If the Commission considers that the Member State has acted in compliance with the recommendation (or notice) and that the EDP fiscal requirements are likely to be fulfilled, it informs the Council of its assessment, and the procedure is put in abeyance (see section 2.3.4). Otherwise, the procedure is either stepped up (if no effective action has been taken – see below) or a revised EDP recommendation or notice is issued (if the assessment of effective action is positive but *"unexpected adverse economic events with major unfavourable consequences for government finances occurred"* (Article 3(5) of Regulation (EC) 1467/97). The notion of *adverse economic events* encompasses those developments outside of the government's control, which may result in the deficit target not being met, in spite of the government

([114]) Economic and Financial Affairs Council conclusions of the meeting of 20 June 2014: http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/143293.pdf

putting in place measures that could have been expected to correct the deficit based on the scenario underlying the recommendation. Essentially, these unexpected developments consist mainly of lower economic growth or a shortfall in revenues compared to what was expected at the time of the recommendation, as well as impact of other unexpected and unusual events. The following Section 2.3.2.1 and Annex 5 detail how these factors are taken into account in the assessment of effective action.

After the first assessment of effective action, Member States' compliance with the recommendation (or notice) is subject to continuous monitoring (section 2.3.4). The regular Commission forecast exercises provide a natural occasion to check whether Member States are on track with the correction of their excessive deficit.

After the opening of an EDP and alongside the first assessment of effective action following an Article 126(7) recommendation, euro area Member States' Economic Partnership Programme (EPP) is also assessed. To that end, the Commission prepares a proposal for a Council opinion on the EPP, following the guidance set out in section 3.1.2.1.

2.3.2.1 The assessment of effective action following Article 126(7) recommendations or 126(9) decisions to give notice

The Code of Conduct on the SGP stipulates that *"A Member State should be considered to have taken 'effective action' if it has acted in compliance with the recommendation or notice, regarding both the implementation of the measures required therein and budgetary execution. The assessment should in particular take into account whether the Member State concerned has achieved the annual budgetary targets initially recommended by the Council and the underlying improvement in the cyclically adjusted balance net of one off and other temporary measures. In case the observed budget balance proves to be lower than recommended or if the improvement of the cyclically-adjusted balance net of one-off and other temporary measures falls significantly short of the adjustment underlying the target, a careful analysis of the reasons for the shortfall would be made. In particular, the analysis should take into account whether expenditure targets have been met and the planned discretionary measures on the revenue side have been implemented."*

Following the specifications provided in the Code of Conduct on the SGP which are based on Regulation (EC) 1467/97, the logical and procedural steps for the assessment of effective action are summarised in a decision tree, endorsed by the ECOFIN Council of June 2014, which is described in Graph 2.3. Thus, the Commission first examines whether the Member State concerned has met or is forecast to meet the recommended headline deficit target and the underlying improvement in the structural balance.([115]) Compliance with both requirements leads to the EDP being held in abeyance.

If, on the contrary, the Member State fails or is a risk of failing to meet the recommended headline deficit or/and the required improvement in the structural balance, the Commission engages in a more detailed examination to identify the reasons for any shortfall. This examination is known as the careful analysis. The aim of the careful analysis is to evaluate whether the Member State concerned has delivered on the policy commitments set out in the recommendation or in the notice despite the effects of the action taken not being reflected in the deficit figures. Thus, it is essential to determine whether the targets were missed due to an inadequate policy response or due to forecast errors or adverse economic outturns.

([115])The structural balance is defined as the cyclically-adjusted general government balance net of one off and other temporary measures (see Box 1.4).

To that end, the careful analysis builds on two measures of fiscal effort: (i) a top-down measure which corresponds to the change in the structural balance adjusted for forecast errors (ΔS^*) and (ii) a bottom-up measure based on a direct estimation of the budgetary impact of fiscal measures (FE). According to the Code of Conduct, the bottom-up assesses "*whether expenditure targets have been met and the planned discretionary measures on the revenue side have been implemented*". In both cases the aim is to determine whether the Member State has actually delivered on the policy commitments engaged in its Article 126(7) recommendations or Article 126(9) notices.

In the case where both measures indicate that the fiscal effort was equal or above the recommended one, there is a presumption that the Member State concerned has delivered on its policy commitments. Conversely, if both the top-down and bottom-up measures fall below the recommended effort, there is a presumption of non-delivery. When the top-down and bottom-up approaches come to different conclusions, there is no prior presumption on which metric best appraises the extent of government action. In order to enhance the quality of the estimated budgetary impact of revenue measures, the Commission uses all available information including, in particular, estimates from the Independent Fiscal Institutions. To ensure transparency the Commission provides the Council with all data needed to replicate the Commission estimates, including data on the yields of fiscal measures and a quantification of the main discretionary tax measures incorporated in the bottom-up approach. In order to conclude whether the Member State concerned has delivered on its policy commitments, the Commission uses qualitative economic judgement in making its final assessment where relevant, in particular where the top-down and bottom-up approaches come to different conclusions, as part of the careful analysis.

A positive conclusion to the careful analysis implies that effective action has been taken and the procedure is put in abeyance. In this case if the deadline for correction turns out to be out of reach, there is the possibility to extend the deadline for the correction of the excessive deficit, even if the headline deficit target has not been met (see Section 2.3.3). Conversely, if the careful analysis concludes that the Member State has not delivered on its policy commitments, the procedure will be stepped up. However, an EDP cannot be stepped up if the Member State achieves its intermediate headline deficit targets, even when the recommended change in the structural balance is not achieved. At the same time, though, a careful analysis should be conducted to better understand the nature of the underlying budgetary developments. Where the absence of stepping-up of the procedure is taken based on in-year data, should the (notified) ex post data show that the intermediate budgetary balance has eventually not been met, the EDP can still be stepped up.

It has to be borne in mind that the methodology for the assessment of effective action aims at assessing whether the action taken by the Member States is sufficient to meet the budgetary objectives of the recommendation or notice and is, as such, solely based on the analysis of indicators of budgetary effort. Therefore, a Member State's failure to deliver on effective action cannot be offset by structural reform efforts. By the same token, failure to deliver on structural reform commitments shall not affect EDP abeyance decisions, if/when effective action has been delivered. The Communication on Flexibility within the rules of the SGP([116]) restated that the assessment of effective action remains as per the agreed methodology,[117] which is focused on the delivery of the required budgetary effort At the same time, the lack of implementation of the agreed([118]) structural reforms can constitute an aggravating relevant factor:

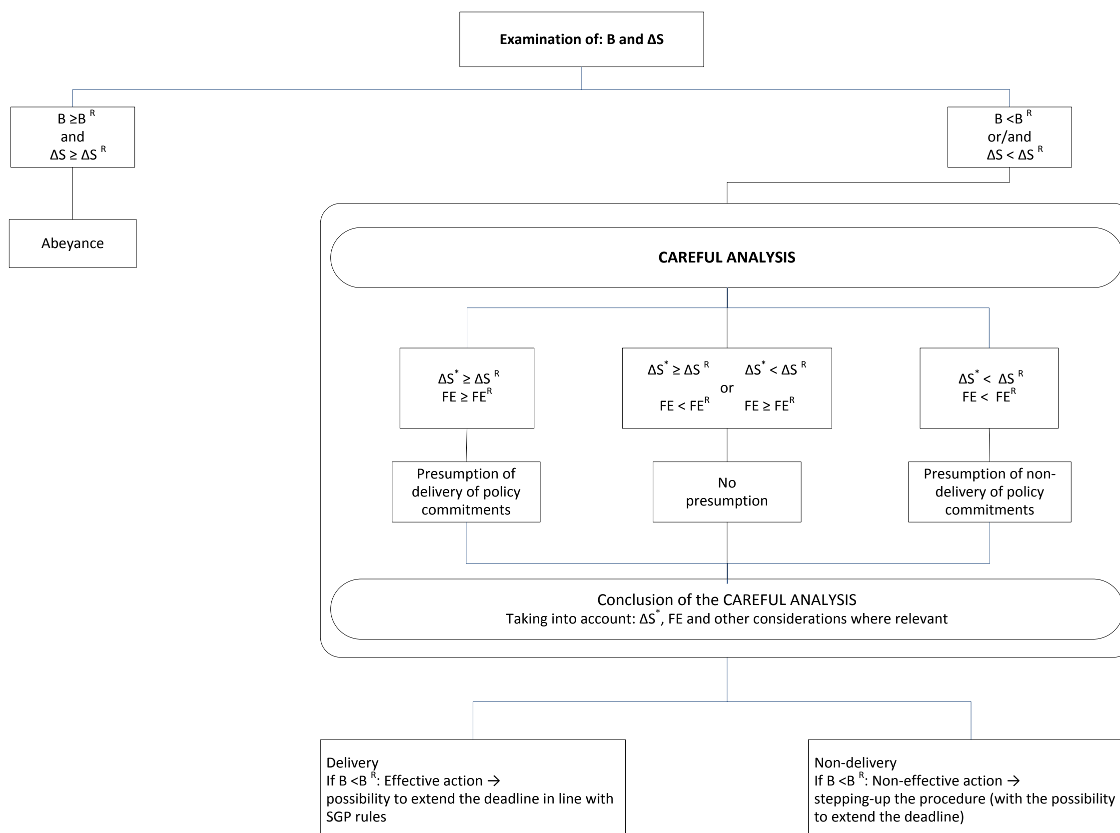
([116]) COM(2015) 12: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/2015-01-13_communication_sgp_flexibility_guidelines_en.pdf
([117]) As endorsed by the ECOFIN Council in June 2014.
([118]) E.g. the implementation of structural reforms in the context of the European Semester, such as within the Excessive Imbalance Procedure, as well as structural reforms detailed in the Economic Partnership Programme (see Section 3.1.2.2).

this could have a bearing at the margin of the careful analysis, in case of conflicting and not conclusive indication stemming from the top-down and bottom-up metrics.([119])

The experience gained since the entry into force of the Six Pack in 2011 has shown that focusing on the evolution of the fiscal variables in a given year can lead to an asymmetry in the assessment of compliance with the recommendations. Therefore, since autumn 2014, the Commission has examined whether the fiscal effort over the correction period under scrutiny was delivered on a cumulative basis. In this way, a Member State cannot be unduly punished for a frontloaded effort. At the same time, this ensures that a Member State meeting its nominal target the first year without delivering the recommended annual fiscal effort would only be found compliant with the recommendation in the following years if it has delivered the cumulative fiscal effort over the correction period under scrutiny, in case the nominal deficit falls short of the recommended one thereafter. Thus, for the purposes of the assessment of effective action, the cumulative (adjusted) change in the structural balance and the annual amount of fiscal consolidation measures is compared with the cumulative (adjusted) change in the structural balance and the additional fiscal consolidation measures required in the recommendation. A numerical example of the assessment of effective action is presented in Annex 10.

([119]) The implementation of reforms cannot be expected to shift per se the conclusion in favour of a positive assessment of effective action given that it can be assumed that the reform effort would have already been taken into account in the formulation of the EDP recommendation or notice as a relevant factor that may warrant longer deadlines for correction of the excessive deficit.

Graph 2.3: **The EDP decision tree for conducting effective action assesment**



Definitions
Observed Budget balance (deficit) = B
Recommended Budget balance (deficit)= B^R
Top-down approach:
Required change in the structural budget balance = ΔS^R
Observed change in the structural budget balance= ΔS
Corrected observed change in the structural budget balance = ΔS^*
Bottom-up approach:
Required new fiscal measures = FE^R
Observed budget impact of the new measures implemented = FE

The top-down approach: the change in the adjusted structural balance

Since the 2011 reform of the SGP, recommendations under Article 126(7) and notices under Article 126(9) include annual nominal and structural targets, which, on the basis of the forecast underpinning the recommendation, should be consistent with a minimum annual improvement in the structural balance of 0.5% of GDP as a benchmark.([120]) However, given the limitations by construction of the structural balance as a measure of fiscal effort,([121]) the top-down approach adjusts the estimated change in the structural balance for the impact of revisions to potential output and revenue outturns with respect to the no-policy change scenario (see Box 1.5) forecast at the time of the recommendation (ΔS*). Thus, it provides a better estimate of whether a country has delivered on the policy commitments laid down in its

([120]) EDP recommendations issued before the 2011 reform contained average targets for the overall correction period.
([121]) See for instance, Part III of the “Report on Public Finances in EMU 2013”, European Economy 4/2013

recommendation than a direct comparison of the estimated and the required change in the structural balance. See the decision tree presented in Graph 2.3.

The change in the structural balance is adjusted (see annex 5 for more details) to net out:

- The impact of revisions to potential output growth compared to the estimate underlying the recommendation, through the so-called *α*-parameter. In fact, a higher (or a lower) rate of potential output growth than estimated at the time of the recommendation would lead, in the absence of correction, to a higher (or a lower) estimate in terms of the change in the structural balance.

- The impact of revisions to the composition of economic growth or of other windfalls/shortfalls in revenue, through the so-called β-parameter. This captures the fact that apparent revenue elasticities can differ from those underlying the EDP recommendations, for reasons outside the government's control.

- The impact of other unexpected events under very unusual and significant circumstances, through the so-called γ-parameter.([122])

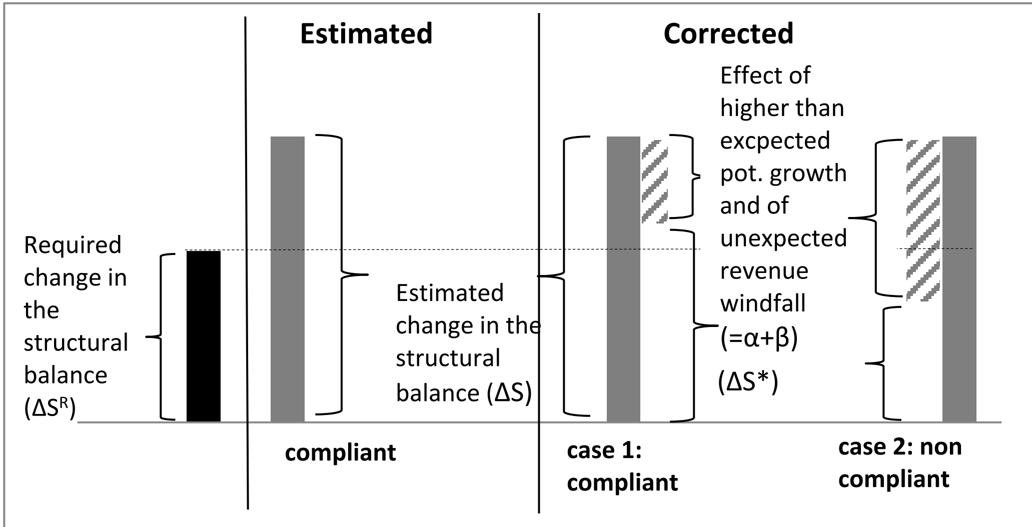
These parameters are then brought together to yield $\Delta S^{*}=\Delta S-(\alpha+\beta+\gamma)$, where ΔS is the estimated change in the structural balance.

Thus, in any given year, the total structural adjustment recommended since the Article 126(7) recommendation (or Article 126(9) notice) was issued is compared with the adjustment delivered measured by the cumulative adjusted structural balance.

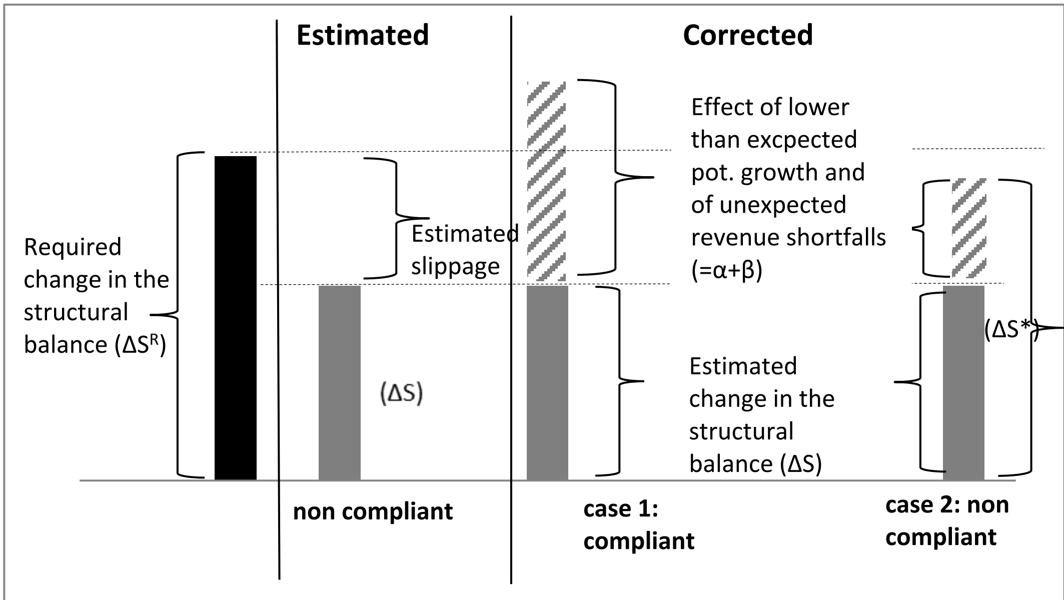
All in all, the comparison between the adjusted and the unadjusted change in the structural balance gives rise to four possible situations set out in Graphs 2.4 and 2.5. A country that appears to be delivering the structural effort on the unadjusted measures (Graph 2.4) could be judged to be compliant or non-compliant on the adjusted. Similarly, a Member State whose estimated change in the structural balance falls short of the recommended change, could show an adjusted structural balance signifying compliance (see Graph 2.5).

([122]) Importantly, this parameter should include neither elements that affect potential growth (which will go through the parameter *α*), nor revenue elasticity (which would be already taken into account in the revenue gap *β),* nor one-off effects (which will not even affect the structural balance at all), nor any cyclical expenditure effects (since these will be filtered out via the cyclical adjustment).

Graph 2.4: **Estimated and corrected fiscal effort – The case of a positive unexpected event**



Graph 2.5: **Estimated and corrected fiscal effort – The case of a negative unexpected event**



The bottom-up approach

Since 2013, Article 126(7) recommendations contain an estimate of the amount of measures needed to attain the budgetary and structural deficit targets.([123]) Notices under Article 126(9) contain a detailed amount of the measures to be taken to meet the annual structural budgetary targets as well as a timeline to implement them. As a result, the bottom-up assessment of effective action aims at identifying the budgetary impact of the additional fiscal measures implemented since the recommendation or notice was issued – measures introduced before that would already be included in the baseline scenario (see Box 2.6).

The methodology underlying the bottom-up assessment treats revenue and expenditure measures differently, reflecting the degree of control that governments typically have over them in the short-term. ([124]) While the total amount of revenues largely depends on endogenous factors beyond the direct control of the government (e.g. changes in the tax bases), expenditure can be considered as falling largely under the direct control of the government, except for a limited number of expenditure items.([125]) Therefore, nominal changes in public expenditure can be broadly considered as resulting from autonomous decisions by the government, while on the revenue side the degree of government action is measured by the amount of discretionary measures effectively implemented.

The annual bottom-up fiscal effort is defined as follows:

$$FE_t = \underbrace{\frac{DRM_t^{assessment}}{GDP_t^{assessment}}}_{\text{(revenue component)}} - \underbrace{\frac{\left(\Delta E_t^{assessment} - \Delta E_t^{baseline}\right)}{GDP_t^{assessment}}}_{\text{(expenditure component)}}$$

Where:

$DRM_t^{assessment}$ is the estimated budgetary impact of the discretionary revenue measures additional to the ones already included in the no-policy change scenario([126]), as estimated at the time of the assessment, net of one-off measures([127]) implemented in year *t* (or under the relevant sub-period of time under scrutiny).

$\Delta E_t^{assessment}$ is the change in total nominal expenditure in year *t*, net of one-off measures, non-discretionary changes in interest payments, non-discretionary changes in unemployment benefits and public expenditures matched by EU funds as estimated at the time of the assessment as well as other country-specific effects in limited cases.

([123]) For recommendations issued before 2013, a figure for the annual budgetary measures to be implemented was not included in the recitals. Therefore, it is not possible to compare the bottom-up assessment to any meaningful target; in those cases the assessment of effective action should be based on the top-down measure of fiscal effort as well as any other relevant considerations.
([124]) The different treatment also reflects the fact that for expenditures it is in many cases impossible to define a correct benchmark against which to evaluate the action by governments.
([125]) These are changes in unemployment benefits due to a change in the number of unemployed, changes in interest expenditure related to fluctuations in interest and exchange rates and the share of public expenditures matched by EU funds.
([126]) In the context of the bottom-up analysis, a "no-policy change scenario" can be also referred to as a "baseline scenario", as it serves as point of reference to which the current forecast is compared. It is defined in the Staff Working Document accompanying the EDP recommendation.
([127]) One-off measures are by definition excluded from the calculation of the structural balance, and should therefore also not be taken into account in the bottom-up analysis, which presents a complementary view on effective action. For discussion on the one-off measures, see: Public Finances in EMU 2015, chapter II.3: One-off measure – classification principles used for fiscal surveillance, and Box 1.4 of this Vade mecum..

- $\Delta E_t^{baseline}$ is the change in the 'no-policy change' total nominal expenditure in year *t*, as stated in the EDP recommendation, corrected for statistical revisions, net of one-off measures, non-discretionary changes in interest payments, non-discretionary changes in unemployment benefits and public expenditure matched by EU funds as estimated at the time the recommendation was issued as well as other country-specific effects in limited cases.

- $GDP_t^{assesment}$ is nominal GDP in year *t* as estimated at the time of the assessment of effective action.

The resulting total fiscal effort delivered since the recommendation was issued is then compared to the annual amount of discretionary fiscal measures specified in the recitals of the Council recommendation or notice, on a cumulative basis.

The assumptions underlying the recommendations are included in the Staff Working Document accompanying them. In order to further enhance transparency on the ex post assessment of effective action, the Staff Working Document, since 2015, also includes the forecast of key variables for the computation of the fiscal effort under the baseline (EDP) scenario.

Bringing it all together: the careful analysis

The careful analysis is warranted when the Member State concerned fails or it is at risk of failing to meet the headline deficit target and/or the required improvement in the structural balance. In order to determine the reasons of the shortfall and ultimately whether the country has delivered on the policy commitments laid down in the recommendation, the careful analysis first and foremost builds on the top-down and bottom-up measures of fiscal effort. If these indicators send conflicting messages, the careful analysis aims at disentangling the possible sources of the differences. Where relevant, any other considerations can also be taken into account. As already indicated, the lack of implementation of agreed structural reforms can constitute an aggravating relevant factor: this could have a bearing at the margin of the careful analysis, in case of conflicting and not conclusive indication stemming from the top-down and bottom-up metrics.

Differences between the top-down and the bottom-up indicator of fiscal effort could arise for the following reasons:

- The top-down and the bottom-up measures are based on different benchmark growth rates for structural expenditure. Namely, the baseline scenario estimated at the time of the recommendation which serves as baseline in the bottom-up approach and the nominal potential GDP growth rate corrected by the α parameter in the top-down assessment. Since the α parameter only brings a correction in real terms, surprises in inflation will affect the two benchmark growth rates, which are set in nominal terms.

- The items excluded in the bottom-up indicator – in particular, interest payments and public expenditures matched by EU funds – , which remain in the computation of the top-down measure of fiscal effort could also explain the difference between both indicators.

- The effect of the cycle on public expenditure, and more specifically on unemployment expenditure, is not measured in the same manner and may lead to slightly divergent indicators.

2.3.3. Cases for extending the deadline for correction – Effective action

If a Member State is judged to have taken effective action and unexpected adverse economic events with major unfavourable consequences for government finances have occurred, the Commission may issue a recommendation for a revised Council recommendation to end the excessive deficit under Article 126(7). This new recommendation may extend the deadline for the correction of excessive deficit, usually by one year, although it could also issue new nominal and structural targets linked by a new underlying macroeconomic scenario, without extending the deadline. There is no obligation to extend the deadline. If the Commission does not choose to issue a revised recommendation, it may still do so in the future, provided that the Member State continues to be judged to have taken effective action.

A conclusion of compliance or effective action should therefore lead to the following:

- either the Commission considers that the Member State has acted in compliance with the Article 126(7) recommendation (and when required informs the Council accordingly) and the procedure is placed in abeyance;

- or the Commission considers that the Member State has taken effective action with regard to the Article 126(7) recommendation but that adverse unexpected events occurred. Then, the Commission communicates its view that effective action has been taken, and presents the Council with a recommendation for a revised Article 126(7) recommendation. Where this happens, the guidelines set out in Section 2.2.3 should be followed.

- Alternatively, the Commission may conclude that effective action has been taken, but that no revised recommendation should be issued. In this case, no further action is taken and the procedure is put in abeyance.

2.3.3.1 A general and severe downturn in the euro area or EU as a whole

Regulation (EC) 1467/97 also includes the provision for a revised Article 126(7) recommendation (or notice) to be issued "*in the case of a severe economic downturn in the euro area or in the Union as a whole",* as long as the revised recommendation *"does not endanger fiscal sustainability over the medium term".* This condition is a waiver to the obligation to show effective action and, a revised Article 126(7) or Article 126(9) may be issued. This exceptional provision is expected to be used only in the most unusual of circumstances.

2.3.4. Continuous monitoring of the EDPs placed in abeyance and the correction of the excessive deficit

After the initial assessment of effective action, which is the only one specifically required by the SGP, Member States' compliance with the recommendation (or notice([128])) is subject to a continuous monitoring. This embeds specific milestones to take stock of the situation for euro area countries which have had the regular reporting requirements activated, as explained in Section 2.3.1. Those countries will

([128]) Notices under Article 126(9) include a series of deadlines with recommendations attached to them that will rhythm the pace of the monitoring.

need to submit reports to the Commission and the Economic and Financial Committee of the Council, every six months when subject an Article 126(7) recommendation or three months for Article 126(9) notices after the initial report on action taken as outlined in Section 2.3.1. These regular reports will cover the general government and its subsectors and present the in-year budgetary execution, the budgetary impact of discretionary measures taken on both the expenditure and revenue side, targets for government expenditure and revenues and information on the measures adopted and the nature of those envisaged to achieve the fiscal targets. The specification of the content of the regular reports has been laid down in Commission Delegated Regulation 877/2013([129]) and the tables to be used are shown in Annex 13.

The regular Commission forecast exercises (Box 1.5) provide a natural occasion to check whether Member States (whether subject to the regular reporting or not) are still on track with the correction of their excessive deficit. For euro area Member States, the Two Pack gave the Commission the possibility of issuing an autonomous recommendation to formally warn countries of a risk of non-compliance with the deadline for correction of their excessive deficit, before a lack of effective action has actually materialised. Box 2.8 provides more details. Where Member States are issued with a Commission autonomous recommendation, the assessment of whether they have complied with it should be taken into account in the assessment of compliance with the Council recommendation under Article 126(7) or notice under Article 126(9) as an aggravating or mitigating factor.

A procedure in abeyance can be reactivated if the Commission forecasts show that the intermediary nominal targets set in the recommendation are at risk of not being achieved or if other information, including the reports transmitted by Member States, point to risks of the EDP deadline being missed. A planned breach of the intermediary nominal targets by the Member State itself can also lead to a procedure becoming active again.

The assessment of compliance should be based on the methodology set out in Section 2.3.2. As in the first assessment, meeting the nominal target and the required improvement in the structural balance is sufficient to keep the procedure in abeyance. In the case of multi-annual EDPs, being on course to meet the intermediate nominal targets without delivering the required structural adjustment still entails risks for the future years since, if the nominal targets are later missed, it is likely that the cumulated fiscal effort will also be below the recommended one. This would lead to the procedure being stepped up.

Box 2.8: **Issuing an autonomous Commission recommendation to euro area Member States at risk of non-compliance with their EDP deadline**

Following the entry into force of Regulation (EU) 473/2013 on 30 May 2013, the Commission may address euro area Member States it considers to be at risk of non-compliance with their EDP deadline with an autonomous recommendation, aiming at warning the concerned Member State of the implicit risks.([130]) The autonomous recommendation can call for the full implementation of the measures in the Council recommendation under Article 126(7) or in the notice under Article 126(9), the adoption of other measures, or both, within a timeframe consistent with the deadline for correction of the excessive deficit.

This autonomous recommendation is not meant to replace a stepping up of an EDP; instead its role is to warn Member States that can still meet the deadline for correcting their excessive deficits if the observed risks are catered for on time. The autonomous recommendation can serve in the case where there is a risk of the structural effort falling short of the one required, even if the nominal is on track as such a situation still entails risks.

([129]) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:244:0023:0031:EN:PDF
([130]) This provision does not apply with regard to Member States under a macroeconomic adjustment programme.

An autonomous Commission recommendation for euro area Member States at risk of non-compliance with their EDP correction deadline can be issued at any time during an EDP.

Once issued, the recommendation should be made public and presented to the Economic and Financial Committee and can be presented to the national Parliament of the Member State it is addressed to, at its request. The autonomous recommendation should contain a deadline for the Member State to report back to the Commission on the measures taken – for countries under regular reporting requirements the report on the measures taken in response to the autonomous recommendation should be presented at the next regular reporting date. The report on action taken should include the budgetary impact of all discretionary measures taken, targets for government expenditure and revenues, information on the measures adopted and the nature of those envisaged to achieve the targets, and information on the other actions being taken in response the Commission recommendation. The report will be made public and presented to the Economic and Financial Committee. On the basis of that report, the Commission will then assess whether the Member states has complied with the autonomous recommendation, which should be then taken into account in the assessment of compliance with its recommendation under Article 126(7) or notice under Article 126(9).

Finally, the correction of the excessive deficit will lead to the abrogation of the procedure, if this correction is found to be lasting. Section 2.5 sets out the procedures to be followed.

2.4. PROCEDURE FOLLOWING A LACK OF EFFECTIVE ACTION TO A COUNCIL EDP RECOMMENDATION OR DECISION TO GIVE NOTICE

This Section looks at the procedures to be followed once the Council concludes, based on Article 126(8), that a Member State has not taken effective action to its Article 126(7) recommendation. Such conclusion leads to the stepping up of the EDP resulting in a Council decision to give notice under Article 126(9) and the imposition of additional sanctions for euro area Member States and in a revised Article 126(7) recommendation for non-euro area Member States. The only possible exception to this is in the case of a severe economic downturn in the euro area or the EU as a whole. The procedure following a lack of effective action by euro area Member States in response to a notice under Article 126(9), which consists of a stepping up following Article 126(11) with the imposition of sanctions and the issuance of a revised notice under Article 126(9), is also described in this Section.

2.4.1. Issuing a Commission recommendation on a lack of effective action under 126(8)

Where the Commission concludes, following the methodology set out in Section 2.3.2 that effective action has not been taken, it issues a recommendation for a Council decision establishing lack of effective action under Article 126(8). Following an Article 126(8) recommendation the Commission will then issue a recommendation for a Council decision giving notice under Article 126(9) for euro area Member States, or for a new Council recommendation under Article 126(7) for non-euro area Member States.

As part of the follow-up to an Article 126(8) decision, the Commission may undertake surveillance missions (and invite representatives of the European Central Bank, if appropriate) to the Member State

for the purpose of on-site monitoring.([131]) In this case, the Commission will report the findings of its mission to the Council and may use them to inform its assessment of effective action.

2.4.2. Procedures following a lack of effective action in response to a recommendation under Article 126(7): Imposing sanctions to euro area member States and the application of macroeconomic conditionality

Following the Council's adoption of a decision under Article 126(8) establishing a lack of effective action in response to the Article 126(7) recommendations, the Commission shall issue a recommendation for a Council decision requiring the euro area Member State to pay a fine equal to 0.2% of its previous year's GDP. The Commission shall issue its recommendation within 20 days of the Council's adoption of the Article 126(8) decision. The fine will be payable to the Commission and will be assigned to the European Stability Mechanism. If the Member State had already lodged a non-interest bearing deposit (see Section 2.2.4), the latter will be converted into a fine and any difference in the applicable amount will be returned to the Member State or made up by it.

The decision imposing a fine shall be considered adopted, unless the Council decides by a qualified majority to reject the Commission's recommendation within 10 days of the Commission's adoption.

While the default position is for the Commission to ask for a fine equal to 0.2% of the previous year's GDP, the Commission may recommend that the Council reduce the amount or cancel the fine altogether. This can happen on the grounds of exceptional economic circumstances or following the reasoned request by the Member State concerned, addressed to the Commission within 10 days of the Council's adoption of the Article 126(8) decision. Moreover, the Council may also amend the Commission's recommendation for a fine using qualified majority voting and adopt the amended text as a Council decision.

In addition, all Member States, except the United Kingdom, could have a suspension of commitments – or payments – of the European Structural and Investment Funds, following an Article 126(8) decision. For (non-euro area) Member States subject to a second or subsequent Article 126(8) decision, the application of macroeconomic conditionality should involve an increase in suspensions. Box 2.9 explains this macroeconomic conditionality.

Box 2.9: European Funds conditionality in 2014-2020

From 2014, a new regulatory framework has entered into force, which links the economic surveillance procedures to all the European Structural and Investment Funds (ESI) for the first time. Previously, a macro-fiscal conditionality clause existed for the Cohesion Fund since its inception in 1994, linked to the fund original purpose to ensure growth-oriented investment necessary for real convergence while Member States were implementing budgetary consolidation with the aim of meeting the Maastricht criteria.

Since 1 January 2014 the conditionality clause applies to the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund. The extension of the macroeconomic conditionality to all the

([131]) In accordance with Article 10a of amended Regulation 1467/97.

ESI Funds means that it now applies to all Member States, as all Member States are recipients of at least some of these funds.([132]) Non-compliance with specific elements of the SGP can therefore lead to a suspension of funding in addition to the provisions contained in Regulation 1467/97 on the corrective arm and in sanctions Regulation 1173/2011 for euro area Member States. The idea underlying this macroeconomic conditionality is that the effectiveness of cohesion policy should not be undermined by unsound fiscal and macroeconomic policies.

There are two mechanisms for suspending financing under the structural funds. The first is after a lack of effective action by the Member State following a Commission request to review and propose amendments to its Partnership Agreement and relevant programmes ('first strand'). Such a request can be made in order to support reforms addressing Council recommendations under the European Semester or the Excessive Imbalances Procedure, or to maximise the impact of the funds for countries receiving financial assistance.([133]) This mechanism is therefore not directly linked to the quantitative assessments under the SGP, although it is linked to the Country-Specific Recommendations issued under the preventive arm of the SGP. In addition, following the commitment taken at the Statement of 20 December 2013([134]), the Commission adopted a Communication in July 2014([135]) which provides guidelines on how some of the provisions of this first mechanism linking effectiveness of ESI Funds to sound economic governance will be implemented.

The second mechanism ('second strand') is both automatic and directly linked to the corrective arm of the SGP. It provides for suspensions of ESI Funds in the event of non-compliance with specific elements of the EDP, the Excessive Imbalances Procedure and adjustment programmes linked to financial assistance. In terms of the EDP, a Council decision on a lack of effective action under article 126(8) or 126(11) will automatically lead to a Commission proposal for the suspension of part or all of the commitments under the ESI Funds. In the case where immediate action is sought, or where there has been significant non-compliance – the Commission may instead propose a suspension of part or all of the payments rather than commitments.

A Commission proposal on the suspension of commitments is subject to Reverse Qualified Majority Voting (RQMV) in the Council.([136]) It is deemed adopted unless a qualified majority of the Council decides to reject it within one month of its submission. Once adopted, it applies to commitments from 1 January of the forthcoming year. Conversely, a Commission proposal on the suspension of payments is subject to normal qualified majority voting in the Council. Once adopted, it applies to requests for payment submitted after the date of the decision to suspend.

Regulation 1303/2013 sets out specific conditions for both the scope and the level of suspensions that the Commission may propose: the principles of proportionality, equal treatment between Member States and the need to take the economic and social circumstances and the impact of the suspension on the economy of the Member State concerned will have to be taken into account. Annex III of the Regulation provides details on how these conditions should be applied.([137])

For a decision to suspend commitments following a first decision on a lack of effective action under 126(8), the suspension can be at most equal to 50% of the commitments or 0.5% of GDP and applies to

([132])The only exception to this is the United Kingdom, which by virtue of Article 23(13) is exempt from any suspensions of commitments or payments of the Funds, based in particular on Protocol 15 of the TFEU on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland.
([133]) A request to re-programme can only be made between 2015 and 2019.
([134]) Statement by the European Commission on Article 23. OJ C375/2 of 20 December 2013.
([135]) Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions; "Guidelines on the application of the measures linking effectiveness of the European Structural and Investment Funds to sound economic governance according to Article 23 of Regulation 1303/2013", COM (2014) 494 final of 30 July 2014.
([136]) Annex 10 provides more details on voting modalities, including RQMV.
([137]) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2013:375:0002:0004:EN:PDF

the year following the decision to suspend. These limits can increase gradually to 100% of the next year's commitments, following subsequent decisions on a lack of effective action, in line with the seriousness of non-compliance, and to 1% of nominal GDP in the case of persistent non-compliance with the EDP.

The suspensions of commitments or payments should be lifted once the EDP is placed in abeyance or abrogated by the Council. In the case of suspension of commitments, it is the role of the Commission to lift the suspension, without delay. The suspended commitments are then budgeted. In the case of a suspension of payments, a Council decision based on a Commission proposal is necessary.

2.4.3. Procedures following a lack of effective action in response to a notice under Article 126(9): Imposing sanctions to euro area Member States([138])

Where the Commission concludes, following the methodology set out in Section 2.3.2 that effective action has not been taken, it will issue a recommendation for a Council decision establishing a lack of effective action under Article 126(11), which should impose/intensify sanctions. Following an Article 126(11) recommendation the Commission will then issue a new recommendation for a Council decision giving notice under Article 126(9).

The Commission recommendation under Article 126(11) should, as a rule, impose a fine on the Member State. The amount of the fine will comprise a fixed component equal to 0.2% of GDP and a variable component. The variable component should equal 1/10 the absolute value of the difference between the balance as a percentage of GDP in the preceding year and either the reference value for the government balance or, if non-compliance with budgetary discipline includes the debt criterion, the budget balance as a percentage of GDP that should have been achieved that year under the Article 126(9) notice. No fine should exceed 0.5% of GDP, annually. However, fines can be supplemented by other sanctions specified under Article 126(11), namely:

- a requirement for the Member State concerned to make public additional information, to be specified by the Council, before issuing bonds and securities

- an invitation to the European Investment Bank to reconsider its lending policy towards the Member State.

Each year after the imposition of such a fine, the Commission will assess whether the Member State has taken effective action in relation to its Article 126(9) notice and issue a recommendation to the Council to take a decision about effective or a lack of effective action according to the methodology set out in Section 2.3.2. Where the recommendation is for a lack of effective action decision, the Commission will recommend a new decision under Article 126(11) accompanied by a new notice under Article 126(9) and hence the imposition of another fine. Fines should therefore be paid every year until the EDP is placed in abeyance or abrogated. The fines will be assigned to the European Stability Mechanism (as per Article 16 of Regulation 1467/97).

In addition, the application of macroeconomic conditionality linked to the European Structural and Investment Funds should be widened, as set out in Box 2.9. With each decision on a lack of effective action, the Commission will recommend an increase in suspensions.

([138]) Article 139(2) of the TFEU specify that the provisions of Articles 126(9) and 126(11) apply to those Member States whose currency is the euro.

2.5. ABROGATION OF THE EDP

The conditions for abrogating the EDP([139]) are included in the Code of Conduct on the SGP. In particular, abrogation should be based on notified (i.e. observed) data and the EDP should only be abrogated if the correction of the excessive deficit will be lasting and the debt will be compliant with the debt benchmark in its forward-looking specification. Therefore, an EDP can only be abrogated if both criteria – deficit and debt – are projected to be met on the basis of the Commission forecast.([140])

For the deficit criterion, compliance with the nominal requirement is absolute, apart from the possibility to take into account the cost of pension reforms as set out in Box 2.4. Irrespective of the structural effort implemented, a "lasting correction" is deemed achieved if:

(i) the notified data for the previous year show a deficit below 3% of GDP or a deficit close to 3% of GDP that has declined substantially and continuously and where the excess over the 3% threshold is fully explained by the net cost of the implementation of a multi-pillar pension system that includes a mandatory, fully funded pillar;

and

(ii) the Commission forecasts indicate that the deficit will not exceed the 3% of GDP reference value over the forecast horizon on a no-policy change basis (see Box 1.5) or where the excess over the 3% threshold is fully explained by the net cost of the implementation of a multi-pillar pension system that includes a mandatory, fully funded pillar.

It should be noted that as abrogation takes place on the basis of achievement of the nominal targets, apart from the special case of pension reforms, the impact of one-off and temporary measures (including financial sector interventions) is not netted out of the figures considered, as it is in assessing effective action based on the calculation of the structural balance.

For the debt criterion, the requirement is as follows:

(i) the notified debt is below 60% of GDP and it is expected to remain so based on the Commission forecast.

or,

(ii) the debt is above 60% of GDP but the forward-looking element of the debt benchmark assessed for the year t+2 is met, based on the Commission forecast (on a no-policy change basis).

It is worth emphasising that the need to respect both criteria implies that an EDP cannot be abrogated if the forward-looking debt benchmark is not complied with, even if the deficit is below 3% of GDP, irrespective of whether the EDP was opened on the basis of deficit criterion, debt criterion or both.

Table 2.2 details possible cases in which an EDP abrogation can be considered, in relation to the fulfilment of the forward-looking element of the debt benchmark, for a deficit- or a debt-based EDP. One point deserves attention. When the forward-looking element of the debt benchmark is fulfilled, Member

([139]) An excessive deficit may be deficit and/or debt based as indicated in section 2.2.1.
([140]) It should be noted that the provision for a transition period for the debt benchmark means that the EDPs that were open in November 2011, should be abrogated on the basis of the deficit criterion only.

States are assessed according to the position of their general government deficit vis-à-vis the 3% of GDP Treaty reference value. However, when the forward-looking element of the debt benchmark is not fulfilled, Member States are assessed according to the position of their general government deficit vis-à-vis the target set in the recommendation for the final year: this can lead to a revised recommendation or to a stepping-up of the procedure (along with revised recommendation).

The difference stems from the fact that, if the debt has achieved a path consistent with the forward-looking element of the debt benchmark on the basis of the Commission forecast under a no-policy change assumption, there is no particular reason to require a further adjustment, provided the general government deficit is below the 3% of GDP Treaty reference value over the Commission forecast horizon. However, if the forward-looking element of the debt benchmark has not been complied with by the deadline, the above argument does not hold and the reference for the assessment of the general government deficit is no longer the 3% of GDP Treaty reference value, but the specific value set in the recommendation.

Table 2.2 also confirms that this approach secures full consistency between EDPs opened on the basis of debt and deficit criteria.

Following the abrogation of the EDP, a Member State that had lodged a non-interest bearing deposit should have the deposit returned to it. The Council (on a Commission recommendation) will also abrogate all outstanding sanctions, but any fines imposed will not be reimbursed. The suspensions of commitments or payments due to the macroeconomic conditionality condition of the European Structural and Investment Funds should also be lifted once the EDP is abrogated by the Council. In the case of suspension of commitments, it is the role of the Commission to lift the suspension, without delay. The suspended commitments are then budgeted. In the case of a suspension of payments, a Council decision based on a Commission proposal is necessary.

Table 2.2: **Decision matrix for the abrogation of deficit-based and debt-based EDPs, depending on the fulfilment of the forward-looking element of the debt benchmark**

	Forward-looking element of the debt benchmark					
	Fulfilled			Not fulfilled		
	General government deficit			**General government deficit**		
	Below 3% in actual data and over the forecast horizon	Above 3% in actual data or over the forecast horizon		Below the nominal target set for the final year and below 3% over the forecast horizon	Above the nominal target set for the final year (possibly < 3%) or above 3% over the forecast horizon	
		Assessment of effective action			**Assessment of effective action**	
		Positive	*Negative*		*Positive*	*Negative*
Deficit-based EDP	abrogation	revised recommendation	revised recommendation and stepping-up	revised recommendation	revised recommendation	revised recommendation and stepping-up
Debt-based EDP	abrogation	revised recommendation	revised recommendation and stepping-up	revised recommendation	revised recommendation	revised recommendation and stepping-up

3. THE INSTITUTIONAL CONTEXT OF BUDGETARY SURVEILLANCE LINKED TO THE STABILITY AND GROWTH PACT (SGP)

This Part focuses on the institutional context and is divided into two Sections. Section 3.1 considers the institutional dimension of the European side of budgetary surveillance, placing the SGP (with a special focus on the Draft Budgetary Plans) in the context of not just budgetary but also wider economic surveillance. Section 3.2 discusses the obligations on Member States in terms of their own budgetary processes, stemming from the Six Pack, the Two Pack, and the Fiscal Compact established by the inter-governmental Treaty for Stability Coordination and Governance in the Economic and Monetary Union (TSCG).

3.1. THE CYCLE OF INTEGRATED BUDGETARY AND ECONOMIC SURVEILLANCE

Between its adoption in 1997 and the start of the economic crisis in 2008, the SGP was amended once, in 2005. The onset of the crisis prompted an all-encompassing reform of the EU economic governance structure with the institution of the European Semester and the entry into force of the so-called Six Pack and Two Pack legislative packages (as set out in Graph 0.1 in the Introduction Section). Outside of the EU framework, the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), which includes the Fiscal Compact, was signed by 25 of the then 27 EU Member States.([141]) The 2005 reform focussed on strengthening the economic rationale of the SGP while remaining strictly within the original framework. The reforms that followed branched out into new directions, increasing the interrelations between fiscal, macroeconomic and structural policy surveillance and completing the cycle of surveillance by reinforcing the links between the preventive and the corrective arms of the Pact and introducing requirements on Member States' national fiscal rules and frameworks that are central to the attainment of European goals.

3.1.1. The integration of the preventive and the corrective arms and the annual cycle of monitoring

At its inception the SGP envisaged that compliance with the preventive arm of the Pact would be assessed once a year on the basis of the Member States SCPs and in the corrective arm compliance would be assessed on an ad hoc basis depending on the timing of the opening of the EDP. Fiscal targets were originally set in nominal terms both in the preventive and in the corrective arm of the Pact. Once a Member State deficit came in below 3% a Member State was considered to have corrected its excessive deficit, remaining then subject to the preventive arm's requirement of progress towards a budgetary position of close to balance or in surplus. The requirements under both arms were brought closer together with the 2005 reform of the SGP, by which Member States were requested to deliver a determined fiscal effort – measured by the improvement of the structural balance – so as to ensure either a correction of its excessive deficit when in the corrective arm or the attainment of a medium-term objective (MTO) expressed in structural terms in the preventive arm.

The interlinkages between the preventive and the corrective arm of the SGP were further reinforced with the 2011 reform of the SGP – the so-called Six Pack. Compliance with the preventive and corrective arms

([141]) Croatia joined the EU on 1 July 2013.

is now subject to continuous monitoring. The experience of the crisis highlighted the crucial importance of ensuring strong underlying public finances during good economic times. The Commission forecasts (see Box 1.5), which are issued three times a year – winter, spring and autumn –, constitute the key milestones for these regular fiscal assessments. For Member States in the corrective arm, should the Commission assessment conclude on non-compliance with the SGP requirements, this would lead to a stepping up of the EDP together with the issuance of revised recommendations or notice and likely financial sanctions for euro area countries (Section 2.4). For Member States under the preventive arm, a significant deviation from the adjustment path towards the MTO would trigger ex post a procedure for the correction of the significant deviation (Significant Deviation Procedure, as described in Section 1.4), while a breach of the deficit or debt criteria could lead to an EDP being launched (Section 2.2). Furthermore, Regulation (EU) 1173/2011 *on the effective enforcement of budgetary surveillance in the euro area* states that for Member States having placed an interest-bearing deposit under the preventive arm, the latter is automatically turned into a non-interest-bearing deposit with the start of an EDP. Thus, linking non-compliance with the preventive arm to the sanctions system under the corrective arm.

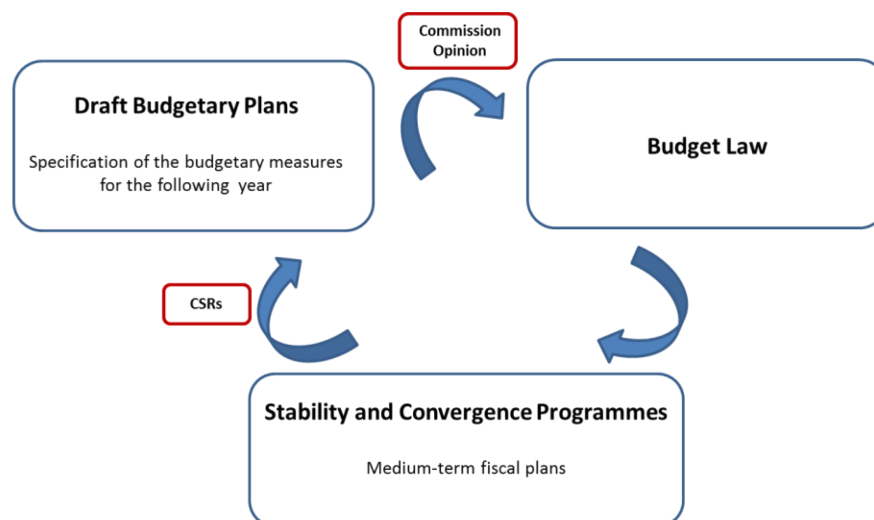
With the entry into force of the Two Pack in May 2013, the regular surveillance processes become formalised for euro area Member States. Regulation (EU) 473/2013 sets a common budgetary timeline, according to which all euro area Member States must prepare and make public their draft budget([142]) for the forthcoming year by 15 October. By that date all euro area Member States – except those under a macroeconomic adjustment programme – must transmit a Draft Budgetary Plan (DBP) for the next year to the Commission and the Eurogroup.

The Commission then assesses the DBPs for (ex ante) compliance with the Member State's obligations under the SGP, covering both the preventive and corrective arms of the Pact, as appropriate for each Member State. The methodology and the rationale used for the assessment of compliance of the DBPs is the same that applies to the assessment of the Stability and Convergence Programmes (SCPs) in spring, as outlined in Section 1.3.2.

The resulting annual cycle of surveillance, which applies across both arms of the Pact for the euro area, is shown in Graph 3.1. The assessment of the SCPs occurs alongside the publication of the Commission spring forecasts, while the Commission opinion on the DBPs is issued alongside the Commission autumn forecasts. On the basis of the Commission winter forecasts, which are usually published around February, the Commission also checks whether Member States took into account the Commission Opinion on their DBP. Furthermore, the Commission can issue an autonomous recommendation when appropriate. All in all, the Two-Pack addresses the need for stronger surveillance mechanisms in the euro area given the higher potential for spillover effects of budgetary policies in the common currency area.

([142]) For central government and the main parameters for the other subsectors of the general government

Graph 3.1: **The annual cycle of surveillance for the euro area**



3.1.1.1 The Draft Budgetary Plans for the euro area

With the entry into force of the Regulation (EU) 473/2013 in May 2013, euro area Member States must submit their Draft Budgetary Plans (DBPs) by the 15 October every year.

According to the Code of Conduct on the Two Pack,([143]) if a Member State is ruled by a government not enjoying full budgetary powers according to the national constitutional rules and/or conventions at the time when the draft budget law should be submitted to the national parliament (e.g. caretaker government; end-of mandate government in reason of upcoming national elections), the incoming government should submit an updated draft budgetary plan to the Commission and to the Eurogroup once it takes office. This is without prejudice to the obligation of submitting a DBP by 15 October, as per Article 6(1) of Regulation 473/2013.([144]) The Code of Conduct provisions are meant at preserving the Two-Pack spirit of enhanced budgetary cooperation, which aims at equipping the debate in the National Parliament with an independent Opinion from the Commission before the final approval of the budget, while allowing for the flexibility needed to cover different national processes and situations. The submission of the updated draft budgetary plan should as a rule take place at least one month before the draft budget law is planned to be adopted by the national parliament, except where this would prove not feasible due to the country specific parliamentary approval calendar. In the latter case, the submission should still take place in time to allow the Commission to adopt an informed opinion on the DBP and the Eurogroup to hold a proper discussion well before the draft budget law is planned to be adopted by the national parliament.

The DBPs translate the SCP plans into concrete and detailed macro-fiscal projections and measures for the forthcoming year. They are synthetic documents that present the actual measures that the government is placing before national Parliament. In line with the requirements on the SCPs for euro area Member States, the DBPs should also be based on independently produced or endorsed macroeconomic forecasts.

([143]) http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf
([144]) In this context, it can be considered a best practice to submit a DBP under the no-policy-change assumptions.

The DBPs are then examined by the Commission to check their compliance with the SGP requirements and the fiscal Country-Specific Recommendations issued under the European Semester. Section 3.1.1.2 describes the relevant requirements. Then, as detailed in Section 3.1.1.3, the Commission issues an Opinion on each plan by the latest on 30 November – which is meant to allow changes to be made to the draft budget before its adoption.

3.1.1.2 Assessing compliance with the reporting requirement for the Draft Budgetary Plans

The content of the DBPs must comply with Regulation 473/2013 and the Code of Conduct on the Two Pack([145]), which sets out guidelines on their content and format. Member States are expected to follow these guidelines, and to justify any departure from them. In order to facilitate comparisons across countries, Member States are expected, as far as possible, to follow the model structure for the plans presented in the Code of Conduct on the Two Pack, summarising quantitative information in a standardised set of tables. This standardisation of the format and content of the plans should ensure equality of treatment. The tables to be supplied are replicated in Annex 12. The DBPs should show whether the draft budget is consistent with the SGP.

Economic and budgetary forecasts and plans

The DBPs contains projections for the main variables relative to government finances as well as their relevant components, including a detailed description of the discretionary measures included in the draft budget.

They should provide detailed information on the underlying macroeconomic scenario in order to allow their fiscal information to be assessed in the appropriate context. Crucially, since the entry into force of the Two Pack, national budgets – and consequently draft budgetary plans – should be based on macroeconomic forecasts either produced or endorsed by an independent body. From the fiscal side, they should contain general government budgetary targets broken down by subsector along with detailed information on the general government debt. These overall figures allow an assessment of compliance of the overall strategy with the SGP. General government expenditure and revenue projections should be given both at unchanged policy (explaining the assumptions, methodologies and relevant parameters) and in terms of targets along with a description of the discretionary measures taken by the central government (and other subsectors of the general government, where possible) that will bridge the gap between the targets and the unchanged policy figures, in order to assess possible risks associated to the attainment of such targets. The discretionary measures should be presented in terms of an exhaustive technical description of the measures taken by all sub-sectors, along with information concerning the motivation, design and implementation of the measures. The time profile of measures should be given in such a way as to distinguish between measures with a transitory budgetary effect that does not lead to sustained change in the inter-temporal budgetary position and those that have a permanent impact.

In addition to these data, the DBPs should also indicate whether the budgetary targets for the forthcoming year are consistent with the Member State's obligations under the SGP and other surveillance procedures. A description and indication of how the discretionary measures in the draft budget contribute to the attainment of the Country-Specific Recommendations or the national targets in accordance with the Union's strategy for growth and jobs should be given.

([145]) http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf

The DBPs should also contain a comparison of the general government net lending/borrowing figures both overall and on unchanged policies with the figures presented in the Stability Programme and distributional assessment of the main measures should also be given, where possible. The methodology, economic models and assumptions underpinning the information contained in the draft budgetary plans should be set out.

As the aim of the DBPs should be to assess whether the forthcoming budget is consistent with the common European fiscal rules and to inform the national budgetary debate, the DBPs contain data for the year that is ending and the forthcoming year.

Quality of the data

The figures presented must be based on realistic and cautious macroeconomic forecasts, that have been produced or endorsed by and independent body – Section 3.2.2 provides more details. There is also a requirement for Member States to indicate whether their budgetary forecasts have been produced or endorsed by an independent body.

The data used should be in line with the standards established at European level, in particular in the context of the European system of accounts (ESA) as set out in *Regulation (EU) 549/2013 of the European Parliament and of the Council of 21 May 2013* as of September 2014. Moreover, the forecasts presented should be prepared in a manner that is consistent with the requirements of the *Council Directive 2011/85/EU of the 8 November 2011 on requirements for budgetary frameworks of the Member States*.

3.1.1.3 Preparing the Commission opinion on the Draft Budgetary Plans

The Commission must issue an opinion on each DBP as soon as possible after its submission and at the latest by the 30 November. At the outset, it is important to realise that the assessment is done in two stages: (i) taking the DBP targets at face value after recalculating the structural balance based on the commonly agreed methodology([146]), in order to detect possible deliberate deviations from the requirements, and (ii) taking into account the risks attached to the DBP scenario, as embodied in, for instance, the most recent Commission forecasts.

The opinion will either indicate a positive assessment of the plan or will point out the underlying risks which could stem from the implementation of the plan for the forthcoming year. The Opinion will be based on the adequacy and likely impact of the discretionary measures included in the draft budget in meeting the Member State's obligation with respect to the SGP.

Unlike the Country-Specific Recommendations under the European Semester, the Opinions on the DBPs are adopted by the Commission instead of the Council. Once adopted, these opinions will be made public and presented to the Eurogroup, alongside a Commission assessment of the overall budgetary situation and prospects in the euro area as a whole. This assessment may outline measures to reinforce the coordination of budgetary and macroeconomic policy at the euro area. Furthermore, the Commission should present its Opinion to the national Parliament of the Member State concerned at its request, after it has been made public. The opinion will serve as an additional element to be taken into account as a

([146]) For more details, see "The production function methodology for calculating potential growth rates and output gaps", European Economy, Economic Papers No. 535, November 2014. This is implemented by the Commission services through the CONV simplified routine to recalculate the potential GDP/output gap submitted by the Member States in their plans.

relevant factor in any subsequent steps under the SGP, especially where an excessive deficit materialises, following risks identified in the opinion not being addressed by the Member State.

In the case of particularly serious non-compliance with the SGP, an Opinion will be adopted requesting submission of a new plan according to the timetable set out in Table 3.1. In such cases, the Commission must consult the Member State within one week of receiving the DBP and will then adopt its Opinion requesting a new plan within two weeks of the submission of the DBP. According to the Code of Conduct on the Two Pack, if as a result of the consultation process the concerned Member State decides to modify the draft budget, notably through additional measures, to avoid being issued a negative opinion, the changes to the DBP should be publicly announced and ideally embedded, if feasible, in an updated DBP before the expiry of the two weeks deadline for the adoption of an opinion requesting a new DBP.

In general, a revised draft budgetary plan should be submitted as soon as possible and in any event within three weeks of the date of the Opinion requesting the revision. Following the submission of the revised plan, the Commission will issue a new Opinion within three weeks of its receipt. This tight time schedule has been adopted to enable the Member State to submit a new draft plan and receive the Opinion on the new draft plan in view of the adoption of the budget law by the national Parliament before the end of the year.

Table 3.1: **Process for the autumn assessment of DBPs**

Deadline	Actor	Action
15 October	Member States	Submission of the DBP to the Commission and the Eurogroup
End-November at the latest	***Commission***	Adopts an Opinion on each DBP
If Commission detects particularly serious non-compliance with SGP obligations in a DBP		
1 week of submission	Commission	Consults the Member State concerned
2 weeks of submission	Commission	Adopts a negative Opinion requesting a revised DBP to be submitted within 3 weeks
3 weeks of the date of Commission's Opinion at the latest	Member State concerned	Submits a revised DBP
3 weeks of submission of revised DBP at the latest	Commission	Adopts a new Opinion on revised DBP

According to Code of Conduct on the Two Pack, 'particularly serious non-compliance' could be found in the cases described below. These examples are non-exhaustive. Therefore, there may be other circumstances which represent a serious risk of non-compliance with the SGP and trigger a Commission Opinion requesting the submission of a new DBP:

- if an obvious breach of the Treaty deficit or debt criteria would follow from the implementation of the DBP;

- for Member States in the preventive arm of the SGP, if the fiscal effort envisaged in the DBP falls clearly short of the fiscal effort recommended by the Council in accordance existing Council recommendation issued in accordance with Article 121(4) of the TFEU;
- for Member States in the corrective arm of the SGP, if the fiscal effort envisaged in the DBP falls clearly short of the recommended fiscal effort by the Council in accordance with Article 126(7) or 126(9) TFEU;
- where the implementation of the initial budgetary plan would put at risk the financial stability of the Member State concerned or would risk jeopardizing the proper functioning of the economic and monetary union.

3.1.2. The wider EU's annual cycle of economic surveillance

3.1.2.1 The main steps of the European Semester

Since the introduction of the European Semester in 2010, the surveillance of budgetary and economic policies takes place over the first six months of every year.

The entry into force of the Six Pack continued along this road of integration of economic governance. The role of the European Semester was codified in the newly amended Regulation (EC) 1466/97 on the preventive arm of the Pact, placing the submission and assessment of the SCPs within its context. It also introduced the Macroeconomic Imbalances Procedure (MIP), which is also conducted under the auspices of the European Semester.

The European Semester is launched each year with the presentation of the Annual Growth Survey (AGS) by the Commission at the end of the previous year. In this document, the Commission presents its assessment of the economic situation in the European Union and sets out its priorities for the coming year in terms of the economic and budgetary policies and reforms to boost growth and employment. At the same time, the Commission produces the recommendations for the Euro area. This common timing reflects common challenges of the Euro area ahead of country specific discussions. In addition, an Alert Mechanism Report (AMR) is published under the macroeconomic of imbalances procedure (MIP), to identify which countries deserve closer attention through in-depth reviews that are integrated in country reports. At the end of February, the Commission releases the Country Reports (Staff Working documents). The Country Reports analyse Member States' economic and social developments. They identify key macroeconomic and structural challenges and assess progress in advancing reforms. They also analyse more specifically the existence and the extent of possible macroeconomic imbalances for those Member States which have been selected as requiring an In-Depth Review in the Alert Mechanism Report, which is published in the context of the MIP.

The March European Council reports on its conclusions on the discussion of the AGS and issues general policy guidance for Member States. Following the adoption of the European Council conclusions, Member States submit their SCPs in April, preferably by mid-April and not later than 30 April to the Commission and the Council. These outline the public finance plans of Member States([147]) and are submitted alongside the National Reform Programmes (NRPs), which outline economic plans and report on progress made over the past year.

([147]) The SCPs are also the vehicle through which Member State can apply for the use of the structural reform clause or the investment clause under the preventive arm of the SGP (see annex 3).

Based on the Country Reports and upon examining the SCPs and NRPs the Commission proposes country-specific recommendations in the relevant policy areas. The Commission proposal includes its opinion for relevant Member States (all except Member States subject to a macroeconomic adjustment programme) on their Stability or Convergence Programme.

Based on the Commission's proposals, the ECOFIN Council then adopts the country specific recommendations. The Council opinions on each Member State's Stability or Convergence Programme are usually reflected in the recitals and the recommendation n°1 of the Country Specific Recommendations. The recommendations for each Member State are discussed and are endorsed by the European Council in June before being adopted by the ECOFIN, which concludes the European Semester. In line with Article 2-ab of Regulation (EC) 1466/97 the Council is "expected to, as a rule, follow the recommendations and proposals of the Commission or explain its position publicly". This is known as the "comply or explain" principle and is not just confined to the European Semester. It creates a strong presumption in favour of the Council's opinion following the Commission's line, unless any divergence from it can be backed up by strong public explanations.

In addition to the documents submitted directly to the Commission and the Council, euro area Member States must also make public their national medium-term fiscal plans in the context of the European Semester. The national medium-term fiscal plans must contain at least all the information contained in the Stability Programmes and must be consistent with the framework for economic policy coordination in the context of the annual cycle surveillance, including the policy guidance issued at the beginning of the cycle and with recommendations issued under the SGP, the European Semester and the opinions on the Economic Partnership Programmes.

Box 3.1: Euro area countries experiencing financial difficulties – a lightening of the budgetary surveillance obligations under the Two Pack for countries under a macroeconomic adjustment programme

Regulation (EU) 472/2013 of the Two Pack, which entered into force in May 2013, provides a framework for the surveillance of euro area Member States experiencing or threatened with serious difficulties with respect to their financial stability. In doing so, it sets out the conditions under which countries can be placed under enhanced surveillance and the obligations that then apply to them, as well as the general framework within which the surveillance of countries under a macroeconomic adjustment programme will take place. In order to avoid overburdening countries through a replication of surveillance and monitoring exercises, the Regulation streamlines the requirements of the SGP for countries under a macroeconomic adjustment programme.

In this way, euro area Member States that are under a macroeconomic adjustment programme are:

- exempt from submitting a Stability Programme, as the content that would form the Stability Programme should be integrated in the macroeconomic adjustment programme. In addition, such Member States are exempt from the general monitoring and assessments under the European Semester.
- exempt from submitting the reports on action taken for the first assessment after the issuance of the Article 126(7) recommendations or notice under Article 126(9) when under EDP, and from the regular monitoring envisaged by the EDP Regulation 1467/97
- exempt from the enhanced regular surveillance when under EDP, as set up by the Two Pack, from the submission of an EPP when placed under EDP and from ad hoc information requests as part of their EDP
- exempt from the submission of their Draft Budgetary Plans in the autumn.

3.1.2.2 Introducing concepts of structural policy into the SGP: the role of the Economic Partnership Programmes (EPPs)

The institution of the European Semester and integration of the Macroeconomic Imbalances Procedure (MIP) within it were a clear indication of the decision to treat economic and budgetary policy in a more unified manner, taking their interactions and interdependencies into account. The TSCG built on this through a commitment for signatories placed under EDP to "put in place a budgetary and economic partnership programme (EPP) including a detailed description of the structural reforms which must be put in place and implemented to ensure an effective and durable correction of its excessive deficit." This commitment was subsequently put within the EU framework in Regulation (EU) 473/2013 of the Two Pack, which requires the submission of an EPP for all euro area Member States entering EDP.

The introduction of EPPs is based on the fact that excessive public deficits may be rooted – at least in part – in structural weaknesses. If these weaknesses are not directly addressed, budgetary measures may be insufficient to produce a lasting correction of the deficit. Instead, addressing the underlying weaknesses is likely to be effective and more efficient from an economic point of view, over the medium and longer terms. The role of the EPP is to act as a roadmap for the fiscal structural reforms which Member States consider to be necessary to ensure the efficient and lasting correction of their excessive deficit and thus, they serve to complement the budgetary measures taken over the course of an EDP with a wider strategy aimed at avoiding the occurrence of excessive deficits. According to the Code of Conduct on the Two Pack, the EPPs should identify specific priorities enhancing competitiveness and long-term sustainable growth and addressing its structural weaknesses. In particular, EPPs should detail the main fiscal structural reforms, such as those referring to taxation, pension, health systems and budgetary frameworks that will be instrumental to correct the excessive deficit in a lasting manner. Where appropriate, the EPPs should also identify the potential financial needs and resources.

The EPPs are drawn up by national authorities and submitted at the time of the report on action taken, following the opening of the EDP and the issuance of a Council recommendation under Article 126(7) of the Treaty. In drawing up its EPP, the Member State should base its approach on the existing surveillance instruments, such as the Country-Specific Recommendations issued on the basis of the Stability Programme and the National Reform Programmes, in order to identify the set of fiscal structural reforms and priorities that will best underpin a lasting correction of its deficit. As a general guide, the relevant CSRs might be those referring to taxation, social security and health systems and budgetary frameworks. The EPP should therefore act as a continuation and intensification of the coordination between budgetary and structural policies which takes place under the European Semester.

Countries under the corrective arm of the MIP – known as the Excessive Imbalances Procedure (EIP) – will already have drawn up a comprehensive roadmap of reforms when entering the EIP, known as the Corrective Action Plan (CAP). As it would make little sense from the point of view of policy coherence to add another policy document on structural reforms, countries already under the EIP are not asked to submit an EPP. Instead their pre-existing CAP can be amended to ensure that there is sufficient focus on measures that can underpin healthy public finances.

Similarly, the link between the EPP and the CAP is recognised for countries under the EIP once they are under EDP and have submitted and EPP. In these cases, the EPP should be incorporated in the new CAP, which then takes precedence in the monitoring.

The EPP will be submitted at the time of the report on action taken, after the opening of an EDP. In this way, it will be assessed at the same time as the report on action taken, usually six months after adoption of the Council recommendations under Article 126(7). The EPP should be a one-off document detailing

the policy priorities and the fiscal structural strategy over time. As such, after its first assessment, its implementation should be monitored through the European Semester framework.

The Commission will issue a proposal for a Council opinion on the EPP issued at the same time as the Commission assessment of the action taken in response to the Article 126(7) recommendations. In order to continue in the spirit of integration of various aspects of economic policy and to reduce the monitoring burden, the monitoring of EPPs' implementation will be based on Member States reporting in National Reform Programmes and/or the Stability Programme, as appropriate, within the context of the European Semester.

3.2. NATIONAL BUDGETARY PROCESSES AND THE SGP

While the European dimension of budgetary policy is set through overarching fiscal rules and associated sanctions, the detailed contour and implementation of budgetary choices remain the competence of the Member States. However, the Six-pack set of reforms has brought about a shift in the approach by which Member States conduct fiscal policy domestically. Starting in 2011 with the directive on national budgetary frameworks,([148]) a series of legislative acts has set seminal requirements on Member States' budgetary policy arrangements. These reforms recognise the major impact that national arrangements – including fiscal rules and budgetary actors and processes – can have on the ability of EU countries to fulfil their obligations with respect to the SGP and deliver prudent and appropriate fiscal policy over the years.

Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States set out minimum standards that Member States have to comply with in terms of their national budgetary framework, which is defined as comprising the arrangements, procedures, rules and institutions that underlie the conduct of budgetary policies. It establishes requirements on fiscal statistics and accounting, on the preparation of macroeconomic and budgetary forecasts, the setting up and monitoring of fiscal rules, the medium-term budgetary planning, and the transparency of general government finances. The choice of a directive – rather than a regulation as for the other five pieces of legislation making up the Six Pack – was made to reflect the diversity of the Member States' budgetary arrangements and in recognition of the fact that there is more than one way to ensure that national budgetary frameworks are able to deliver the desired results, but that countries can choose the most appropriate set-up given their own specific situation. The directive set a deadline of 31 December 2013 for Member States to ensure that all the requirements were in place. Within its competence of checking the application of EU law, the Commission is currently analysing the transposition of directive provisions across the Member States.

By specifying that compliance with national fiscal rules should be overseen by an independent body or one with functional autonomy with respect to the fiscal authorities, the directive was the first piece of EU legislation giving a role to independent bodies in fiscal policy matters. Following on the heels of the directive, the Treaty for Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) committed its signatories bound by the Fiscal Compact chapter([149]) to introducing a balanced-budget rule in structural terms – defined essentially as a country attaining its MTO – into their national law, with independent bodies being tasked with monitoring compliance with this rule.

Regulation (EU) 473/2013 incorporated a large part of the TSCG requirements in the EU framework. Specifically, it legislated for the setting up of independent bodies to be involved in the budgetary process

([148]) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32011L0085:EN:NOT
([149]) All 19 euro area Member States and 3 non-euro area countries (Bulgaria, Denmark and Romania).

– through the preparation or endorsement of forecasts and the monitoring of national fiscal rules (including in particular those incorporating the MTO in the national budgetary processes). Section 3.2.1 considers the requirement of translating the MTO into national fiscal rules and Section 3.2.2 considers the role of independent bodies, in more detail.

3.2.1 National balanced-budget rules and the MTO

The TSCG commits its signatories bound by the Fiscal Compact to incorporating the medium-term budgetary objective (MTO) and the adjustment path towards it, into national law through "provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the budgetary process." In addition, they should also put in place correction mechanisms to be triggered automatically in the event of significant deviations from the MTO or the adjustment path towards it, which should include an obligation for the Member State to implement measures to correct the deviations over a defined period of time. In this sense, the TSCG adds a national layer to European commitments, requiring Member States to integrate the requirements of the preventive arm of the SGP in the national legislation. The TSCG sets a deadline of 31 December 2013 for this to occur.

The requirement to incorporate the MTO and the adjustment path towards it into national law aims to ensure that compliance with the MTO is at the heart of the budgetary decisions taken by national governments. The TSCG follows the specifications of the SGP in defining the MTO, including the requirement that compliance with the MTO be judged on the basis of the structural balance and the expenditure benchmark and that a temporary deviation from the MTO or the adjustment path towards it can be permitted in exceptional circumstances (known as the escape clause, as defined in the SGP). Importantly, it goes beyond the SGP by stipulating a tighter lower bound of -0.5% of GDP – compared to -1% of GDP in the SGP for euro area Member States – for all countries except those with debt significantly below 60% of GDP and where risks in terms of long-term sustainability of public finances are low, for which the lower bound is set at -1% of GDP. Given the methodology to set the minimum MTO (as set out in Section 1.2.1.1), there should be no contradiction between the SGP and the TSCG requirements in most cases.

The TSCG tasked the European Commission with proposing "common principles" underlying the design of the requested corrective mechanisms. The Commission's Communication on *Common principles for the national correction mechanisms* was published on 20 June 2012([150]) and the principles it presents are given in Box 3.2.

In addition, the TSCG called for independent bodies to be put in place to monitor compliance with the national balanced-budget rules incorporating the MTO requirement and the operation of the related national correction mechanism. This requirement has also been incorporated into EU law via the Two Pack and Section 3.2.2 provides more details on the role and structure of such bodies.

Box 3.2: **COMMON PRINCIPLES FOR THE NATIONAL CORRECTION MECHANISMS**

The common principles presented in the Commission's Communication of 20/6/2012 are:

([150]) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0342:FIN:EN:PDF.

(1) Legal status: The correction mechanism shall be enshrined in national law 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 mechanism shall fully respect the prerogatives of national Parliaments.

(2) Consistency with EU framework: National correction mechanisms shall rely closely on the concepts and rules of the European fiscal framework. This applies in particular to the notion of a 'significant deviation' and the definition of possible escape clauses. The correction, in terms of size and timeline, shall be made consistent with possible recommendations addressed to the concerned Member State under the Stability and Growth Pact.

(3) Activation: The activation of the correction mechanism shall occur in well-defined circumstances characterising a significant deviation from the medium-term objective (MTO) or the adjustment path towards it. The activation triggers may comprise EU-driven or country-specific criteria, to the extent that they meet the above condition. Subject to the same condition, both ex ante mechanisms that set budgetary objectives preventing the materialisation of deviations and ex post mechanisms that trigger corrections in reaction to prior deviations, may fulfil the requirements.

(4) Nature of the correction: The size and timeline of the correction shall be framed by predetermined rules. Larger deviations from the medium-term objective or the adjustment path towards it shall lead to larger corrections. Restoring the structural balance at or above the MTO within the planned deadline and maintaining it there afterwards, shall provide the reference point for the correction mechanism. The correction mechanism shall ensure adherence to critical fiscal targets as set before the occurrence of the significant deviation, thereby preventing any lasting departure from overall fiscal objectives as planned before the occurrence of the significant deviation. At the onset of the correction Member States shall adopt a corrective plan that shall be binding over the budgets covered by the correction period.

(5) Operational instruments: The correction mechanism may give a prominent operational role to rules on public expenditure and discretionary tax measures, including in activating the mechanism and implementing the correction, to the extent that these rules are consistent with attainment of the MTO and the adjustment path towards it. The design of the correction mechanism shall consider provisions as regards, in the event of activation, the coordination of fiscal adjustments across some or all sub-sectors of general government

(6) Escape clauses: The definition of possible escape clauses shall adhere to the notion of 'exceptional circumstances' as agreed in the Stability and Growth Pact. This would include an unusual event outside the control of the concerned Member State with a major impact on the financial position of the general government, or periods of severe economic downturn as defined in the Stability and Growth Pact, including at the level of the euro area. The suspension of the correction mechanism in the event of an escape clause shall be on a temporary basis. The correction mechanism shall foresee a minimum pace of structural adjustment once out of the escape clause, with the requirement from the Stability and Growth Pact a lower limit. When exiting the escape clause, Member States shall adopt a corrective plan that shall be binding over the budgets covered by the correction period.

(7) Independent bodies or bodies with functional autonomy acting as monitoring institutions: They shall support the credibility and transparency of the correction mechanism. These institutions would provide public assessments over: the occurrence of circumstances warranting the activation of the correction mechanism; of whether the correction is proceeding in accordance with national rules and plans; and over the occurrence of circumstances for triggering, extending and exiting escape clauses. The concerned Member State shall be obliged to comply with, or alternatively explain publicly why they are not following the assessments of these bodies. The design of the above bodies shall take into account the

already existing institutional setting and the country-specific administrative structure. National legal provisions ensuring a high degree of functional autonomy shall underpin the above bodies, including: i) a statutory regime grounded in law; ii) freedom from interference, whereby the above bodies shall not take instructions, and shall be in a capacity to communicate publicly in a timely manner; iii) nomination procedures based on experience and competence; iv) adequacy of resources and appropriate access to information to carry out the given mandate.

3.2.2 The role of independent bodies in the national budgetary processes

3.2.2.1 The mandates of the independent bodies

Building on the Council Directive 2011/85/EU on requirements for national budgetary frameworks and on the intergovernmental TSCG, Regulation (EU) 473/2013 gives independent bodies two key roles in euro area Member States. Independent bodies should be in place to:

- monitor compliance with numerical fiscal rules, including those incorporating the MTO into the national budgetary process. The independent bodies will provide public assessments with respect to the national fiscal rules, including with respect to the activation and operation of the national correction mechanism and the escape clauses;

- prepare or endorse the macroeconomic forecasts (and, if so chosen by the Member State, the budgetary forecasts) underlying the national medium-term fiscal plans (which may be the SCPs themselves) and the draft budgets.

The Regulation leaves open the possibility that these two functions could be served by two – or even more – independent bodies, provided they fulfil requirements attesting to their independence. The Regulation defines independent bodies as bodies that are structurally independent or bodies endowed with functional autonomy vis-à-vis the budgetary authorities of the Member State, and which are underpinned by national legal provisions ensuring a high degree of functional autonomy and accountability, including:

i. a statutory regime grounded in national laws, regulations or binding administrative provisions;

ii. not taking instructions from the budgetary authorities of the Member State concerned or from any other public or private body;

iii. the capacity to communicate publicly in a timely manner;

iv. procedures for nominating members on the basis of their experience and competence;

iv. adequate resources and appropriate access to information to carry out their given mandate.

3.2.2.2 Key role in preparing the forecasts underlying the budgetary process

The Two Pack requires that the macroeconomic forecasts underlying the national medium-term fiscal plans and the draft budgets be produced or endorsed by independent bodies. Member States should indicate in these documents whether the endorsement or production model has been chosen. In addition, they should indicate whether independent bodies have prepared or endorsed the budgetary forecasts, although they are free to choose neither of these two options. Given the link between the national

medium-term fiscal plans and the Stability Programmes([151]) and between the draft budgets and the draft budgetary plans, the requirements relating to the involvement of independent bodies in the preparation of the forecasts effectively translate to the Stability Programmes and DBPs as well.

In order to ensure that independent bodies are able to fulfil their task in preparing or endorsing the macroeconomic forecasts in line with the requirements on forecasts set out in the Directive 2011/85/EU, Member States should define and adopt transparent forecasting procedures, setting out specific criteria and procedural safeguards. The Code of Conduct on the Two-Pack([152]) further specifies some considerations for national arrangements framing the involvement of independent bodies in the production or endorsement of macroeconomic forecasts.

Specifically, in the case of macroeconomic forecasts produced by the independent body, the independent body should have in place a dedicated procedure for this purpose as set out in the directive, which should be consistent with the stages of the national budgetary process and related timetable. The Ministry of Finance should provide support to facilitate the production of the macroeconomic forecasts by the independent body, such as access rights to relevant budgetary information, including budgetary execution data. Additionally, the national legislation or the internal procedures of the Ministry of Finance should define rules governing the handling of forecasts received from the independent body.

Analogously, for the macroeconomic forecasts produced by public sector entities and submitted for endorsement to the independent body, Member States should lay down implementing aspects of the endorsement process (including deadlines for action and the consequences arising from the forecast-related decisions of the independent body), without prejudice to the independent assessment of the endorsing body. The independent body should make clear whether it endorses or not the forecasts and provide the underlying justifications. It is understood that, while the endorsement would enable the use of the respective forecasts for fiscal planning purposes, should the independent body decide that conditions are not met to endorse the macroeconomic forecasts underpinning the programme/plan, this would typically trigger a review of the forecasts in the light of comments issued by the independent body. A revised forecast may be produced and submitted for assessment to the independent body, which would have to issue a new decision.

Irrespective of the choice of having forecasts produced or endorsed independently, Member States should have in place specific mechanisms to cope with situations in which there are different views between the independent body and the Ministry of Finance on the main variables of the forecast. These could, for example, take the form of arrangements to reach an agreement.([153])

([151]) In fact, national medium-term fiscal plans and stability programmes may be the same document.
([152]) http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf
([153]) Beyond the aforementioned requirements deriving from EU legislation and the intergovernmental TSCG, national legislation in some euro-area Member States has entrusted independent bodies with additional tasks (e.g. sustainability computations, costing, promotion of budgetary transparency) or provided a higher degree of specification of the tasks referred to in EU legislation. The exact nature and degree of detail of such tasks may depend on political appetite at the national level, which can itself be influenced by specific considerations, such as identified weaknesses in national fiscal-policy processes, the federal (or heavily decentralised) structure of some Member States, or severe fiscal consolidation challenges.

ANNEX 1
LINKS TO THE RELEVANT LEGISLATIVE TEXTS

Treaties

Treaty of the Functioning of European Union (including protocol 12)

http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT&from=EN

Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (including the Fiscal Compact)

http://www.consilium.europa.eu/european-council/pdf/Treaty-on-Stability-Coordination-and-Governance-TSCG/

Regulation on the preventive arm of the SGP

Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies

Original from 1997:

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1997:209:0001:0005:EN:PDF

Consolidated following Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1466:20111213:EN:PDF

Regulation on the corrective arm of the SGP

Council Regulation No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure

Original from 1997:

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1997:209:0001:0005:EN:PDF

Consolidated following Council Regulation (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1467:20111213:EN:PDF

Other texts linked to the SGP or its application

Resolution of the European Council on the Stability and Growth Pact, Amsterdam, 17 June 1997

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997Y0802(01):EN:HTML

European Council Presidency conclusions of 22-23 March 2005, endorsing and including the ECOFIN Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact"

http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2005-03-23_council_presidency_conclusions_en.pdf

Council Regulation (EC) No 479/2009 of 25 May 2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:145:0001:0009:EN:PDF

Regulation (EU) No 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0001:0007:EN:PDF

Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0041:0047:EN:PDF

Code of Conduct: "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", of 3 September 2012

http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf

Communication from the Commission on "Making the best use of the flexibility within the existing rules of the stability and growth pact", of 13 January 2015

http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/2015-01-13_communication_sgp_flexibility_guidelines_en.pdf

Commonly agreed position on Flexibility in the Stability and Growth Pact

http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf

The macroeconomic imbalances procedure

Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0025:0032:EN:PDF

Regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0008:0011:EN:PDF

Legislation and other documents related to the Two Pack

Regulation (EU) No 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0001:0010:EN:PDF

Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area

http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0473&from=EN

Commission delegated regulation No 877/2013, supplementing Regulation (EU) No 473/2013, on reporting obligations of euro area Member states subject to the excessive deficit procedure

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:244:0023:0031:EN:PDF

Code of Conduct: "Specifications on the implementation of the Two Pack and guidelines on the format and content of draft budgetary plans, economic partnership programmes and debt issuance reports", of 7 November 2014.

http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf

ANNEX 2
2015 UPDATE OF THE MINIMUM BENCHMARKS

The preventive arm of the Stability and Growth Pact requires that Member States achieve and maintain their medium-term budgetary objectives (MTO) to ensure, inter alia, a sufficient safety margin against the risk of breaching the 3% of GDP reference value of the Treaty. This sufficient margin is a threshold value for the structural government deficit, called the minimum benchmark (MB), which ensures the respect of the 3% reference value under normal cyclical conditions. This is calculated by adjusting the 3% of GDP deficit threshold for the effect of a normal cyclical fluctuation (encapsulated by the representative output gap). The MB thus provides a lower bound for the determination of the MTOs.

Formula: The standard formula for the computation of the minimum benchmark is

$$MB = -3 - \varepsilon * ROG$$

where the two elements necessary for the calculation are the semi-elasticity of the budget to the output gap - ε - and the representative output gap - ROG.

The representative output gap is a country-specific measure of cyclical conditions Member States typically experience. It reflects the fact that different countries typically experience different magnitudes of economic cycles, and this has an impact on the cyclical fluctuation of their public finances. Countries with larger cycles and therefore bigger negative values require larger safety margin for the MTO to ensure compliance with the 3% deficit limit under a normal economic cycle. The representative output gap is calculated in the following way, containing a country-specific and a horizontal component:

$$ROG = \frac{N_i}{(N_t + N_i)} P_{5\%}(country) + \frac{N_t}{(N_t + N_i)} P_{5\%}(EU\,27)$$

where $P_{5\%}$ (country) represents the 5% percentile of the distribution of the country-specific output gap series and $P_{5\%}$ (EU 27) the 5% percentile of output gap data for all countries. N_i and N_t stand for the number of country-specific and common annual observations available, respectively over a period of 25 years. N_t is set at 25.

The logic of this approach is to use the simplest and most direct statistical indicator which captures the idea of the representative output gap, i.e. a particularly low value of the output gap likely to be observed with a probability of 5%. The percentile is moreover computed after outlier values are deleted.([154])

It should be noted that the relative weights of the common and country-specific component in equation 2 above are different across countries, especially for the recently acceded Member States due to the limited availability of data before 1995. However, the weights will automatically converge to the same value when the length of the time series increases over time reaching and exceeding 25 years.

([154]) Outliers are defined as observations of the distribution for the entire sample - including all Member States - below, and above, respectively, the 2.5% and the 97.5% percentiles. Exceptionally, the country-specific series have also been trimmed of their most negative values between 2009 and 2010, as these do not reflect normal conditions.

Table A1: **Minimum Benchmarks**

Country	Current Minimum Benchmark	New Minimum Benchmark (for 2017-2019)
BE	-1.7	-1.7
BG	-1.7	-2.1
CZ	-1.7	-1.7
DK	-0.7	-0.9
DE	-1.5	-1.5
EE	-1.8	-1.7
IE	-1.2	-1.3
EL	-1.9	-2.1
ES	-1.5	-1.1
FR	-1.6	-1.3
HR		-1.5
IT	-1.7	-1.5
CY	-1.8	-1.6
LV	-1.8	-1.7
LT	-1.8	-1.5
LU	-1.7	-1.5
HU	-1.5	-1.4
MT	-1.9	-1.8
NL	-1.4	-1.1
AT	-1.8	-1.6
PL	-1.9	-1.0
PT	-1.8	-1.6
RO	-1.8	-1.6
SI	-1.7	-1.4
SK	-1.5	-1.7
FI	-0.5	-1.1
SE	-0.9	-1.0
UK	-1.5	-1.1

ANNEX 3
TABLES TO BE SUPPLIED IN THE STABILITY AND CONVERGENCE PROGRAMMES

Provision of data on variables in bold characters is a requirement.

Provision of data on other variables is optional but highly desirable.

The tables should be submitted to the Commission by means of the dedicated web application.

Table 1a: **Macroeconomic prospects**

	ESA Code	**Year X-1**	**Year X-1**	**Year X**	**Year X+1**	**Year X+2**	**Year X+3**
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g						
2. Nominal GDP	B1*g						
Components of real GDP							
3. Private final consumption expenditure	P.3						
4. Government final consumption expenditure	P.3						
5. Gross fixed capital formation	P.51g						
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53						
7. Exports of goods and services	P.6						
8. Imports of goods and services	P.7						
Contributions to real GDP growth							
9. Final domestic demand		-					
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-					
11. External balance of goods and services	B.11	-					

Table 1b: **Price developments**

	ESA Code	**Year X-1**	**Year X-1**	**Year X**	**Year X+1**	**Year X+2**	**Year X+3**
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator							
2. Private consumption deflator							
3. HICP[1]							
4. Government consumption deflator							
5. Investment deflator							
6. Export price deflator (goods and services)							
7. Import price deflator (goods and services)							

[1] Optional for stability programmes.

Table 1c: **Labour market developments**

	ESA Code	**Year X-1**	**Year X-1**	**Year X**	**Year X+1**	**Year X+2**	**Year X+3**
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]							
2. Employment, hours worked[2]							
3. Unemployment rate (%)[3]							
4. Labour productivity, persons[4]							
5. Labour productivity, hours worked[5]							
6. Compensation of employees	D.1						
7. Compensation per employee					optional	optional	optional

[1]Occupied population, domestic concept national accounts definition.

[2]National accounts definition.

[3]Harmonised definition, Eurostat; levels.

[4]Real GDP per person employed.

[5]Real GDP per hour worked.

Table 1d: **Sectoral balances**

% of GDP	ESA Code	**Year X-1**	**Year X**	**Year X+1**	**Year X+2**	**Year X+3**
1. Net lending/borrowing vis-à-vis the rest of the world	B.9					
of which:						
- Balance on goods and services						
- Balance of primary incomes and transfers						
- Capital account						
2. Net lending/borrowing of the non-government sector	B.9					
3. Net lending/borrowing of general government	B.9					
4. Statistical discrepancy			optional	optional	optional	optional

Table 2a: **General government budgetary prospects**

	ESA Code	**Year X-1**	**Year X-1**	**Year X**	**Year X+1**	**Year X+2**	**Year X+3**
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (+) / net borrowing (-) (B.9) by sub-sector							
1. General government	S.13						
1a. Central government	S.1311						
1b. State government	S.1312						
1c. Local government	S.1313						
1d. Social security funds	S.1314						
General government (S13)							
2. Total revenue	TR						
3. Total expenditure	TE[1]						
4. Net lending/borrowing	B.9						
5. Interest expenditure	D.41						
6. Primary balance[2]	B.9+D.41						
7. One-off and other temporary measures[3]							
Selected components of revenue							
8. Taxes on production and imports	D.2					optional	optional
9. Current taxes on income, wealth, etc	D.5					optional	optional
10. Capital taxes	D.91					optional	optional

11. Social contributions	D.61					optional	optional
12. Property income	D.4					optional	optional
13. Other [4]						optional	optional
14=2. Total revenue	TR						
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]							
Selected components of expenditure							
15. Compensation of employees + intermediate consumption	D.1+P.2						
15a. Compensation of employees	D.1						
15b. Intermediate consumption	P.2						
16. Social payments (16=16a+16b)							
***of which* Unemployment benefits**[6]							
16a. Social transfers in kind - purchased market production	D.632						
16b. Social benefits other than social transfers in kind	D.62						
17=5. Interest expenditure	D.41						
18. Subsidies	D.3						
19. Gross fixed capital formation	P.51g						
20. Capital transfers	D.9						
21. Other[7]							
22=3. Total expenditure	TE[1]						
p.m.: Government final consumption expenditure (nominal)	P.3						

[1]TR-TE=B.9.

[2]The primary balance is calculated as B.9 (item 4) plus D.41 (item 5).

[3]A plus sign means deficit-reducing one-off measures.

[4] P.11+P.12+P.131+D.39rec+D.7rec+D.9rec (other than D.91).

[5]Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

[6] Includes social benefits other than social transfers in kind (D.62) and social transfers in kind via market producers (D.632) related to unemployment benefits.

[7] D.29pay+D4pay (other than D.41pay) + D.5pay+D.7pay+P.52+P.53+NP+D.8.

Table 2b: **No-policy change projections**[1]

		Year X-1	Year X-1	Year X	Year X+1	Year X+2	Year X+3
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
1. Total revenue at unchanged policies							
2. Total expenditure at unchanged policies							

[1]The projections shall start at the time when the Stability or Convergence Programme is drafted (please indicate the cut-off date) and show revenue and expenditure trends under a 'no-policy change' assumption. Therefore, figures for X-1 should correspond to actual data for revenue and expenditure.

Table 2c: **Amounts to be excluded from the expenditure benchmark**

		Year X-1	Year X-1	Year X	Year X+1	Year X+2	Year X+3
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
1. Expenditure on EU programmes fully matched by EU funds revenue							
2. Cyclical unemployment benefit expenditure [1]							
3. Effect of discretionary revenue measures [2]							
4. Revenue increases mandated by law							

[1]Please detail the methodology used to obtain the cyclical component of unemployment benefit expenditure. It should build on unemployment benefit expenditure as defined in COFOG under the code 10.5

[2]Revenue increases mandated by law should not be included in the effect of discretionary revenue measures: data reported in rows 3 and 4 should be mutually exclusive.

Table 3: **General government expenditure by function**

% of GDP	COFOG Code	**Year X-2**	**Year X+3**
1. General public services	1		
2. Defence	2		
3. Public order and safety	3		
4. Economic affairs	4		
5. Environmental protection	5		
6. Housing and community amenities	6		
7. Health	7		
8. Recreation, culture and religion	8		
9. Education	9		
10. Social protection	10		
11. Total expenditure (=item 3=22 in Table 2a)	TE		

Table 4: **General government debt developments**

% of GDP	ESA Code	**Year X-1**	**Year X**	**Year X+1**	**Year X+2**	**Year X+3**
1. Gross debt[1]						
2. Change in gross debt ratio						
Contributions to changes in gross debt						
3. Primary balance[2]	B.9+D.41					
4. Interest expenditure[3]	D.41					
5. Stock-flow adjustment						
of which:						
- Differences between cash and accruals[4]						
- Net accumulation of financial						

assets[5]						
of which:						
- privatisation proceeds						
- Valuation effects and other[6]						
p.m.: Implicit interest rate on debt[7]						
Other relevant variables						
6. Liquid financial assets[8]						
7. Net financial debt (7=1-6)						
8. Debt amortization (existing bonds) since the end of the previous year						
9. Percentage of debt denominated in foreign currency						
10. Average maturity				-	-	-

[1]As defined in amended Regulation 479/2009.

[2]Cf. item 6 in Table 2a.

[3]Cf. item 5=17 in Table 2a.

[4]The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

[5]Currency and deposits, government debt securities, government controlled enterprises and the difference between listed and unlisted shares could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

[6]Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

[7]Proxied by interest expenditure divided by the debt level of the previous year.

[8] Liquid assets are here defined as stocks of AF.1, AF.2, AF.3 (consolidated for general government, i.e. netting out financial positions between government entities), AF.511, AF.52 (only if listed on stock exchange).

Table 5: **Cyclical developments**

% of GDP	ESA Code	**Year X-1**	**Year X**	**Year X+1**	**Year X+2**	**Year X+3**
1. Real GDP growth (%)						
2. Net lending of general government	B.9					
3. Interest expenditure	D.41					
4. One-off and other temporary measures[1]						
5. Potential GDP growth (%)						
contributions: - labour - capital - total factor productivity						
6. Output gap						
7. Cyclical budgetary component						
8. Cyclically-adjusted balance (2 - 7)						
9. Cyclically-adjusted primary balance (8 + 3)						
10. Structural balance (8 - 4)						

[1]A plus sign means deficit-reducing one-off measures.

Table 6: **Divergence from previous update**

	ESA Code	Year X-1	Year X	Year X+1	Year X+2	Year X+3
Real GDP growth (%)						
Previous update						
Current update						
Difference						
General government net lending (% of GDP)	B.9					
Previous update						
Current update						
Difference						
General government gross debt (% of GDP)						
Previous update						
Current update						
Difference						

Table 7: **Long-term sustainability of public finances**

% of GDP	2007	2010	2020	2030	2040	2050	2060
Total expenditure							
Of which: **age-related expenditures**							
Pension expenditure							
Social security pension							
Old-age and early pensions							
Other pensions (disability, survivors)							
Occupational pensions (if in general government)							
Health care							
Long-term care							

Education expenditure							
Other age-related expenditures							
Interest expenditure							
Total revenue							
Of which: property income							
Of which: from pensions contributions (or social contributions if appropriate)							
Pension reserve fund assets							
Of which: consolidated public pension fund assets (assets other than government liabilities)							
Systemic pension reforms[1]							
Social contributions diverted to mandatory private scheme[2]							
Pension expenditure paid by mandatory private scheme[3]							
Assumptions							
Labour productivity growth							
Real GDP growth							
Participation rate males (aged 20-64)							
Participation rates females (aged 20-64)							
Total participation rates (aged 20-64)							
Unemployment rate							
Population aged 65+ over total population							

[1]Systemic pension reforms refer to pension reforms that introduce a multi-pillar system that includes a mandatory fully funded pillar.

[2]Social contributions or other revenue received by the mandatory fully funded pillar to cover for the pension obligations it acquired in conjunction with the systemic reform

[3]Pension expenditure or other social benefits paid by the mandatory fully funded pillar linked to the pension obligations it acquired in conjunction with the systemic pension reform

Table 7a: **Contingent liabilities**

% of GDP	Year X-1	Year X
Public guarantees		Optional
Of which: linked to the financial sector		Optional

Table 8: **Basic assumptions**

This table should preferably be included in the programme itself; if not, these assumptions should be transmitted to the Council and the Commission together with the programme.

	Year X-1	Year X	Year X+1	Year X+2	Year X+3
Short-term interest rate[1] (annual average)					
Long-term interest rate (annual average)					
USD/€ exchange rate (annual average) **(euro area and ERM II countries)**					
Nominal effective exchange rate					
(for countries not in euro area or ERM II) **exchange rate vis-à-vis the € (annual average)**					
World excluding EU, GDP growth					
EU GDP growth					
Growth of relevant foreign markets					
World import volumes, excluding EU					
Oil prices (Brent, USD/barrel)					

[1]If necessary, purely technical assumptions.

ADDITIONAL TABLE FOR STABILITY AND CONVERGENCE PROGRAMMES OF MEMBER STATES APPLYING FOR USE OF THE STRUCTURAL REFORM CLAUSE

Table: Structural reforms (table to be included in both SCP and NRP) – To be completed for **each** structural reform under consideration

<table>
<tr><th rowspan="4">Description of the reform

(1)</th><th colspan="2" rowspan="2">Methodological elements</th><th colspan="7">Quantitative elements</th><th colspan="2">In cases of ex-ante implementation</th></tr>
<tr><th colspan="6">Main outcome of macroeconomic simulations (4)</th><th rowspan="3">Other impacts/ indicators

(7)</th><th rowspan="3">Timeline for adoption and implementation of measures

(8)</th><th rowspan="3">Institutional process for approval of measures

(9)</th></tr>
<tr><th rowspan="2">Relevant features of the model used/estimation technique (2)</th><th rowspan="2">Main macroeconomic assumptions/simulation assumptions

(3)</th><th>Description

(5)</th><th colspan="5">Yearly and cumulated effect on GDP and other main macroeconomic variables
(6)</th></tr>
<tr><th></th><th>Year X+5</th><th>Year X+10</th><th>Year X+15</th><th>Year X+20</th><th>Year X+25*</th></tr>
<tr><td rowspan="5"></td><td rowspan="5"></td><td rowspan="5"></td><td>GDP</td><td></td><td></td><td></td><td></td><td></td><td></td><td rowspan="5"></td><td rowspan="5"></td></tr>
<tr><td>Gross capital formation</td><td></td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>Employment</td><td></td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>Direct fiscal impact upon primary balance (10)</td><td></td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>Total impact upon primary balance (11)</td><td></td><td></td><td></td><td></td><td></td><td></td></tr>
</table>

***The impact at X+25 is akin to the final impact in a steady-state economic environment.**

(1) This column should contain “Measure 1”, “Measure 2” etc and short titles e.g. labour market reform.

(2) This column should include all relevant information on the analytical and methodological approach used in the empirical exercise. This would include: (a) the type of the model used/estimation technique (e.g. econometric estimations or simulation based assessments with DSGE/dynamic CGE/static CGE models, etc.); (b) data sources and the frequency of macroeconomic data used in the empirical exercise; (c) if available, the list of references related to the main methodological paper(s) that describes the structure of the country-specific model underlying the empirical exercise.

(3) This column should encompass the main macroeconomic and simulation assumptions underlying the estimation including transmission channels and elasticities.

(4) This column summarises the main macroeconomic variables involved as well as the quantitative results of the macroeconomic simulations exercise.

(5) Specifically, this column contains the list of the macroeconomic variables which are assumed to be affected by the enacted or planned structural reforms presented in the programmes. The list reported in the reporting table is illustrative (but not exhaustive) and can be changed and/or broadened according to the type of reforms implemented at national level.

(6) This column reports the quantitative impact of the structural reforms expressed as the yearly and/or cumulated effect on GDP and the other main macroeconomic variables involved in the simulation as well as the policy simulation horizon. The macroeconomic impact of structural reforms needs to take the form of a number expressing the difference (in percentage points) with respect to the reference scenario, i.e. the scenario that does not include the structural measures).

(7) This column shall contain other relevant indicators that can also demonstrate economic impacts, for example resource efficiency indicators. This can also include information on the expected direct results from the measure (e.g. how many people are expected to be supported by a new ALMP measures; or which increase in the proportion of unemployed will be covered by an increase ALMP budget).

(8) This column should set out the timeline for the adoption and implementation of any reform measures which justify an application for use of the structural reform clause on an ex-ante implementation basis as detailed in the dedicated structural reform plan adopted by Government..

(9) This column should set out the institutional plans and processes for the implementation of reform measures which justify an application for use of the structural reform clause on an ex-ante implementation basis

(10) This row should contain the direct budgetary impact (budgetary savings minus budgetary costs) of reform measures, excluding any impact through associated changes to output. The effects should be shown as a percentage of GDP.

(11) This row should contain the total budgetary impact of reform measures, including both direct fiscal effects and any indirect effects through associated changes to output. The effects should be shown as a percentage of GDP.

ANNEX 4
THE MEDIUM-TERM REFERENCE RATE OF POTENTIAL GROWTH AND THE CONVERGENCE MARGIN FOR THE ASSESSMENT OF 2015 AND 2016 BASED ON SPRING 2015 COMMISSION FORECAST

	2015				2016([155])			
	Medium-term rate of pot. GDP growth	Conv. margin	Converg. Margin Rec.([156])	Ref. rate	Medium-term rate of pot. GDP growth	Conv. Margin	Converg. Margin Rec.	Ref. rate
BE	1.2	1.0	1.2	0.0	1.1	1.0	1.2	0.0
BG	2.1	1.4	0.0	2.1	1.1	1.3	1.4	0.7
CZ	1.6	1.2	-0.7	2.3	1.2	1.2	1.2	0.5
DK	1.1	0.9	-3.0	4.2	0.8	0.9	0.0	1.1
DE	1.1	1.2	-3.9	5.0	1.3	1.2	-3.5	4.8
EE	2.1	1.3	-0.4	2.5	1.8	1.2	1.0	1.1
IE	0.6	1.4	0.0	0.6	1.9	1.5	1.8	0.1
EL	-1.6	1.2	0.0	-1.6	-2.3	1.1	0.5	-2.1
ES	0.2	1.3	0.0	0.2	0.4	1.3	0.5	-0.1
FR	1.1	0.9	0.5	0.6	1.1	0.9	0.5	0.6
HR([157])					-0.1	1.1	0.5	-0.5
IT	0.0	1.1	0.6	-0.5	-0.1	1.1	0.2	-0.2
CY	0.2	1.2	0.0	0.2	-0.5	1.3	0.0	0.2
LV	1.4	1.5	-1.0	2.4	1.5	1.4	0.9	0.5
LT	1.9	1.5	0.5	1.4	1.9	1.5	1.5	0.4
LU	1.1	1.2	-2.6	3.7	2.2	1.1	-0.2	2.4
HU	0.1	1.1	1.2	-1.1	1.0	1.1	1.3	-0.3
MT	1.8	1.3	1.5	0.3	2.7	1.2	1.4	1.3
NL	0.9	1.0	-0.6	1.4	0.6	1.1	-0.4	1.2
AT	1.1	1.0	-0.1	1.3	1.0	1.0	0.6	0.5
PL	3.7	1.3	1.3	2.5	3.2	1.3	1.3	2.5
PT	-0.1	1.2	0.0	-0.1	-0.1	1.2	1.4	-1.5
RO	2.5	1.4	0.1	2.4	2.1	1.5	0.9	1.6
SI	0.5	1.0	0.0	0.5	0.6	1.1	1.3	-0.7
SK	2.9	1.4	0.0	2.9	2.8	1.2	0.7	2.2
FI	0.8	0.9	0.2	0.6	0.3	0.9	0.9	-0.1
SE	1.9	1.0	-0.1	2.1	1.6	1.0	-0.1	2.0
UK	1.2	1.1	1.3	-0.2	1.2	1.2	1.3	-0.2

([155]) The reference rates in use for the budgetary figures of 2015 were computed on the basis of the Commission winter forecast 2013. Following the introduction of yearly update of the reference rate (in spring 2015), a transitional arrangement was put in place, only for the assessment of 2016, according to which the less demanding reference rate between the old and the updated one is used.
([156]) The recalibrated convergence margin can be obtained by dividing the conv. margin (column 2) by 0.5 and multiplying the result by the corrected (e.g. for the flexibility clauses) requirements of the preventive arm, as shown in Annex 14.
([157]) The reference rate for the assessment of 2015 were computed on the basis of the Commission winter forecast 2013, when Croatia had not yet accessed the EU.

ANNEX 5
CALCULATING THE TOP-DOWN FISCAL EFFORT

1) Correcting for revisions of potential output growth: α

The α-parameter measures how revisions of potential growth (especially compared to the forecast underlying the Council recommendations) can affect the estimated change in the structural balance.

Traditionally, changes in the CAB are used as an indicator of discretionary fiscal policy. The following shows that this reading needs to be qualified in the presence of higher or lower than expected growth.

Ex ante, an approximate of the expected change in the CAB in year t with respect to year t-1 is:

$$\left.\frac{\Delta^d R_t^S - \Delta^d G_t^S}{Y_t^P}\right|_{E_{t-1}Y}$$

where $\Delta^d G_t^S$ and $\Delta^d R_t^S$ are the planned structural expenditure and revenue, respectively, in year *t,* and Y_t^P is the expected potential output in year *t*. The ratio is conditional on the expected level of actual GDP, $E_{t-1}Y_t$, as potential output is extracted from observed real GDP.

Ex post, the ratio of structural expenditure to potential GDP in year *t* results from the implementation of expenditure plans, discretionary fiscal policy corrections and actual economic growth:

$$\left.\frac{G_t^S}{Y_t^P}\right|_{Y_t} = \left.\frac{G_{t-1}^S(1+E_{t-1}\omega_t^P + E_{t-1}\pi_t) + \Delta^d G_t^S}{Y_t^P}\right|_{Y_t}$$

where $E_{t-1}\omega_t^P$ and $E_{t-1}\pi_t$ are expected real potential output growth and expected inflation respectively.

The actual ratio is conditional on real GDP in year *t*. In contrast to the ex-ante case, it is not expected real GDP but the actual level observed ex post. Hence, if the observed real GDP in year *t* differs from the forecast, it will also affect potential output and the output gap compared to what was expected ex ante. This affects both the denominator and the nominator of the ratio.

In addition, lower or higher than expected growth affects potential output, not only in year t, but it also in previous years.

As a result, assuming that the tax system is proportional, the ex post change in the CAB in year *t* with respect to year *t-1* is:

$$\Delta CAB_t = \left.\frac{\Delta^d R_t^S - \Delta^d G_t^S}{Y_t^P}\right|_{Y_t} - \left.\frac{G_{t-1}^S}{Y_{t-1}^P}\left(\frac{(1+E_{t-1}\omega_t^P + E_{t-1}\pi_t)}{(1+\omega_t^P + \pi_t)} - 1\right)\right|_{Y_t}$$

The observed change in the CAB will exclusively reflect discretionary fiscal policy interventions only if structural expenditure follows potential output growth. However, given that expenditure plans are fixed in advance based on economic projections, inertia in the budgetary processes or adherence to plans will lead to a departure from the projected change in the CAB ex-ante. This effect may be called passive fiscal policy. In particular, if growth is overestimated

$\left(1+E_{t-1}\omega_t^P+E_{t-1}\pi_t\right)>\left(1+\omega_t^P+\pi_t\right)$ a full implementation of expenditure plans results in a deterioration of the CAB, even in the absence of discretionary fiscal policy measures.

Simplifying the notation, the difference between ex-ante and ex post changes in the CAB can be written as:

$$\left.\left[\frac{\Delta^d B_t^S-G_{t-1}^S(1+E_{t-1}\omega_t+E_{t-1}\pi_t)}{Y_t^P}+\frac{G_{t-1}^S}{Y_{t-1}^P}\right]\right|_{Y_t}-\left.\left[\frac{\Delta^d B_t^S}{Y_t^P}\right]\right|_{E_{t-1}Y_t}=$$

ex post change in the CAB ex-ante change in the CAB

where $\frac{\Delta^d B_t^S}{Y_t^P}$ is the discretionary fiscal policy intervention $\frac{\Delta^d R_t^S-\Delta^d G_t^S}{Y_t^P}$. Rearranging the difference between ex post and ex-ante yields

$$=\frac{\Delta^d B_t^S\big|_{Y_t}-\Delta^d B_t^S\big|_{E_{t-1}Y_t}}{Y_t^P\big|_{Y_t}}+\left(\frac{\Delta^d B_t^S\big|_{E_{t-1}Y_t}}{Y_t^P\big|_{E_{t-1}Y_t}}\right)\frac{Y_t^P\big|_{E_{t-1}Y_t}-Y_t^P\big|_{Y_t}}{Y_t^P\big|_{Y_t}}-\left.\frac{G_{t-1}^S}{Y_{t-1}^P}\right|_{Y_t}\left(\frac{1+E_{t-1}\omega_t+E_{t-1}\pi_t}{1+\omega_t+\pi_t}-1\right)\approx$$

$$\approx\frac{\Delta^d B_t^S\big|_{Y_t}-\Delta^d B_t^S\big|_{E_{t-1}Y_t}}{Y_t^P\big|_{Y_t}}+\left(\frac{\Delta^d B_t^S\big|_{E_{t-1}Y_t}}{Y_t^P\big|_{E_{t-1}Y_t}}\right)\frac{Y_t^P\big|_{E_{t-1}Y_t}-Y_t^P\big|_{Y_t}}{Y_t^P\big|_{Y_t}}-\left.\frac{G_{t-1}^S}{Y_{t-1}^P}\right|_{Y_t}\left((E_{t-1}\omega_t+E_{t-1}\pi_t)-(\omega_t+\pi_t)\right)$$

Hence, if expenditure plans and discretionary fiscal policy measures are fully implemented in volume terms, the difference between ex-ante and ex post is a function of:

- the effect of the revision of growth on the output gap and, in turn, on the discretionary component of the budget (first term). A revision in the output gap entails that budgetary items which ex-ante were thought to be cyclical, turn out to be structural or vice versa. Empirically, this term will tend to be fairly negligible;
- the effect of the revision of growth on the level of potential output and, via the assumption of adherence to plans, on the size of the discretionary correction expressed in percent of potential GDP (second term);
- the effect of the revision of growth on the level of potential output and, in turn, on the non-cyclical expenditure to potential GDP ratio (third term). Numerically, this term clearly dominates as the non-cyclical expenditure to potential GDP ratio is generally around 0.4-0.6, whereas discretionary corrections tend to be comparatively small.

The α-parameter controls for the impact of the potential growth outturn being different from that forecast in the third term in the decomposition above. It is defined as:

$$\alpha_t=\frac{G_{t-1}^S}{Y_{t-1}^p}\left(\omega_t-\mathrm{E}_{t-1}\omega_t\right)$$

As a result, in case of negative surprises to real growth, the Commission adjusts upwards the observed change in the structural balance, and vice versa for positive growth surprises.

The way the α-parameter is defined implies that it does not incorporate the impact of an inflation surprise. Instead, it implicitly treats expenditure as being set in real terms. As the bottom-up approach is, by contrast, based on the assumption that expenditure plans are made in nominal terms, the careful analysis can allow to identify the impact of these assumptions and assess whether the policy response was appropriate.

2) Correcting for revenue shortfalls or windfalls: β

The β-parameter corrects the change in the structural balance for unexpected changes in revenues that are outside the control of government. It is the case when revenues turn out higher or lower than foreseen based on economic growth developments (resulting in revenue windfalls or shortfalls compared to what was expected at the time of the recommendation), because the relationship between revenues and growth differs from the standard assumed elasticity.

The recommendations made under Art. 126(7), or the notice given under Article 126(9), are based on a fully-fledged macroeconomic forecast made under the usual no-policy change assumption. Among other things, this forecast implies an apparent revenue elasticity to GDP in year *t*, η_t^{rec} (where the superscript *rec* denotes values underlying the recommendation or notice):

$$\eta_t^{rec} = \frac{\left(\Delta R_t^{rec} - DM_t^{rec}\right) / R_{t-1}^{rec}}{\Delta GDP_t^{rec} / GDP_{t-1}^{rec}}$$

where R_t^{rec} is the forecast for the level of current revenues in year *t*, DM_t^{rec} is the level of discretionary revenue measures for year *t* that have been clearly specified and committed to by governments, ahead of the recommendation, relative to *t-1*, and GDP_t^{rec} is the forecast for the level of GDP in *t*.

The Commission forecastCommission forecast for revenue developments in year *t* is then given by the following formula:

$$\Delta R_t^{rec} = \eta_t^{rec} \left(\frac{\Delta GDP_t}{GDP_{t-1}}\right)^{rec} R_{t-1}^{rec} + DM_t^{rec}$$

This apparent elasticity can, however, depart from the elasticity underlying the computation of the cyclically adjusted balance (η^R, which is close to one). In the short term, there could be reasons for the revenue elasticity to temporarily depart from its long-term value (e.g. if the composition of growth or the tax collection rate change), and the recommendation could therefore be based on a revenue elasticity that is different from its long-term value.

In the calculation of the cyclically adjusted balance, the change in cyclically adjusted revenues is equal to([158]):

$$\Delta\, CAR_t = \Delta\left(\frac{R_t}{Y_t}\right) - \varepsilon_R . \Delta OG_t = \frac{\Delta R_t - y_t . R_{t-1}}{Y_t} - \left(\frac{R_0}{Y_0}\right) . (\eta^R - 1) . \Delta OG_t$$

([158]) It is recalled that all the displayed quantities are nominal, except the output gap which is expressed in real terms.

where $y_t = \frac{\Delta Y_t}{Y_{t-1}}$ is the nominal output growth, and

$$\Delta\left(\frac{R_t}{Y_t}\right) = \frac{R_t}{Y_t} - \frac{R_{t-1}}{Y_{t-1}} = \frac{R_{t-1} + \Delta R_t}{Y_{t-1} + \Delta Y_t} - \frac{R_{t-1}}{Y_{t-1}} = \frac{Y_{t-1}.\Delta R_t - R_{t-1}.\Delta Y_t}{Y_{t-1}.Y_t} = \frac{\Delta R_t - y_t.R_{t-1}}{Y_t}$$

After adding and subtracting the discretionary measures introduced in year *t*, $\frac{DM_t}{Y_t}$, we can decompose the change in *CAR* in order to isolate the discretionary part of the change in revenues-to-output ratio:

$$\Delta\, CAR_t = \frac{DM_t}{Y_t} + \frac{\Delta R_t - DM_t - y_t.R_{t-1}}{Y_t} - \left(\frac{R_0}{Y_0}\right).(\eta^R - 1).\Delta OG_t$$

And after a further manipulation([159]):

$$\Delta\, CAR_t = \underbrace{\frac{DM_t}{Y_t}}_{(i)} + \underbrace{\frac{\Delta R_t - DM_t - \eta^R\, y_t.R_{t-1}}{Y_t}}_{(ii)} + \underbrace{(\eta^R - 1).\left[\frac{R_{t-1}}{Y_t} y_t - \left(\frac{R_0}{Y_0}\right).\Delta OG_t\right]}_{(iii)}$$

The change in structural revenues is thus broken down into three terms which can be interpreted as follows:

- The first term, *(i)*, measures the impact of discretionary revenue measures, expressed as a percentage of actual output.

- The second term, *(ii)*, corresponds to possible revenue windfalls or shortfalls, expressed as a percentage of actual output. The difference between the change in total revenue and the discretionary measures can be written as $\Delta R_t - DM_t = \eta_t^R.y_t.R_{t-1}$, where η_t^R is the apparent revenue elasticity to GDP in year *t*, as explained above . The revenue windfall/shortfall term reflects the fact that the apparent elasticity η_t^R can depart, in the short term, from the long-term elasticity η^R which is used in the computation of the revenue semi-elasticity ε_R (e.g. due to changes in the composition of growth or in the tax collection).

- The third term, *(iii),* can be developed and rewritten as:

  $$(\eta^R - 1)(y_t - \Delta OG_t).\frac{R_{t-1}}{Y_t} + (\eta^R - 1)\left(\frac{R_{t-1}}{Y_t} - \frac{R_0}{Y_0}\right).\Delta OG_t$$

  It captures two different effects. First, it reflects the fact that the nominal output growth y_t is generally different from the change in the output gap ΔOG_t, which is expressed in real terms. Second, it takes into account the difference between $\frac{R_{t-1}}{Y_t}$ and the revenues-to-GDP ratio $\frac{R_0}{Y_0}$ that is used as a weight in the computation of ε_R.

While no correction is needed for term *(i)* as it reflects policy action, the β-parameter corrects for the difference between the ex-ante and ex post revenue windfalls/shortfalls described by term *(ii)*, as well as for forecasting errors relating to term *(iii)* above.

([159]) The intermediate step is:
$$\Delta CAR_t = \frac{DM_t}{Y_t} + \frac{\Delta R_t - DM_t - y_t.R_{t-1}}{Y_t} - (\eta^R - 1).\frac{R_{t-1}}{Y_t} y_t + (\eta^R - 1).\frac{R_{t-1}}{Y_t} y_t - \left(\frac{R_0}{Y_0}\right).(\eta^R - 1).\Delta OG_t$$

The revenue windfall/shortfall that is observed ex post on the basis of actual data may differ from the ex-ante value, based on the Commission forecastCommission forecast. which underlies the recommendation. The difference between both values, the so-called “revenue gap”, is a forecast error and is outside the direct control of the authorities:

$$(\Delta R_t - DM_t - \eta^R\, y_t . R_{t-1}) - (\Delta R_t^{rec} - DM_t^{rec} - \eta^R\, y_t^{rec}\, R_{t-1}^{rec})$$

When assessing government's actions, this error can be corrected by subtracting the following term from the ex post value of $\Delta\, CAR_t$:

$$\frac{(\Delta R_t - DM_t - \eta^R\, y_t . R_{t-1}) - (\Delta R_t^{rec} - DM_t^{rec} - \eta^R\, y_t^{rec}\, R_{t-1}^{rec})}{Y_t}$$

As regards term *(iii)*, its second element $(\eta^R - 1)\left(\frac{R_{t-1}}{Y_t} - \frac{R_0}{Y_0}\right).\, \Delta\, OG_t$ is virtually equal to zero, since it is the product of three very small terms. On the contrary, the first element $(\eta^R - 1)(y_t - \Delta\, OG_t).\frac{R_{t-1}}{Y_t}$ is not negligible and is therefore taken into account in the correction. In economic terms, this item can be interpreted as the automatic response of government revenue to nominal potential growth.([160])

Including this term yields:

$$\beta = \frac{(\Delta R_t - DM_t - [y_t + (\eta^R - 1).\Delta OG_t].R_{t-1}) - (\Delta R_t^{rec} - DM_t^{rec} - [y_t^{rec} + (\eta^R - 1).\, \Delta\, OG_t^{rec}].R_{t-1}^{rec})}{Y_t}$$

3) The assessment of compliance for countries with pre-existing recommendations phrased in terms of average annual targets

While all the new Article 126(7) recommendations have annual nominal and structural targets, before the Six Pack reform, the EDPs recommendations were phrased in terms of average annual figures over a multiannual time period. In these cases, assessing compliance with the recommendations required more judgment, particularly in assessing effective action before being close to the deadline. Without a specified path towards the correction, an apparent lack of effective action in early years of the consolidation path could be compensated by higher effort implemented by future budgets. However, lower effort in initial years compared to that recommended were normally be taken into account as an aggravating factor in case correcting by the deadline was at risk in the later years even if due to a deteriorated macroeconomic scenario in those years.

Therefore, for the pre Six Pack EDP recommendations, the assessment of effective action was therefore adjusted for the specificities of the average target effort. When assessing the structural effort, it was important to consider the structural effort made since the start of the EDP, rather than just in the previous year. Similarly, in computing the adjusted fiscal effort, the change in the estimates of potential output and revenues windfalls/shortfalls was relative to the year when the EDP was issued rather than relative to the previous year.

([160]) $y_t - \Delta OG_t \simeq y_t^{(real)} + \pi_t - \Delta OG_t \simeq \pi_t + y_t^*$ where π_t and y_t^* respectively are the inflation rate and (real) potential growth.

ANNEX 6
CALCULATING THE MINIMUM LINEAR STRUCTURAL ADJUSTMENT (MLSA) FOR THE APPLICATION OF THE DEBT CRITERION DURING THE TRANSITION PERIOD

Member States that were in EDP on the date that the Six Pack amendments to the SGP were adopted (8 November 2011) are subject to transitional arrangements – concerning the debt rule – for the three years following the correction of their excessive deficit, in order to ensure that they have time to adapt their structural adjustments to the level needed to comply with the debt reduction benchmark. During those three years, compliance with the debt criterion is judged according to whether the Member State makes sufficient progress towards compliance. The concept of "sufficient progress towards compliance" is set out in the Code of Conduct on the SGP. It is defined as the Minimum Linear Structural Adjustment (MLSA) ensuring that – if followed – Member States will comply with the debt rule at the end of the transition period.

COMPUTATION OF THE MLSA

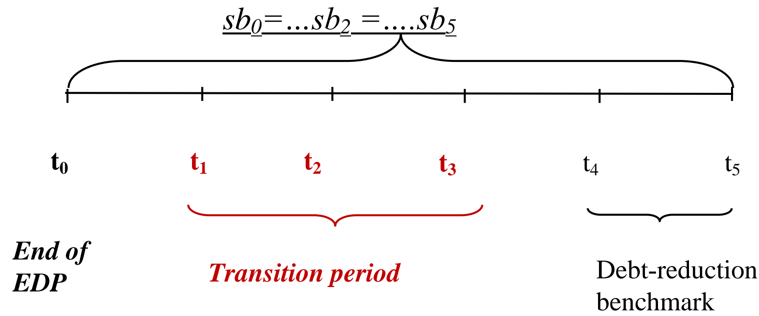
Two scenarios are considered for a Member State correcting its excessive deficit in year t_0: a baseline scenario based on no adjustment and a counterfactual scenario based on a constant (linear) adjustment *adj* implemented for the three years of the transition period.

Baseline scenario

If no adjustment is implemented: the structural balance (*sb*) remains constant over the period([161]) shown in Graph A6.1 below. This implies that during the transition period, which covers year t_1 to year t_3, the deficit: $bal_i^* = sb_0 + o_i + cb_i$ with i=1,…5, evolves according to the cyclical balance (the cyclical components of the general government balance *cb*) and the one-off measures (*o*), while the debt-to-GDP ratio: $b_i^* = \frac{b_0}{1+g_i} - bal_i^* + sfa_i$ with i=1,…5 , evolves according to growth (*g*), the cyclical balance and the stock-flow adjustments (*sfa.*).

([161]) Years t_4 and t_5 are taken into account as relevant for the forward-looking debt benchmark.

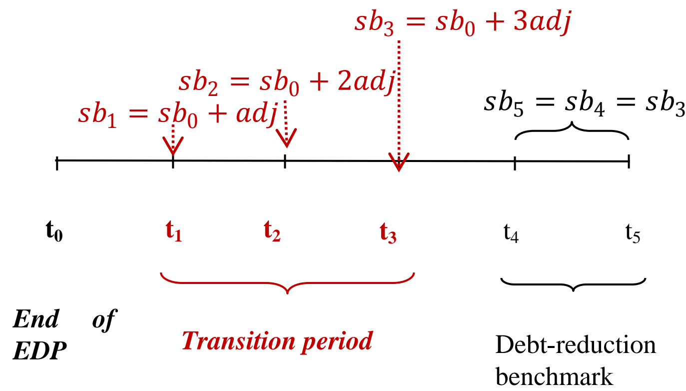
Graph A6.1: **Baseline scenario**



Counterfactual scenario

A constant (linear) adjustment (*adj*) is implemented during the transition period, while keeping the structural balance constant after it.

Graph A6.2: **Counterfactual scenario**



Thus, the trajectories for debt: $b_i = \frac{b_0}{1+g_i} - bal_i + sfa_i$ and deficit: $bal_i = sb_0 + i \cdot adj + o_i + cb_i$ with i=1,…5 , change accordingly under this scenario. In particular, for year t_1-t_5 the debt becomes:

✓in year t_1: $b_1 = b_1^* + adj \times e_1$

$$as \quad b_1^* - b_1 = \left(\frac{b_0}{1+g_1} - sb_0 - cb_1 - o_1 + sfa_1\right) - \left(\frac{b_0}{1+g_1} - (sb_0 + adj) - cb_1 - o_1 + sfa_1\right) = adj = adj \times e_1 \quad \text{where } e_1 = 1$$

✓ in year t_2: $b_2 = b_2^* + adj \times e_2$

As $b_2^* - b_2 = \left(\frac{b_1^*}{1+g_2} - sb_0 - cb_2 - o_2 + sfa_2\right) - \left(\frac{b_1}{1+g_2} - (sb_0 + 2adj) - cb_2 - o_2 + sfa_2\right) = 2adj + \frac{b_1^* - b_1}{1+g_2} = adj \times e_2$

and, following the same logic:

✓ in year t_3: $b_3 = b_3^* + adj \times e_3$
as $b_3^* - b_3 = 3adj + \frac{b_2^* - b_2}{1+g_3} = adj \times e_3$

✓ in year t_4: $b_4 = b_4^* + adj \times e_4$

as $b_4^* - b_4 = 3adj + \frac{b_3^* - b_3}{1+g_4} = adj \times e_4$

✓ in year t_5: $b_5 = b_5^* + adj \times e_5$
as $b_5^* - b_5 = 3adj + \frac{b_4^* - b_4}{1+g_5} = adj \times e_5$

with the sequence *e* defined as follows:

$$\begin{cases} e_0 = 0 \\ e_i = i + \dfrac{e_{i-1}}{1+g_1} \; if \; i \in [1;3] \\ e_i = 3 + \dfrac{e_{i-1}}{1+g_1} \; if \; i \in [4;5] \end{cases}$$

In order to identify the constant (linear) annual structural adjustment (*adj*) to be implemented during the transition period, the following equation has to be solved:

$$G_3(adj) = \min(b_3 - bb_3\,; b_5 - bb_5; b_3^{3-year-adjusted} - bb_3) = 0 \qquad (1)$$

which implies finding that minimum adjustment that assures, at the end of the transition period, the respect with at least one of the configurations of debt benchmarks based on the counterfactual scenario. This is done in three steps:

1. calculate the adjustment (*BLadj*) allowing closing the gap to the backward-looking debt benchmark: bb_3= 60% + 0.95/3 (b_2 - 60%) + 0.95^2/3 (b_1 - 60%) + 0.95^3/3 (b_0 - 60%)

$$b_3 = bb_3$$

$$\Leftrightarrow b_3^* - BLadj \times e_3 = 60 + \frac{0.95^3}{3}(b_0 - 60) + \frac{0.95^2}{3}(b_1^* - BLadj \times e_1 - 60) + \frac{0.95}{3}(b_2^* - BLadj \times e_2 - 60)$$

$$<=> BLadj = \frac{b_3^* - bb_3^*}{e_3 - \frac{0.95^3}{3}e_0 - \frac{0.95^2}{3}e_1 - \frac{0.95}{3}e_2}$$

where $b_3^* - bb_3^*$ is the gap to the backward-looking element of the debt reduction benchmark at the end of the transition period in the baseline scenario.

2. calculate the adjustment ($CYCLadj$) allowing closing the gap between the cyclically adjusted debt([162]), at the end of the transition period, and the backward-looking debt ratio:

$$b_3^{3-year-adjusted} = bb_3$$

$$<=> CYCLadj = \frac{\alpha b_3^* - \beta - bb_3^*}{\alpha e_3 - \frac{0.95^3}{3}e_0 - \frac{0.95^2}{3}e_1 - \frac{0.95}{3}e_2}$$

3.- calculate the adjustment ($FLadj$) allowing closing the gap to the forward-looking debt benchmark: $bb5$ = 60% + 0.95/3 (b_4 - 60%) + 0.95^2/3 (b_3 - 60%) + 0.95^3/3 (b_2 - 60%)

$$b_5 = bb_5$$

$$<=> FLadj = \frac{b_5^* - bb_5^*}{e_5 - \frac{0.95^3}{3}e_2 - \frac{0.95^2}{3}e_3 - \frac{0.95}{3}e_4}$$

Finally, the Minimum Linear Structural Adjustment needed to ensure compliance with the debt criterion at the end of the transition period results from:

$$MLSA = \min(BLadj\,; FLadj\,; CYCLadj)$$

If the adjustment really implemented by the country under analysis in the first year (or second year) of the transition period, differs from the MLSA, one needs to follow the same logic, as presented above, and find the linear constant structural adjustment for the two (one) remaining years of the transition period assuring the respect of the debt rule at the end of the transition period. This implies to consider as a starting point a structural balance corresponding to year t_2 (year t_3) and a transition period lasting only two years (1 year).

([162]) $b_3^{3-year-adjusted} = \frac{\prod_{i=1}^{3}(1+g_i)}{\prod_{i=1}^{3}\left(1+g_i^{pot}\right)(1+p_i)} \times b_3 + \frac{\sum_{i=1}^{3} cb_i \prod_{j=1}^{i}(1+g_j)}{\prod_{i=1}^{3}\left(1+g_i^{pot}\right)(1+p_i)} = \alpha \cdot b_3 + \beta$ where g represents the nominal growth g^{pot} the potential growth and pthe GDP deflator growth

ANNEX 7
VOTING MODALITIES UNDER THE SGP

In all voting under the SGP, the Member State concerned does not vote. For the corrective arm of the Pact, non-euro area Member States do not participate in the voting on euro area countries. This is also the case in the preventive arm, for all the Council legal acts adopted within the context of a significant deviation procedure following a Commission warning and for the vote to impose an interest-bearing deposit on euro area countries.

Unless otherwise specified, all votes are taken under qualified majority voting (QMV). From 1 November 2014, the Lisbon definition of a qualified majority is applicable, although until the end of the transition period in 2017, any Member State can request that the Nice Treaty definition be used. The Lisbon definition considers that a qualified majority has been reached when 55% of Member States participating in the decisions comprising at least 65% of population of these States are in favour of a proposal. The Nice Treaty definition considers that a qualified majority is reached when 2/3 of concerned Member States weighted according to Protocol 36 to the Treaty, and representing 62% of the population, are in favour of a proposal.

The exceptions to the use of qualified majority voting are the following:

Reversed simple majority voting (RSMV) – whereby an unweighted majority of Member States is need to reject of Commission proposal for a Council decision – is used to vote on a Council decision establishing a lack of effective action to Council recommendations following a Commission warning in the preventive arm, the second time such a decision is recommended by the Commission.

Reversed qualified majority voting (RQMV) – whereby a qualified majority of Member States is needed to reject a Commission proposal for a Council decision – is used:

- To impose sanctions in the form of an interest-bearing deposit under the preventive arm
- To impose or convert the interest-bearing deposit into a non-interest bearing deposit under the corrective arm, following an Article 126(6) decision
- To impost a fine under the corrective arm, following an Article 126(8) decision on a lack of effective action
- To suspend commitments under the European Structural and Investment Funds (applicable to commitments from 1 January of the forthcoming year), following a stepping up of the EDP procedure.

It should be noted that the imposition of a fine with a variable component following an Article 126(11) decision on a lack of effective action to notice under Article 126(9) is decided using normal QMV. In a similar vein, a Commission proposal on the suspension of payments under the European Structural and Investment Funds is subject to normal qualified majority voting in the Council.

The euro area Contracting Parties of the TSCG have committed themselves to voting on in line with the Commission's recommendations on all aspects of EDPs on the basis of the deficit criterion for euro area countries, as long as there is no qualified majority against the recommendations. This is a behavioral, rather than a legal, commitment, and mimics the use of RQMV.

ANNEX 8
THE FISCAL COMPACT

ARTICLE 3

1. The Contracting Parties shall apply the rules set out in this paragraph in addition and without prejudice to their obligations under European Union law:

(a) the budgetary position of the general government of a Contracting Party shall be balanced or in surplus;

(b) the rule under point (a) shall be deemed to be respected if the annual structural balance of the general government is at its country-specific medium-term objective, as defined in the revised Stability and Growth Pact, with a lower limit of a structural deficit of 0,5 % of the gross domestic product at market prices. The Contracting Parties shall ensure rapid convergence towards their respective medium-term objective. The time-frame for such convergence will be proposed by the European Commission taking into consideration country-specific sustainability risks. Progress towards, and respect of, the medium-term objective shall be evaluated on the basis of an overall assessment with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures, in line with the revised Stability and Growth Pact;

(c) the Contracting Parties may temporarily deviate from their respective medium-term objective or the adjustment path towards it only in exceptional circumstances, as defined in point (b) of paragraph 3;

(d) where the ratio of the general government debt to gross domestic product at market prices is significantly below 60 % and where risks in terms of long-term sustainability of public finances are low, the lower limit of the medium-term objective specified under point (b) can reach a structural deficit of at most 1,0 % of the gross domestic product at market prices;

(e) in the event of significant observed deviations from the medium-term objective or the adjustment path towards it, a correction mechanism shall be triggered automatically. The mechanism shall include the obligation of the Contracting Party concerned to implement measures to correct the deviations over a defined period of time.

2. The rules set out in paragraph 1 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 Contracting Parties shall put in place at national level the correction mechanism referred to in paragraph 1(e) on the basis of common principles to be proposed by the European Commission, concerning in particular the nature, size and time-frame of the corrective action to be undertaken, also in the case of exceptional circumstances, and the role and independence of the institutions responsible at national level for monitoring compliance with the rules set out in paragraph 1. Such correction mechanism shall fully respect the prerogatives of national Parliaments.

3. For the purposes of this Article, the definitions set out in Article 2 of the Protocol (No 12) on the excessive deficit procedure, annexed to the European Union Treaties, shall apply.

The following definitions shall also apply for the purposes of this Article:

(a) “annual structural balance of the general government” refers to the annual cyclically-adjusted balance net of one-off and temporary measures;

(b) “exceptional circumstances” refers to the case of an unusual event outside the control of the Contracting Party concerned which has a major impact on the financial position of the general government or to periods of severe economic downturn as set out in the revised Stability and Growth Pact, provided that the temporary deviation of the Contracting Party concerned does not endanger fiscal sustainability in the medium-term.

ARTICLE 4

When the ratio of a Contracting Party's general government debt to gross domestic product exceeds the 60 % reference value referred to in Article 1 of the Protocol (No 12) on the excessive deficit procedure, annexed to the European Union Treaties, that Contracting Party shall reduce it at an average rate of one twentieth per year as a benchmark, as provided for in Article 2 of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, as amended by Council Regulation (EU) No 1177/2011 of 8 November 2011. The existence of an excessive deficit due to the breach of the debt criterion will be decided in accordance with the procedure set out in Article 126 of the Treaty on the Functioning of the European Union.

ARTICLE 5

1. A Contracting Party that is subject to an excessive deficit procedure under the Treaties on which the European Union is founded shall put in place a budgetary and economic partnership programme including a detailed description of the structural reforms which must be put in place and implemented to ensure an effective and durable correction of its excessive deficit. The content and format of such programmes shall be defined in European Union law. Their submission to the Council of the European Union and to the European Commission for endorsement and their monitoring will take place within the context of the existing surveillance procedures under the Stability and Growth Pact.

2. The implementation of the budgetary and economic partnership programme, and the yearly budgetary plans consistent with it, will be monitored by the Council of the European Union and by the European Commission.

ARTICLE 6

With a view to better coordinating the planning of their national debt issuance, the Contracting Parties shall report ex-ante on their public debt issuance plans to the Council of the European Union and to the European Commission.

ARTICLE 7

While fully respecting the procedural requirements of the Treaties on which the European Union is founded, 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.

ARTICLE 8

1. The European Commission is invited to present in due time to the Contracting Parties a report on the provisions adopted by each of them in compliance with Article 3(2). If the European Commission, after

having given the Contracting Party concerned the opportunity to submit its observations, concludes in its report that such Contracting Party has failed to comply with Article 3(2), the matter will be brought to the Court of Justice of the European Union by one or more Contracting Parties. Where a Contracting Party considers, independently of the Commission's report, that another Contracting Party has failed to comply with Article 3(2), it may also bring the matter to the Court of Justice. In both cases, the judgment of the Court of Justice shall be binding on the parties to the proceedings, which shall take the necessary measures to comply with the judgment within a period to be decided by the Court of Justice.

2. Where, on the basis of its own assessment or that of the European Commission, a Contracting Party considers that another Contracting Party has not taken the necessary measures to comply with the judgment of the Court of Justice referred to in paragraph 1, it may bring the case before the Court of Justice and request the imposition of financial sanctions following criteria established by the European Commission in the framework of Article 260 of the Treaty on the Functioning of the European Union. If the Court of Justice finds that the Contracting Party concerned has not complied with its judgment, it may impose on it a lump sum or a penalty payment appropriate in the circumstances and that shall not exceed 0,1 % of its gross domestic product. The amounts imposed on a Contracting Party whose currency is the euro shall be payable to the European Stability Mechanism. In other cases, payments shall be made to the general budget of the European Union.

3. This Article constitutes a special agreement between the Contracting Parties within the meaning of Article 273 of the Treaty on the Functioning of the European Union.

ANNEX 9
A NUMERICAL EXAMPLE OF THE EXPENDITURE BENCHMARK

This Section presents a calculation of the expenditure benchmark, in line with the methodology outlined in Box 1.11 in Section 1.3.2.6. The table at the end of this annex presents the data used for the calculation of the expenditure benchmark for an indicative country.

As Box 1.11 sets out, the first data that enters the calculation is the government expenditure aggregate given in line 1. Interest expenditure (line 2), government expenditure on EU programmes fully matched by EU funds revenue (line 3), gross fixed capital formation for the year in question (line7) and cyclical unemployment benefit expenditure (line 9) are all subtracted from the government expenditure aggregate, while the average annual gross fixed capital formation for years t-3 to t (line 8) will be added. The table shows how the average is computed from the nominal figures for the four years in question, using the information from lines 4 to 7. The modified expenditure aggregate is then given in line 14. This is then corrected for discretionary revenue measures (given in line 12) and revenue measures mandated by law (13), in the countries where these latter apply. It is important to check that the increment of these figures relative to the previous year that is used

The change in the net nominal expenditure is then computed in line 16 using the formula from Box 1.11. Note that in doing this, the corrected expenditure net of revenue measures in year t (line 15) is compared to the corrected expenditure for year t-1 that is not net of revenue measures (line 14). This is because the revenue measures from lines 12 and 13 are given on an incremental basis over the previous year. The nominal change is then converted to real terms using the deflator in line 17, which is calculated as the simple arithmetic average of the spring and autumn Commission forecasts from the previous year. The change in real terms in the net expenditure aggregate is given in line 18 according to the formula: real*deflator = nominal, which is to be used to judge compliance with the expenditure benchmark.

In the example given in the table below, the country has an MTO of -0.45% of GDP for the entire period concerned and a structural balance of -1.1% in 2014 and -0.6% in 2015. Line 21 gives the reference rate for the country in question depending chiefly on whether it is at its MTO or not. If one aims at verifying compliance with the expenditure benchmark for instance for 2016, the first stage is to determine the initial position of this Member State at the start of the year (which implies comparing the structural balance in 2015 with the country's MTO). This implies that at the start of 2016, the country in question is assessed to be at its MTO due to the 0.25% of GDP margin of tolerance (-0.6 vs. MTO=-0.45).

If line 18 is at or below the level given in line 21, the country is compliant with the expenditure benchmark for a given year. Otherwise it is not compliant. Line 22 calculates the excess of the growth in expenditure over the reference rate, and converts into the national currency using the figure for the net expenditure aggregate. Using the figure for nominal GDP given in line 23, this difference of net expenditure growth relative to the reference rate is given as a share of GDP in line 24.

The figure in line 24 gives the excess (if it is negative) of net expenditure growth over the reference rate to be used to assess whether the deviation is significant or not. If the deviation exceeds 0.5, it is judged to be significant. As the significance of deviation is judged both in each year and over two years, line 27 gives the average over two years. If this is over 0.25, the deviation is judged to be significant over two years.

		2013	2014	2015	2016
1	**General government expenditure**	164.3	173.4	175.1	177.4
2	**Interest expenditure**	8.4	8.1	7.9	7.8
3	**Government expenditure on EU programmes fully matched by EU funds revenue**	0.3	0.2	0.2	0.2
4	*Gross fixed capital formation t-3*	*9.5*	*9.2*	*9.2*	*9.7*
5	*Gross fixed capital formation t-2*	*9.2*	*9.2*	*9.7*	*9.7*
6	*Gross fixed capital formation t-1*	*9.2*	*9.7*	*9.7*	*9.9*
7	**Gross fixed capital formation t**	**9.7**	**9.7**	**9.9**	**10.1**
8	**Annual average gross fixed capital formation t-3 to t**	**9.4**	**9.5**	**9.6**	**9.9**
9	**Cyclical unemployment expenditure**	0.2	0.3	0.5	0.4
10	*Discretionary measures current revenue*	*1.2*	*0.6*	*0.2*	*-1.9*
11	*Discretionary measures capital transfers received*	*0.0*	*0.0*	*0.0*	*0.0*
12	**Total discretionary revenue measures**	**1.2**	**0.6**	**0.2**	**-1.9**
13	**Revenue measures mandated by law**	**0.0**	**0.0**	**0.0**	**0.0**
14	**Corrected expenditure aggregate* (nominal)** = *(1) –(2) – (3) - ((7) – (8)) – (9)*	155.1	164.6	166.2	168.8
15	**Corrected expenditure aggregate net of (12) and (13)* (nominal)** = *(14) – (12) – (13)*	153.9	164.0	166.0	170.7
16	**Net public expenditure annual growth in % (nominal)**		5.7	0.8	2.7
17	GDP deflator (% change) computed according to agreed methodology		1.7	1.6	1.5
18	**Net public expenditure annual growth in % (real)**		**4.0**	**-0.8**	**1.2**
19	MTO		-0.45	-0.45	-0.45
20	Structural balance		-1.1	-0.6	n.a.
21	**Reference rate to be applied**		**-0.12**	**1.25**	**0.83**
22	Deviation in year t (in national currency) if negative, it is an excess over the benchmark = *((18)-(21))*(14 from the previous year)/100*		-1.4	3.7	-0.03
23	GDP (nominal)		329.3	337.2	347.7
24	**Deviation in year t (in % GDP) if negative, it is an excess over the benchmark** = *(22)/(23)*100*		**-1.5**	**1.09**	**-0.01**
25	**Average deviation in t-1 and t (in % GDP)**			**-0.20**	**0.54**

ANNEX 10
A NUMERICAL EXAMPLE OF AN ASSESSMENT OF EFFECTIVE ACTION TO AN ARTICLE 126(7) RECOMMENDATION OR ARTICLE 126(9) NOTICE

This annex presents an example of an assessment of effective action following an Article 126(7) recommendation or notice under Article 126(9). Assessing compliance with an Article 126(7) recommendation or an Article 126(9) notice implies a systematic economic judgement of the top-down and the bottom-up measure of the fiscal effort([163]).

Scene setter

Consider a Council recommendation under Article 126(7) to a country, setting a deadline for the correction of the excessive deficit as well as intermediate headline and structural deficit targets. For illustrative purposes only, we take as an example the recommendation that the Council addressed to Slovenia in June 2013. Slovenia was recommended to to reach a headline general government deficit of 4.9% of GDP (3.7% of GDP without 1.2% of GDP one off expenditure to recapitalise the two largest banks as then estimated) in 2013, which was deemed consistent with an improvement in the structural balance of 0.7% of GDP and additional measures of 1% of GDP on top of the measures already known at the time of the recommendation and included in the baseline scenario. Tables A10.1 and A10.2 below present the main variables used when defining the EDP adjustment path against which the assessment of effective action is undertaken.

Table A10.1: **Baseline scenario underpinning the EDP recommendation**

% of GDP	2012	2013	2014	2015
Revenues	45.0	45.0	44.2	43.9
Current revenues	44.6	44.3	43.5	43.1
Discretionary measures with impact on current revenue[1]	0.1	0.5	0.0	0.0
Expenditure	49.0	50.5	49.1	49.4
Real GDP growth (%)	-2.3	-2.0	-0.1	1.3
Nominal GDP growth (%)	-2.0	-0.6	1.0	3.1
Potential GDP growth (%)	-1.1	-1.1	-0.7	-0.2
Structural balance	-2.7	-2.6	-3.4	-4.7
General government balance	-4.0	-5.5	-4.9	-5.5
p.m CAB methodology revenue elasticity	0.9	0.9	0.9	0.9
p.m Apparent revenue elasticity	0.6	4.0	-0.9	0.8
p.m Output gap (% of potential output)	-2.7	-3.6	-3.1	-1.9

Note:

[1] Measures clearly specified and committed to by governments ahead of the recommendation

Source: Commission Services' updated 2013 Spring Forecast

([163]) See Section 2.3.2.1 for the definition of both indicators.

Table A10.2: **EDP scenario underpinning the recommendation**

% of GDP	2012	2013	2014	2015
Real GDP growth (%)	-2.3	-2.2	-1.2	0.3
Potential GDP growth (%)	-1.3	-1.4	-1.0	-0.5
Structural balance	-2.8	-2.1	-1.6	-1.1
General government balance	-4.0	-4.9	-3.3	-2.5
p.m Output gap (% of pot. output)	-2.5	-3.3	-3.5	-2.8

Source: Commission Services

The headline deficit (net of bank recapitalisations) reached 4.3% of GDP in 2013, above the corresponding EDP target of 3.7% of GDP, while the structural balance was estimated to have improved by 0.2% of GDP in 2013 (below the recommended 0.7% of GDP). This warranted an assessment of effective action, as detailed below.

Assessment of effective action

When corrected for an upward revision in potential growth (α = -0.3 pp., see Table A10.3) and revenue shortfalls (β = -0.7 pp., see Table A10.4), the estimated structural adjustment delivered in 2013 increased to 0.5% of GDP, which was slightly below the recommended effort of 0.7% of GDP.

Table A10.3: **Detailed calculations for the α parameter**

	Potential GDP growth underlying Council Recommendation (%)	Potential GDP growth at the time of assessment (%)	Forecast error (%)	Structural expenditure (% of potential GDP)	Correction coefficient α (% of nominal potential GDP)
	(1)	(2)	(3)=(1)-(2)	(4)	(5)=(3)*(4)/100
2013	-1.4	-0.6	-0.7	46.9	-0.3

Table A10.4: **Detailed calculations for the β parameter**

	Change in current revenues (yoy) (billions of national currency)		Discretionary current revenue measures (billions of national currency)		Nominal GDP growth assumptions (%)		Current revenues in year t-1 (billions of national currency)		Revenue gap (billion of national currency)*	Correction coefficient β (% of nominal potential GDP)
	(1)	(1')	(2)	(2')	(3)	(3')	(4)	(4')	(5)=[(1')-(2')-ε*(3')*(4')]-[(1)-(2)-ε*(3)*(4)]	
2013	-0.2	0.0	0.2	0.5	-0.6	-0.1	15.5	15.6	-0.2	-0.7

On the other hand, the amount of additional measures implemented by the country was estimated at 1.0% of GDP under the bottom-up metric (see Table A10.5), as recommended by the Council.

Table A10.5: **Additional measures since EDP recommendation as per the bottom-up approach**

	Additional effort in revenue (% of GDP)	Additional effort in expenditure (% of GDP)	**Total annual additional effort (% of GDP)**	**Total cumulated additional effort (% of GDP)**	Additional annual measures indicated in the recommendation (% of GDP)
2013	0.6	0.5	**1.0**	**1.0**	1.0

While the conclusion in terms of effective action is in most cases straightforward when the two indicators point in the same direction, it requires analysing the sources of the discrepancy when they deliver different messages. In cases like the one depicted in this example, as the top-down and bottom-up indicators convey different messages, an analysis of the reasons behind is warranted in order to assess whether the country has taken effective action. This kind of analysis is country-specific, given that the factors that can explain the differences between the two metrics depend on the specific aspects affecting the budgetary execution on the revenue and the expenditure sides, respectively – as explained below.

The careful analysis

Analysing possible differences between the two indicators is therefore a crucial part of the assessment of effective action. In general, the difference between the two indicators can be explained by four main factors that help inform the careful analysis, one on the revenue side and three on the expenditure side:

- Revenue side:

1. The corrected change in structural balance can still be distorted by **windfalls/shortfalls in capital revenues** (as the correction brought by the β parameter concerns only windfalls/shortfalls in current revenues), while the bottom-up measure of the fiscal effort focuses directly on discretionary revenue measures.

- Expenditure side:

2. There may be a difference between the **two benchmark growth rates for structural expenditure**, namely the *no-policy change* scenario used as baseline in the bottom-up approach on the one hand, and the nominal potential GDP growth rate corrected by the α parameter in the corrected change in the structural balance, on the other hand. Since the α parameter only brings a correction in real terms, surprises in inflation will affect the two benchmark growth rates, which are set in nominal terms.

3. **Some expenditure items are excluded from the bottom-up indicator** – in particular, interest payments and EU funds – while these are not excluded when computing the corrected change in structural balance.

4. There may be a difference between the apparent and the conventional values of **expenditure semi-elasticities.** To put it differently, the impact of cyclical conditions on public expenditure – and more precisely on unemployment expenditure – is not measured in the same way in both indicators.

However, it is to be noted that, while the factors indicated above help identifying the source(s) of discrepancy between the two metrics, they do not necessarily point to which one is the relevant indicator to assess the delivery of effective action.

ANNEX 11
PARAMETERS UNDERLYING THE COMMISSION'S CYCLICAL ADJUSTMENT METHODOLOGY

The cyclically-adjusted budget balance (CAB) corresponds to the deficit/surplus-to-GDP ratio that would prevail if the economy was running at potential. It is computed as the difference between the actual balance-to-GDP ratio and an estimated cyclical component. In algebraic terms:

$$CAB_t = \frac{(R_t - G_t)}{Y_t} - \varepsilon \cdot OG_t \qquad (1)$$

where R and G stand for the nominal government revenue and expenditure respectively and Y for nominal GDP. The nominal budget balance B is defined as the difference between the nominal government revenue and expenditure. The cyclical component of the budget balance is the product of a cyclical adjustment parameter (ε) and the output gap (OG). ε is often called semi-elasticity, which captures the reaction of the budget balance, as a percentage of GDP, to the output gap. This cyclical component is subtracted from the actual budget as a percentage of GDP (also called 'headline budget balance' in the fiscal literature) to obtain the CAB. It has the merit to be easily calculated and be clearly communicable to policymakers.

The cyclical adjustment parameter, i.e. the budgetary semi-elasticity is computed based on the weighting parameters ([164]) and the recently revised individual elasticities of revenue and spending ([165]). As shown by Table 1, budgetary semi-elasticities are computed by weighting individual elasticities by the corresponding share of the individual revenue (expenditure) category in total revenue (expenditure) and by the corresponding revenue (expenditure) weight (in percentage of GDP).

$$\varepsilon = \varepsilon_R - \varepsilon_G = (\eta_R - 1)\frac{R}{Y} - (\eta_G - 1)\frac{G}{Y} = \left(\sum_{i=1}^{5} \eta_{R_i} \frac{R_i}{R} - 1\right)\frac{R}{Y} - \left(\eta_{G_U} \frac{G_U}{G} - 1\right)\frac{G}{Y} \qquad (2)$$

where η_R and η_G denote respectively the elasticity of (total) revenue and expenditure with respect to the output gap. $(\eta_R - 1)$ and $(\eta_G - 1)$ correspond to the elasticity of the revenue-to-GDP ratio and the elasticity of the expenditure-to-GDP ratio respectively. Individual revenue/spending elasticities with respect to the output gap are computed using a two-step procedure (see Table 2): (i) the elasticity of the revenue/expenditure item with respect to its base $\varepsilon_{base/OG}$., and (ii) the elasticity of the base with respect to output $\varepsilon_{R/OG}$.

$$\varepsilon_{R/OG} = \varepsilon_{R/base} \cdot \varepsilon_{base/OG} \qquad (3)$$

([164]) For more details, see G. Mourre, G-M. Isbasoiu, D. Paternoster and M. Salto, "The cyclically-adjusted budget balance used in the EU fiscal framework: a revised computation", European Economy. Economic Papers, March 2013

([165]) For more details, see G. Mourrre, C. Astarita and S. Princen, "Adjusting the budget balance for the business cycle: the EU methodology", European Economy. Economic Papers, November 2014 and Price, R. W, Dang T. and Guillemette Y. (2014), "New tax and expenditure elasticity estimates for EU budget surveillance", OECD Economics Department Working Paper No. 1174

Table 1: **Decomposition of the semi-elasticity of budget balance to output gap**

	Elasticity of:				Weights (% of GDP) of:		Semi-elasticity for:		
	Revenue level	Expenditure level	Revenue-to-GDP ratio	Expenditure-to-GDP ratio	Total revenue	Total expenditure	Revenue	Expenditure	Budget balance
	(a)	(b)	c = a-1	d = b-1	(e)	(f)	g = c*e	h = d*f	i = g-h
BE	1.03	-0.17	0.03	-1.17	49.05	50.70	0.015	-0.591	0.605
BG	0.78	-0.03	-0.22	-1.03	37.75	38.10	-0.084	-0.391	0.308
CZ	0.97	-0.02	-0.03	-1.02	39.91	43.77	-0.012	-0.446	0.433
DK	1.00	-0.14	0.00	-1.14	55.75	54.34	-0.001	-0.620	0.619
DE	0.98	-0.21	-0.02	-1.21	44.00	46.45	-0.009	-0.560	0.551
EE	1.10	-0.10	0.10	-1.10	37.63	36.99	0.037	-0.406	0.443
IE	1.05	-0.24	0.05	-1.24	35.20	41.14	0.019	-0.508	0.528
EL	0.94	-0.05	-0.06	-1.05	39.93	48.06	-0.023	-0.506	0.483
ES	1.03	-0.28	0.03	-1.28	38.14	41.13	0.011	-0.528	0.539
FR	1.00	-0.11	0.00	-1.11	49.90	54.11	0.002	-0.601	0.603
HR	0.97	-0.02	-0.03	-1.02	40.48	46.96	-0.011	-0.479	0.467
IT	1.08	-0.03	0.08	-1.03	45.14	48.77	0.038	-0.501	0.539
CY	1.18	-0.04	0.18	-1.04	40.27	43.47	0.071	-0.452	0.523
LV	0.92	-0.07	-0.08	-1.07	35.08	38.26	-0.028	-0.408	0.380
LT	1.07	-0.08	0.07	-1.08	32.92	36.13	0.022	-0.391	0.413
LU	1.01	-0.08	0.01	-1.08	41.87	41.09	0.003	-0.442	0.445
HU	0.96	-0.01	-0.04	-1.01	44.97	50.33	-0.019	-0.511	0.492
MT	1.02	-0.03	0.02	-1.03	39.48	43.74	0.007	-0.449	0.456
NL	1.15	-0.22	0.15	-1.22	45.25	47.37	0.066	-0.579	0.646
AT	1.02	-0.12	0.02	-1.12	48.49	50.77	0.012	-0.569	0.580
PL	1.07	-0.13	0.07	-1.13	38.78	43.79	0.027	-0.494	0.521
PT	0.95	-0.13	-0.05	-1.13	41.08	46.42	-0.019	-0.525	0.506
RO	0.86	-0.04	-0.14	-1.04	32.97	36.78	-0.045	-0.384	0.339
SI	0.99	-0.04	-0.01	-1.04	43.46	46.49	-0.006	-0.483	0.477
SK	0.99	-0.03	-0.01	-1.03	34.23	38.62	-0.005	-0.398	0.393
FI	0.94	-0.18	-0.06	-1.18	53.13	51.08	-0.030	-0.604	0.574
SE	0.96	-0.15	-0.04	-1.15	53.99	53.13	-0.020	-0.609	0.590
UK	1.30	-0.03	0.30	-1.03	40.36	45.60	0.120	-0.471	0.591

Note: The total revenue and expenditure as a percentage of GDP (columns e and f) correspond to the 'Excessive Deficit Procedure' definition, as explained in more detail in Mourre et al.(2013).

Table 2: **Revenue (expenditure)-to-base and base-to-output gap elasticities of individual revenue and expenditure categories**

	Personal income tax			Corporate income tax			Social security contributions			Indirect taxes			Unemployment-related expenditure		
	Revenue-to-base elasticity	*Base-to-output gap elasticity*	*Revenue-to-output gap elasticity*	*Revenue-to-base elasticity*	*Base-to-output gap elasticity*	*Revenue-to-output gap elasticity*	*Revenue-to-base elasticity*	*Base-to-output gap elasticity*	*Revenue-to-output gap elasticity*	*Revenue-to-base elasticity*	*Base-to-output gap elasticity*	*Revenue-to-output gap elasticity*	*Expenditure-to-base elasticity*	*Base-to-output gap elasticity*	*Expenditure-to-output gap elasticity*
	j	*k*	*= j * k*	*l*	*m*	*= l * m*	*n*	*o*	*= n * o*	*p*	*q*	*= p * q*	*r*	*s*	*= r * s*
BE	1.62	0.81	1.31	1.62	1.53	2.48	1.15	0.61	0.71	1.00	1.00	1.00	1.00	-3.70	-3.70
BG	1.11	1.04	1.15	1.81	1.18	2.13	0.93	0.66	0.61	1.00	1.00	1.00	1.00	-3.91	-3.91
CZ	2.23	0.74	1.65	1.23	1.45	1.78	0.99	0.87	0.86	1.00	1.00	1.00	1.00	-2.45	-2.45
DK	1.43	0.70	1.00	2.07	1.52	3.15	0.70	0.59	0.41	1.00	1.00	1.00	1.00	-4.97	-4.97
DE	1.88	1.00	1.87	1.59	1.20	1.91	0.86	0.70	0.60	1.00	1.00	1.00	1.00	-3.30	-3.30
EE	1.46	1.08	1.58	1.81	0.99	1.78	1.36	1.03	1.40	1.00	1.00	1.00	1.00	-5.18	-5.18
IE	2.04	0.77	1.58	1.00	1.26	1.25	1.51	0.69	1.04	1.00	1.00	1.00	1.00	-5.45	-5.45
EL	2.21	1.00	2.22	1.81	1.05	1.90	0.84	0.69	0.58	1.00	1.00	1.00	1.00	-3.15	-3.15
ES	1.88	0.98	1.84	1.32	1.18	1.56	0.82	0.88	0.72	1.00	1.00	1.00	1.00	-5.83	-5.83
FR	1.68	1.11	1.86	2.03	1.36	2.76	0.95	0.66	0.63	1.00	1.00	1.00	1.00	-3.23	-3.23
HR	1.75	0.98	1.71	1.81	1.27	2.29	1.00	0.71	0.70	1.00	1.00	1.00	1.00	-2.39	-2.39
IT	1.85	0.79	1.46	2.09	1.47	3.07	0.97	0.60	0.58	1.10	1.00	1.10	1.00	-2.29	-2.29
CY	2.25	1.01	2.28	1.93	1.17	2.26	1.00	0.91	0.91	1.00	1.00	1.00	1.00	-3.08	-3.08
LV	1.31	1.14	1.50	1.89	1.05	1.99	1.00	0.81	0.81	1.00	1.00	1.00	1.00	-3.94	-3.94
LT	1.46	1.23	1.79	1.68	0.99	1.67	1.00	1.04	1.04	1.00	1.00	1.00	1.00	-5.60	-5.60
LU	2.24	0.60	1.34	1.81	1.30	2.36	0.89	0.44	0.39	1.00	1.00	1.00	1.00	-3.06	-3.06
HU	1.80	0.96	1.73	1.81	1.22	2.21	0.99	0.77	0.76	1.00	1.00	1.00	1.00	-1.25	-1.25
MT	2.11	0.98	2.07	1.81	1.17	2.11	0.92	0.76	0.71	1.00	1.00	1.00	1.00	-1.96	-1.96
NL	2.00	1.19	2.37	2.81	1.11	3.13	0.86	0.73	0.62	1.00	1.00	1.00	1.00	-5.76	-5.76
AT	1.97	0.84	1.66	1.90	1.44	2.74	0.92	0.70	0.65	1.00	1.00	1.00	1.00	-4.71	-4.71
PL	1.93	0.98	1.88	2.30	1.27	2.92	0.97	0.99	0.97	1.00	1.00	1.00	1.00	-6.18	-6.18
PT	2.15	0.91	1.97	1.07	1.24	1.33	1.00	0.79	0.79	1.00	1.00	1.00	1.00	-6.04	-6.04
RO	1.36	0.95	1.29	1.81	1.11	2.02	0.99	0.62	0.62	1.00	1.00	1.00	1.00	-3.91	-3.91
SI	2.14	0.76	1.63	2.72	1.38	3.76	1.00	0.66	0.66	1.00	1.00	1.00	1.00	-2.81	-2.81
SK	2.43	0.79	1.93	1.24	1.28	1.58	1.19	0.75	0.89	1.00	1.00	1.00	1.00	-2.98	-2.98
FI	1.48	0.95	1.41	1.63	1.25	2.03	1.00	0.77	0.77	1.00	1.00	1.00	1.00	-3.66	-3.66
SE	1.42	0.93	1.32	1.19	1.30	1.56	0.95	0.75	0.71	1.00	1.00	1.00	1.00	-4.42	-4.42
UK	1.49	1.12	1.68	2.89	1.35	3.92	1.20	0.50	0.60	1.00	1.00	1.00	1.00	-4.21	-4.21

ANNEX 12
MODEL STRUCTURE AND TABLES TO BE CONTAINED IN DRAFT BUDGETARY PLANS

A. MODEL STRUCTURE FOR DRAFT BUDGETARY PLANS

1. Macroeconomic Forecasts.

2. Budgetary targets.

3. Expenditure and revenue projections under the no-policy change scenario.

4. Expenditure and revenue targets. General government expenditure by function.

5. Discretionary measures included in the draft budget.

6. Possible links between the draft budgetary plan and the targets set by the Union's Strategy for growth and jobs and CSRs.

7. Comparison with latest Stability Programme.

8. Distributional impact of the main expenditure and revenue measures.

Annex: Methodological aspects, including the estimated impact of aggregated budgetary measures on economic growth.

B. TABLES TO BE CONTAINED IN DRAFT BUDGETARY PLANS

1. Macroeconomic forecasts

Table 0.i): **Basic assumptions**

	Year t-1	Year t	Year t+1
Short-term interest rate[1] (annual average)			
Long-term interest rate (annual average)			
USD/€ exchange rate (annual average)			
Nominal effective exchange rate			
World excluding EU, GDP growth			
EU GDP growth			
Growth of relevant foreign markets			
World import volumes, excluding EU			
Oil prices (Brent, USD/barrel)			

1/ If necessary, purely technical assumptions.

Table 0.ii): **Main assumptions. Non-exhaustive check list. (Similar information can be provided in different formats)**

	Year t-1	Year t	Year t+1
1. External environment			
a. Prices of commodities b. Spreads over the German bond			
2. Fiscal policy			
a. General government net lending / net borrowing b. General government gross debt			
3. Monetary policy / Financial sector / interest rates assumptions			
a. Interest rates: i. Euribor ii. Deposit rates iii. Interest rates for loans iv. Yields to maturity of 10 year government bonds b. Evolution of deposits c. Evolution of loans d. NPL trends			
4. Demographic trends			
a. Evolution of working-age population b. Dependency ratios			
5. Structural policies			

Table 1.a.: **Macroeconomic prospects**

	ESA Code	**Year t-1**	**Year t-1**	**Year t**	**Year t+1**	Year t+2	Year t+3	Year t+4
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g							
Of which								
1.1. Attributable to the estimated impact of aggregated budgetary measures on economic growth[1]		---	---					
2. Potential GDP						✓	✓	✓
contributions:								
- labour								
- capital								
- total factor productivity								
3. Nominal GDP	B1*g					✓	✓	✓
Components of real GDP								
4. Private final consumption expenditure	P.3							
5. Government final consumption expenditure	P.3							
6. Gross fixed capital formation	P.51g							
7. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53							
8. Exports of goods and services	P.6							
9. Imports of goods and services	P.7							
Contributions to real GDP growth								
10. Final domestic demand			-					
11. Changes in inventories and net acquisition of valuables	P.52 + P.53		-					
12. External balance of goods and services	B.11		-					

1/ Please report here the estimated impact on real GDP growth of the aggregated budgetary measures contained in the DBP.

Table 1.b.: **Price developments**

	ESA Code	**Year t-1**	**Year t-1**	**Year t**	**Year t+1**	Year t+2	Year t+3	Year t+4
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator						✓	✓	✓
2. Private consumption deflator								
3. HICP								
4. Public consumption deflator								
5. Investment deflator								
6. Export price deflator (goods and services)								
7. Import price deflator (goods and services)								

Table 1.c.: **Labour market developments**

	ESA Code	**Year t-1**	**Year t-1**	**Year t**	**Year t+1**
		Level	rate of change	rate of change	rate of change
1. Employment, persons[1]					
2. Employment, hours worked[2]					
3. Unemployment rate (%)[3]					
4. Labour productivity, persons[4]					
5. Labour productivity, hours worked					
6. Compensation of employees	D.1				
7. Compensation per employee					
			-		
			-		

1/ Occupied population, domestic concept national accounts definition.

2/ National accounts definition.

3/ Harmonised definition, Eurostat; levels.

4/ Real GDP per person employed.

5/ Real GDP per hour worked.

Table 1.d.: **Sectoral balances**

	ESA Code	**Year t-1**	**Year t**	**Year t+1**
1. Net lending/net borrowing vis-à-vis the rest of the world	B.9	% GDP	% GDP	% GDP
of which:				
- Balance on goods and services				
- Balance of primary incomes and transfers				
- Capital account				
2. Net lending/net borrowing of the private sector	B.9			
3. Net lending/net borrowing of general government	B.9			
4. Statistical discrepancy				

2. Budgetary Targets

Table 2.a.: **General government budgetary targets broken down by subsector**

	ESA Code	**Year t**	**Year t+1**	Year t+2	Year t+3	Year t+4
		% GDP	% GDP	% GDP	% GDP	% GDP
Net lending (+) / net borrowing (-) (B.9) by sub-sector[1]						
1. General government	S.13			✓	✓	✓
1a. Central government	S.1311					
1b. State government	S.1312					
1c. Local government	S.1313					
1d. Social security funds	S.1314					
2. Interest expenditure	D.41					
3. Primary balance[2]						
4. One-off and other temporary measures[3]				✓	✓	✓
5. Real GDP growth (%) (=1 in Table 1.a)						
6. Potential GDP growth (%) (=2 in Table 1.a)				✓	✓	✓
contributions:						
- labour						
- capital						
- total factor productivity						
7. Output gap (% of potential GDP)				✓	✓	✓
8. Cyclical budgetary component (% of potential GDP)				✓	✓	✓
9. Cyclically-adjusted balance (1 - 12) (% of potential GDP)						
10. Cyclically-adjusted primary balance (13 + 6) (% of potential GDP)						
11. Structural balance (13 - 8) (% of potential GDP)				✓	✓	✓

1/ TR-TE= B.9.

2/ The primary balance is calculated as (B.9, item 1) plus (D.41, item 2).

3/ A plus sign means deficit-reducing one-off measures.

Table 2.b.: **General government debt developments**

	ESA Code	**Year t**	**Year t+1**	Year t+2	Year t+3	Year t+4
		% GDP	% GDP	% GDP	% GDP	% GDP
1. Gross debt[1]				✓	✓	✓
2. Change in gross debt ratio						
Contributions to changes in gross debt						
3. Primary balance (= item 3 in Table 2.a)						
4. Interest expenditure (= item 2 in Table 2.a)	D.41					
5. Stock-flow adjustment				✓	✓	✓
of which:						
- Differences between cash and accruals[2]						
- Net accumulation of financial assets[3]						
of which:						
- privatisation proceeds						
- Valuation effects and other[4]						
p.m.: Implicit interest rate on debt[5]						
Other relevant variables						
6. Liquid financial assets[6]						
7. Net financial debt (7=1-6)						
8. Debt amortization (existing bonds) since the end of the previous year						
9. Percentage of debt denominated in foreign currency						
10. Average maturity						

1/ As defined in amended Regulation 479/2009.

2/ The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

3/ Currency and deposits, government debt securities, government controlled enterprises and the difference between listed and unlisted shares could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

4/ Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

5/ Proxied by interest expenditure divided by the debt level of the previous year.

6/ Liquid assets are here defined as stocks of AF.1, AF.2, AF.3 (consolidated for general government, i.e. netting out financial positions between government entities), AF.511, AF.52 (only if listed on stock exchange).

Table 2.c.: **Contingent liabilities**

	Year t	Year t+1
	% GDP	% GDP
Public guarantees		
Of which: linked to the financial sector		

3. Expenditure and Revenue Projections under the no-policy change scenario([166]).

Table 3.: **General government expenditure and revenue projections at unchanged policies broken down by main components**

	ESA Code	**Year T**	**Year t+1**
General government (S13)		% GDP	% GDP
1. Total revenue at unchanged policies	TR		
Of which			
1.1. Taxes on production and imports	D.2		
1.2. Current taxes on income, wealth, etc	D.5		
1.3. Capital taxes	D.91		
1.4. Social contributions	D.61		
1.5. Property income	D.4		
1.6. Other[1]			
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[2]			
2. Total expenditure at unchanged policies	TE[3]		
Of which			
2.1. Compensation of employees	D.1		
2.2. Intermediate consumption	P.2		
2.3. Social payments	D.62+D.632		
of which Unemployment benefits[4]			
2.4. Interest expenditure	D.41		
2.5. Subsidies	D.3		
2.6. Gross fixed capital formation	P.51g		
2.7. Capital transfers	D.9		
2.8. Other[5]			

(166) Please note that the no-policy change scenario involves the extrapolation of revenue and expenditure trends before adding the impact of the measures included in the forthcoming year's budget.

4. Expenditure and Revenue targets.

Table 4.: **General government expenditure and revenue targets, broken down by main components**

	ESA Code	**Year T**	**Year t+1**
General government (S13)		% GDP	% GDP
1. Total revenue target	TR		
Of which			
1.1. Taxes on production and imports	D.2		
1.2. Current taxes on income, wealth, etc.	D.5		
1.3. Capital taxes	D.91		
1.4. Social contributions	D.61		
1.5. Property income	D.4		
1.6. Other [1]			
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[2]			
2. Total expenditure target	TE[3]		
Of which			
2.1. Compensation of employees	D.1		
2.2. Intermediate consumption	P.2		
2.3. Social payments	D.62+D.632		
of which Unemployment benefits[4]			
2.4. Interest expenditure (=item 2 in Table 2.a)	D.41		
2.5. Subsidies	D.3		
2.6. Gross fixed capital formation	P.51		
2.7. Capital transfers	D.9		
2.8. Other[5]			

1/ P.11+P.12+P.131+D.39rec+D.7rec+D.9rec (other than D.91rec).

2/ Including those collected by the EU and including an adjustment for uncollected taxes and social contributions D.995), if appropriate.

3/ TR-TE = B.9.

4/ Includes social benefits other than social transfers in kind (D.62) and social transfers in kind via market producers (D.632) related to unemployment benefits.

5/ D.29pay + D.4pay (other than D.41pay) +D.5pay +D.7pay +P.52+P.53+NP+D.8.

Table 4.b: **General government expenditure and revenue targets, broken down by main components**

	ESA Code	Year t-1	Year t-1	Year t	Year t+1
		Level	% GDP	% GDP	% GDP
1. Expenditure on EU programmes fully matched by EU funds revenue					
2. Cyclical unemployment benefit expenditure[1]					
3. Effect of discretionary revenue measures[2]					
4. Revenue increases mandated by law					

1/ Please detail the methodology used to obtain the cyclical component of unemployment benefit expenditure. It should build on unemployment benefit expenditure as defined in COFOG under the code 10.5.

2/ Revenue increases mandated by law should not be included in the effect of discretionary revenue measures: data reported in rows 3 and 4 should be mutually exclusive.

Table 4.c: **General government expenditure by function**

4.c.i) General government expenditure on education, healthcare and employment

	Year t		Year t+1	
	% GDP	% general government expenditure	% GDP	% general government expenditure
Education[1]				
Healthcare[1]				
Employment[2]				

1/ These expenditure categories should correspond respectively to items 9 and7 in table 4.c.ii).

2/ This expenditure category should contain, inter alia, government spending related to active labour market policies (ALMPs) including public employment services. On the contrary, items such as compensation of public employees or vocational training programmes should not be included here.

4.c.ii) Classification of the functions of the Government

Functions of the Government	COFOG Code	Year t	Year t+1
		% GDP	% GDP
1. General public services	1		
2. Defense	2		
3. Public order and safety	3		
4. Economic affairs	4		
4. Environmental protection	5		
6. Housing and community amenities	6		
7. Health	7		
8. Recreation, culture and religion	8		
9. Education	9		
10. Social protection	10		
11. Total Expenditure (= item 2 in Table 4.a)	TE		

5. Description of discretionary measures included in the draft budget

Table 5.a: **Discretionary measures taken by General Government**

List of measures	Detailed description[1]	Target (Expenditure / Revenue component) ESA Code	Accounting principle	Adoption Status	Budgetary impact				
						Year t	Year t+1	Year t+2	Year t+…
						% GDP	% GDP	% GDP	% GDP
(1)									
(2)									
…									
					TOTAL				

1/ Please describe in further detail in case of major fiscal policy reform plans with potential spillover effects for other Member States in the Euro Area.

Table 5.b: **Discretionary measures taken by Central Government**

List of measures	Detailed description[1]	Target (Expenditure / Revenue component) ESA Code	Accounting principle	Adoption Status	Budgetary impact				
						Year t	Year t+1	Year t+2	Year t+…
						% GDP	% GDP	% GDP	% GDP
(1)									
(2)									
…									
					TOTAL				

1/ Please describe in further detail in case of major fiscal policy reform plans with potential spillover effects for other Member States in the Euro Area.

Table 5.c: **Discretionary measures taken by sub-sectors of the General Government[1]**

List of measures	Detailed description[2]	Target (Expenditure / Revenue component) ESA Code	Accounting principle	Adoption Status	Budgetary impact				
						Year t	Year t+1	Year t+2	Year t+…
						% GDP	% GDP	% GDP	% GDP
(1)									
(2)									
…									
					TOTAL				

1/ Please name whether State Government, Local Government and/or Social Security Funds.

2/ Please describe in further detail in case of major fiscal policy reform plans with potential spillover effects for other Member States in the Euro Area.

6. Indications on how the measures in the DBP address CSR and the targets set by the Union's Strategy for growth and jobs

Table 6.a: **CSR recommendations**

CSR number	List of measures	Description of direct relevance

Table 6.b: **Targets set by the Union's Strategy for growth and jobs**

National 2020 headline targets	List of measures	Description of direct relevance to address the target
National 2020 employment target […]		
National 2020 R&D target […]		
GHG emission reduction target […]		
Renewable energy target […]		
National energy efficiency target […]		
National early school leaving target […]		
National target for tertiary education […]		
National poverty target […]		

7. Divergence from latest SP

Table 7: **Divergence from latest SP**

	ESA Code	**Year t-1**	**Year t**	**Year t+1**
		% GDP	% GDP	% GDP
Target general government net lending/net borrowing	B.9			
Stability Programme				
Draft Budgetary Plan				
Difference				
General government net lending projection at unchanged policies	B.9			
Stability Programme				
Draft Budgetary Plan				
Difference[1]				

1/ This difference can refer to both deviations stemming from changes in the macroeconomic scenario and those stemming from the effect of policy measures taken between the submission of the SP and the submission of the DBP. Differences are expected due to the fact that the no-policy change scenario is defined differently for the purpose of this Code of Conduct with respect to the Stability Programme.

8. Distributional impact of the main expenditure and revenue measures

In accordance with Article 6(3)(d) of Regulation 473/2013,Member States should provide, to the extent possible, qualitative information and quantitative estimations on the distributional effects of budgetary measures, presented as best fits each Member State's specific measures and available analytical frameworks.

Quantifying the distributional impact of budgetary measures is a challenging task. For this reason no standardized table on this aspect of DBPs is included in this Annex. Quantitative estimations of the distributional impact of budgetary measures could be assessed by computing the expected changes in the Gini index, the S80/S20 indicator or the poverty rates as a result of them. This methodology could represent one possible way forward among others.

Annex to the DBP: Methodology, economic models and assumptions underpinning the information contained in the DBP

Table 8: **Methodological aspects**

Estimation Technique	Step of the budgetary process for which it was used[1]	Relevant features of the model/ technique used	Assumptions
Tool n.1			
Tool n.2			
…			

1/ Modeling tools may have been used:

- when doing macro forecasts
- when estimating expenditure and revenue under the no policy change scenario
- when estimating the distributional impact of the main expenditure and revenue measures
- when quantifying the expenditure and revenue measures to be included in the draft budget
- when estimating how reforms included in the DBP address targets set by the Union's Strategy for growth and jobs and CSRs.

ANNEX 13
TABLES TO BE INCLUDED UNDER THE ADDITIONAL REPORTING INTRODUCED IN THE TWO PACK

These tables are to be submitted in accordance with Article 10(3) of Regulation (EU) No 473/2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area. In all tables, year t corresponds to the year of submission of the report. Reporting for the items indicated in bold is compulsory. The conceptual framework agreed in the context of Council directive 2011/85 should be implemented.

Table 1a: **In-year quarterly budgetary execution on cash basis[a] for the general government and its sub-sectors[b]**

EUR millions	Year t *			
	Q1	Q2	Q3	Q4
Overall balance by sub-sector (6-7)				
1. General government				
2. Central government				
3. State government				
4. Local government				
5. Social security funds				
For each sub-sector (please indicate which)				
6. Total revenue / inflows				
Of which (indicative list)				
Taxes, of which:				
Direct Taxes				
Indirect taxes, of which:				
VAT				
Social contributions				
Sales				
Other current revenue				
Capital revenue				
Inflows from operations in financial instruments				
7. Total expenditure / outflows				
Of which (indicative list)				
Purchase of goods and services				
Compensation of employees				
Interest				
Subsidies				
Social benefits				
Other current expenditure				
Capital transfers payable				
Capital investments				
Outflows from operations in financial instruments				

* The reporting is mandatory up to the current quarter included. If the data for the current quarter is not available, please provide latest available monthly data, indicating which month it corresponds to. For the overall balance of the general government, please provide the information until the latest available quarter (i.e. q-1). The normal quality assurance and revision policy should apply.

[a] Equivalent figures from public accounting may be provided if cash-based data are not available; please specify the accounting basis used to fill all the information provided in this table.

[b] Corresponding to the reporting to be provided in accordance with Article 3(2) of Council Directive 2011/85/EU.

Table 1b: **In-year quarterly budgetary execution and prospects in accordance with ESA standards and seasonally non-adjusted[a] for the general government and its sub-sectors**

The data of budgetary execution provided in Table 1a and 1b should be consistent; a reconciliation table showing the methodology of transition between the two tables should be communicated.

EUR millions	ESA code	**Year t ***			
		Q1	**Q2**	**Q3**	**Q4**
Net lending (+)/ net borrowing (-)					
1. General government [a]	S.13				
2. Central government	S.1311				
3. State government	S.1312				
4. Local government	S.1313				
5. Social security funds	S.1314				
For the general government (voluntary for the sub-sectors)					
6. Total revenue [a]	TR				
Of which					
Taxes on production and imports	D.2				
Current taxes on income, wealth, etc.	D.5				
Capital taxes	D.91				
Social contributions	D.61				
Property income	D.4				
Other[b]					
7. Total expenditure [a]	TE				
Of which					
Compensation of employees	D.1				
Intermediate consumption	P.2				
Social payments	D.62, D.632[c]				
Interest expenditure	D.41				
Subsidies	D.3				
Gross fixed capital formation[a]	P.51				
Capital transfers	D.9				
Other[d]					
8. Gross debt[e]					

* The reporting shall span until the end of the current Year t; quarterly prospects are not binding and reported as estimates (possibly subject to revisions) for informational and monitoring purposes.

[a] For the general government, the items labelled with "a" are to be additionally provided in seasonally-adjusted terms; if it cannot be provided by the national authorities, the seasonal adjustment will be performed by Eurostat, in liaison with the Member State concerned.

[b] P.11+P.12+P.131+D.39rec +D.7rec +D.9rec (other than D.91rec) .

[c] Under ESA95: D6311_D63121_D63131pay; in ESA2010 D632pay

[d] D.29pay+D.4pay (other than D.41pay) +D.5pay+D.7pay+P.52+P.53+K.2+D.8.

[e] As defined in Regulation (EC) No 479/2009.

Table 1c: **Annual budgetary targets in accordance with ESA standards for the general government and its sub-sectors**

	ESA Code	**Year t-1**	**Year t**	**Year t + …** *
Net lending(+)/ net borrowing (-) by sub-sector (% GDP)				
1. General government	S.13			
2. Central government	S.1311			
3. State government	S.1312			
4. Local government	S.1313			
5. Social security funds	S.1314			
General government (S.13) (% GDP)				
6. Total revenue	TR			
7. Total expenditure	TE			
8. Interest expenditure	D.41			
9. Primary balance[a]				
10. One-off and other temporary measures[b]				
		rate of change	rate of change	rate of change
11. Real GDP growth				
12. Potential GDP growth				
contributions:				
- labour				
- capital				
- total factor productivity				
		% potential GDP	% potential GDP	% potential GDP
13. Output gap				
14. Cyclical budgetary component				
15. Cyclically-adjusted balance (1 – 14)				
14. Cyclically-adjusted primary balance (13 + 6)				
15. Structural balance (13 – 10)				

* Following the request from the Commission to activate the reporting requirements provided for by Article 10(3) of Regulation (EU) No 473/2013, the reporting starts from the year of the opening of the excessive deficit procedure in accordance with Article 126(6) TFEU, and spans until the excessive deficit is planned to be corrected, in accordance with the deadline set by the Council recommendation in accordance with Article 126(7) TFEU or decision to give notice in accordance with Article 126(9) TFEU.

[a] The primary balance is calculated as (B.9, item 8) plus (D.41, item 9).

[b] A plus sign means deficit-reducing measures.

Table 2: **Targets for the expenditure and revenues of the general government (S.13) in accordance with ESA standards**

% GDP	ESA Code	**Year t-1**	**Year t**	**Year t+1**	Year t + … [*]
1. Total revenue target (= table 1c. 6)	TR				
Of which					
1.1. Taxes on production and imports	D.2				
1.2. Current taxes on income, wealth, etc.	D.5				
1.3. Capital taxes	D.91				
1.4. Social contributions	D.61				
1.5. Property income	D.4				
1.6. Other[a]					
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[b]					
2. Total expenditure target (= table 1c.7)	TE[c]				
Of which					
2.1. Compensation of employees	D.1				
2.2. Intermediate consumption	P.2				
2.3. Social payments	D.62, D.6311, D.63121, D.63131[f]				
of which **Unemployment benefits**[d]					
2.4. Interest expenditure	D.41				
2.5. Subsidies	D.3				
2.6. Gross fixed capital formation	P.51				
2.7. Capital transfers	D.9				
2.8. Other[e]					

[*] Following the request from the Commission to activate the reporting requirements provided for by Article 10(3) of Regulation (EU) No 473/2013, the reporting starts from the year of the opening of the excessive deficit procedure in accordance with Article 126(6) TFEU, and spans until the excessive deficit is planned to be corrected, in accordance with the deadline set by the Council recommendation in accordance with Article 126(7) TFEU or decision to give notice in accordance with Article 126(9) TFEU.

[a] P.11+P.12+P.131+D.39rec+D.7rec+D.9rec (other than D.91rec).

[b] Including those collected by the EU and including an adjustment for uncollected taxes and social contributions D.995), if appropriate.

[c] TR-TE = B.9.

[d] Includes cash benefits (D.621 and D.624) and in kind benefits (D.631) related to unemployment benefits.

[e] D.29+D.4 (other than D.41) +D.5+D.7+P.52+P.53+K.2+D.8.

[f] In ESA2010: D.62, D.632

Table 3a: **Budgetary measures adopted and envisaged by the general government and its sub-sectors on both the expenditure and the revenue side to achieve the targets presented in Table 2**

Expected budgetary impact of measures adopted and envisaged[a]										
List of measures	**Detailed description**[b]	**Target (Expenditure / Revenue) ESA Code**	**Accounting principle**[c]	**Adoption Status**	**Incremental budgetary impact (EUR million) on year**					
						t-1	**t**	**t+1**	**t+2**	**t + ***
					TOTAL					

* Year when the excessive deficit is planned to be corrected, in accordance with the deadline set by the Council recommendation in accordance with Article 126(7) TFEU or decisions to give notice in accordance with Article 126(9) TFEU.

[a] Only measures sufficiently detailed and credibly announced should be reported.

[b] Including reporting on which sub-sector is taking the measure.

[c] By default, the impact of the measures will be reported on accrual basis, but, if impossible and reporting is in cash, it should be indicated explicitly. The impact is to be recorded in incremental terms – as opposed to levels – compared to the previous year's baseline projection. Simple permanent measures should be recorded as having an effect of +/- X in the year(s) they are introduced and zero otherwise (the overall impact on the level of revenues or expenditures must not cancel out). If the impact of a measure varies over time, only the incremental impact should be recorded in the table. By their nature, one-off measures should be always recorded as having an effect of +/-X in the year of the first budgetary impact and -/+ X in the following year, i.e. the overall impact on the level of revenues or expenditures in two consecutive years must be zero.

Table 3b: **In-year quarterly reporting on the budgetary impact of the measures presented in Table 3a**

List of measures[a]	**In-year reporting for measures having an effect on year t (choose one of the alternatives below)**[b]					**Expected annual budgetary impact for year t** **(EUR million)** (= Table 3a)
	Quarterly observed budgetary impact (EUR million)[c]				**Cumulative observed budgetary impact since the start of the year (EUR million)**	
	Q1	**Q2**	**Q3**	**Q4**		
TOTAL						

[a] Select the measures reported in Table 3a which have a budgetary impact in year t.

[b] Filling one of the two alternatives is mandatory: quarterly reporting (estimates possibly subject to revisions) at least until the current quarter and/or sum of the observed budgetary impact until the current date.

[c] Indicate for each quarter whether the data reported corresponds to observed data; the reporting is mandatory up to the current quarter included.

Table 4: **General government (S.13) debt developments and prospects**

		Year t-1	Year t	Year t + … *
	ESA Code	% GDP	% GDP	% GDP
1. Gross debt[a] (=Table 1b.8 for the general government)				
2. Change in gross debt ratio				
Contributions to changes in gross debt				
3. Primary balance (= Table 1c. 9)				
4. Interest expenditure (= Table 1c.8)	D.41			
5. Stock-flow adjustment				
of which:				
- Differences between cash and accruals[b]				
- Net accumulation of financial assets[c]				
of which:				
- Privatisation proceeds				
- Valuation effects and other[d]				
p.m.: Implicit interest rate on debt[e] **(%)**				
Other relevant variables				
6. Liquid financial assets[f]				
7. Net financial debt (7=1-6)				
8. Debt amortization (existing bonds) since the end of the previous year				
9. Percentage of debt denominated in foreign currency (%)				
10. Average maturity (years)				
11. Real GDP growth (%) (= Table 1c row 11)				

[*] Following the request from the Commission to activate the reporting requirements provided for by Article 10(3) of Regulation (EU) No 473/2013, the reporting starts from the year of the opening of the excessive deficit procedure in accordance with Article 126(6) TFEU, and spans until the excessive deficit is planned to be corrected, in accordance with the deadline set by the Council recommendation in accordance with Article 126(7) TFEU or decision to give notice in accordance with Article 126(9) TFEU.

[a] As defined in Regulation (EC) No 479/2009.

[b] The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

[c]: Liquid assets (currency), government securities, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

[d] Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

[e] Proxied by interest expenditure divided by the debt level of the previous year.

[f] Liquid assets are here defined as AF.1, AF.2, AF.3 (consolidated for general government, i.e. netting out financial positions between government entities), A.F511, AF.52 (only if quoted in stock exchange).

ANNEX 14
ASSESSING COMPLIANCE WITH THE PREVENTIVE ARM OF THE SGP: AN OVERVIEW OF 2015 SPRING ASSESSMENT

Member States' compliance with the requirements of the preventive arm of the SGP is summarised in Table A14.1, based on the assessments undertaken at the time of the 2014 and 2015 spring forecasts, respectively.

Table A14.1: **An overview of the 2013-2014 assessment in the light of the spring Forecast 2014-2015**

		2013([167])	**2014([168])**
BE	**At MTO at the start of the year?**	**Not at MTO**	**Not at MTO**
	MTO	0.75	0.75
	SB (at the time of the assessment)	-3.0	-2.8
	SB (used to define the initial position)*	-2.2	-2.3
	Requirement based on matrix (ΔSB)	n.a. in EDP in 2013	0.5
	*Corrected requirement (ΔSB)***		0.5
	ΔSB (SF2015)		-0.1
	ΔSB: deviation from required adjustment		-0.6
	EB: deviation from required adjustment		-0.2
	Conclusion		**overall assessment**
	ΔSB: 2-year average deviation from required adjustment		*n.a. in EDP in 2013*
	EB: 2-year average deviation from required adjustment		
	Conclusion		
BG([169])	**At MTO at the start of the year?**	**YES**	**YES**
	MTO	-1.0	-1.0
	SB (at the time of the assessment)	-0.6	-2.6
	SB (used to define the initial position)*	-0.8	-1.5
	Requirement based on matrix (ΔSB)		*0.0*

([167]) Based on Commission spring forecast 2014.
([168]) Based on Commission spring forecast 2015.
([169]) Bulgaria is eligible to an investment clause in 2013-2014.

	*Corrected requirement (ΔSB)***	**Above the MTO**	*-0.3*
	ΔSB (SF2015)		*-1.7*
	ΔSB: deviation from required adjustment		-1.5
	EB: deviation from required adjustment		1.0
	Conclusion		**overall assessment**
	ΔSB: 2-year average deviation from required adjustment		-0.5
	EB: 2-year average deviation from required adjustment		0.8
	Conclusion		**overall assessment**
		2013	**2014**
CZ	**At MTO at the start of the year?**	**Not at MTO**	**YES**
	MTO	-1.0	-1.0
	SB (at the time of the assessment)	-1.6	-1.0
	SB (used to define the initial position)*	0.2	-0.7
	Requirement based on matrix (ΔSB)	**n.a. in EDP in 2013**	**Compliant**
	*Corrected requirement (ΔSB)***		
	ΔSB (SF2015)		
	ΔSB: deviation from required adjustment		
	EB: deviation from required adjustment		
	Conclusion		
	ΔSB: 2-year average deviation from required adjustment		*n.a. in EDP in 2013*
	EB: 2-year average deviation from required adjustment		
	Conclusion		
DK	**At MTO at the start of the year?**	**YES**	**YES**
	MTO	-0.5	-0.5

	SB (at the time of the assessment)	0.6	0.4
	SB (used to define the initial position)*	1.1	1.2
	Requirement based on matrix (ΔSB)	**n.a. in EDP in 2013**	**Above the MTO**
	*Corrected requirement (ΔSB)***		
	ΔSB (AT THE TIME OF THE ASSESSMENT)		
	ΔSB: deviation from required adjustment		
	EB: deviation from required adjustment		
	Conclusion		
	ΔSB: 2-year average deviation from required adjustment		
	EB: 2-year average deviation from required adjustment		
	Conclusion		
		2013	**2014**
DE	**At MTO at the start of the year?**	**YES**	**YES**
	MTO	-0.5	-0.5
	SB (at the time of the assessment)	0.3	1.2
	SB (used to define the initial position)*	0.8	1.2
	Requirement based on matrix (ΔSB)	**Above the MTO**	
	*Corrected requirement (ΔSB)***		
	ΔSB (SF2015)		
	ΔSB: deviation from required adjustment		
	EB: deviation from required adjustment		
	Conclusion		
	ΔSB: 2-year average deviation from required adjustment		
	EB: 2-year average deviation from required adjustment		

	Conclusion		
		2013	**2014**
EE	**At MTO at the start of the year?**	**YES**	**YES**
	MTO	0.0	0.0
	SB (at the time of the assessment)	0.0	0.2
	SB (used to define the initial position)*	-0.2	0.2
	Requirement based on matrix (ΔSB)	*0.0*	*0.0*
	*Corrected requirement (ΔSB)***	*0.0*	*0.2*
	ΔSB (SF2015)	*-0.3*	*0.9*
	ΔSB: deviation from required adjustment	-0.4	0.7
	EB: deviation from required adjustment	-0.7	-2.0
	Conclusion	**overall assessment**	**overall assessment**
	ΔSB: 2-year average deviation from required adjustment	0.0	0.2
	EB: 2-year average deviation from required adjustment	-0.1	-1.4
	Conclusion	**overall assessment**	**overall assessment**
IT	**At MTO at the start of the year?**	**Not at MTO**	**Not at MTO**
	MTO	0.0	0.0
	SB (at the time of the assessment)	-1.5	-0.9
	SB (used to define the initial position)*	-0.5	-0.8
	Requirement based on matrix (ΔSB)	0.0	*0.0*
	*Corrected requirement (ΔSB)***	*0.0*	*0.0*
	ΔSB (SF2015)	0.6	*-0.1*
	ΔSB: deviation from required adjustment	0.6	-0.1

	EB: deviation from required adjustment	1.3	0.2
	Conclusion	**Compliance**	**overall assessment**
	ΔSB: 2-year average deviation from required adjustment	*n.a.* *in EDP*	0.3
	EB: 2-year average deviation from required adjustment		0.8
	Conclusion		**compliance**
		2013	**2014**
LV[170]	**At MTO at the start of the year?**	**YES**	**YES**
	MTO	-1.0	-1.0
	SB (at the time of the assessment)	-0.1	-1.6
	SB (used to define the initial position)*	-1	-1.4
	Requirement based on matrix (ΔSB)	**Above the MTO**	*0.0*
	*Corrected requirement (ΔSB)***		*-0.5*
	ΔSB (SF2015)		*-0.6*
	ΔSB: deviation from required adjustment		-0.1
	EB: deviation from required adjustment		-0.3
	Conclusion		**overall assessment**
	ΔSB: 2-year average deviation from required adjustment		0.2
	EB: 2-year average deviation from required adjustment		-0.8
	Conclusion		**overall assessment**
LT	**At MTO at the start of the year?**	**Not at MTO**	**Not at MTO**
	MTO	-1.0	-1.0
	SB (at the time of the assessment)	-2.9	-1.2
	SB (used to define the initial position)*	-2.1	-1.2

(170) Latvia is eligible to a pension reform clause from 2013.

	Requirement based on matrix (ΔSB)	*0.5*	*0.5*
	*Corrected requirement (ΔSB)***	*0.5*	*0.5*
	ΔSB (SF2015)	*0.8*	*1.1*
	ΔSB: deviation from required adjustment	0.3	0.6
	EB: deviation from required adjustment	0.3	1.2
	Conclusion	**compliance**	**compliance**
	ΔSB: 2-year average deviation from required adjustment		0.5
	EB: 2-year average deviation from required adjustment		0.8
	Conclusion		**compliance**
		2013	**2014**
LU	**At MTO at the start of the year?**	**YES**	**YES**
	MTO	0.5	0.5
	SB (at the time of the assessment)	1.7	1.6
	SB (used to define the initial position)*	2.5	1.6
	Requirement based on matrix (ΔSB)	**Above the MTO**	**Above the MTO**
	*Corrected requirement (ΔSB)***		
	ΔSB (SF2015)		
	ΔSB: deviation from required adjustment		
	EB: deviation from required adjustment		
	Conclusion		
	ΔSB: 2-year average deviation from required adjustment		
	EB: 2-year average deviation from required adjustment		
	Conclusion		
HU	**At MTO at the start of the year?**	**YES**	**YES**

	MTO	-1.7	-1.7
	SB (at the time of the assessment)	-0.8	-2.5
	SB (used to define the initial position)*	-1.1	-2.2
	Requirement based on matrix (ΔSB)	**Above the MTO**	*0.0*
	*Corrected requirement (ΔSB)***		*-0.9*
	ΔSB (SF2015)		*-1.3*
	ΔSB: deviation from required adjustment		-0.4
	EB: deviation from required adjustment		0.3
	Conclusion		**overall assessment**
	ΔSB: 2-year average deviation from required adjustment	n.a. in EDP in 2012	0.3
	EB: 2-year average deviation from required adjustment		1.0
	Conclusion		**compliance**
		2013	**2014**
MT	**At MTO at the start of the year?**	**Not at MTO**	**Not at MTO**
	MTO	0.0	0.0
	SB (at the time of the assessment)	-3.9	-2.6
	SB (used to define the initial position)*	-2.6	-2.6
	Requirement based on matrix (ΔSB)	*n.a. in EDP in 2013*	*n.a. in EDP in 2014*
	*Corrected requirement (ΔSB)***		
	ΔSB (SF2015)		
	ΔSB: deviation from required adjustment		
	EB: deviation from required adjustment		
	Conclusion		
	ΔSB: 2-year average deviation from required adjustment		

	EB: 2-year average deviation from required adjustment		
	Conclusion		
		2013	**2014**
NL	**At MTO at the start of the year?**	**Not at MTO**	**YES**
	MTO	-0.5	-0.5
	SB (at the time of the assessment)	-2.7	-0.2
	SB (used to define the initial position)*	-0.6	-0.2
	Requirement based on matrix (ΔSB)	*n.a. in EDP in 2013*	*0.0*
	*Corrected requirement (ΔSB)***		*0.1*
	ΔSB (SF2015)		*0.4*
	ΔSB: deviation from required adjustment		0.3
	EB: deviation from required adjustment		0.3
	Conclusion		**compliance**
	ΔSB: 2-year average deviation from required adjustment		*n.a. in EDP in 2013*
	EB: 2-year average deviation from required adjustment		
	Conclusion		
AT	**At MTO at the start of the year?**	**Not at MTO**	**Not at MTO**
	MTO	-0.45	-0.45
	SB (at the time of the assessment)	-1.6	-0.4
	SB (used to define the initial position)*	-1.1	-0.4
	Requirement based on matrix (ΔSB)		*0.6*
	*Corrected requirement (ΔSB)***		*0.6*
	ΔSB (SF2015)		*0.7*
	ΔSB: deviation from required adjustment		0.1
	EB: deviation from required		-1.5

	adjustment	*n.a. in EDP in 2013*	
	Conclusion		**overall assessment**
	ΔSB: 2-year average deviation from required adjustment		*n.a. in EDP in 2013*
	EB: 2-year average deviation from required adjustment		
	Conclusion		
		2013	**2014**
RO	**At MTO at the start of the year?**	**Not at MTO**	**Not at MTO**
	MTO	-1.0	-1.0
	SB (at the time of the assessment)	-2.5	-1.0
	SB (used to define the initial position)*	-1.4	-1.0
	Requirement based on matrix (ΔSB)	*0.1*	*0.0*
	*Corrected requirement (ΔSB)***		*0.0*
	ΔSB (SF2015)	*0.7*	*0.4*
	ΔSB: deviation from required adjustment	0.6	0.4
	EB: deviation from required adjustment	2.7	1.2
	Conclusion	**compliance**	**compliance**
	ΔSB: 2-year average deviation from required adjustment	n.a. in EDP in 2012	0.5
	EB: 2-year average deviation from required adjustment		2.0
	Conclusion		**compliance**
SK([171])	**At MTO at the start of the year?**	**Not at MTO**	**Not at MTO**
	MTO	-0.5	-0.5
	SB (at the time of the assessment)	-3.9	-2.0
	SB (used to define the initial position)*	-1.4	-2.0

([171]) Slovakia is eligible to the investment clause in 2014.

	Requirement based on matrix (ΔSB)		*0.0*
	*Corrected requirement (ΔSB)***		*-0.4*
	ΔSB (SF2015)		*-0.6*
	ΔSB: deviation from required adjustment		-0.2
	EB: deviation from required adjustment		0.8
	Conclusion	*n.a. in EDP in 2013*	**overall assessment**
	ΔSB: 2-year average deviation from required adjustment		*n.a. in EDP in 2013*
	EB: 2-year average deviation from required adjustment		
	Conclusion		
		2013	**2014**
FI	**At MTO at the start of the year?**	**YES**	**YES**
	MTO	-0.5	-0.5
	SB (at the time of the assessment)	-1.0	-1.6
	SB (used to define the initial position)*	-0.6	-0.9
	Requirement based on matrix (ΔSB)	**Above the MTO**	*0.0*
	*Corrected requirement (ΔSB)***		*0.0*
	ΔSB (SF2015)		*-0.8*
	ΔSB: deviation from required adjustment		-0.8
	EB: deviation from required adjustment		0.3
	Conclusion		**overall assessment**
	ΔSB: 2-year average deviation from required adjustment		0.2
	EB: 2-year average deviation from required adjustment		0.5
	Conclusion		**Compliance**

		2013	2014
SE	**At MTO at the start of the year?**	**YES**	**YES**
	MTO	-1.0	-1.0
	SB (at the time of the assessment)	0.3	-1.1
	SB (used to define the initial position)*	0.5	-0.9
	Requirement based on matrix (ΔSB)	**Above the MTO**	
	*Corrected requirement (ΔSB)***		
	ΔSB (SF2015)		
	ΔSB: deviation from required adjustment		
	EB: deviation from required adjustment		
	Conclusion		
	ΔSB: 2-year average deviation from required adjustment		
	EB: 2-year average deviation from required adjustment		
	Conclusion		

Legend

SB - structural balance; ΔSB: change in structural balance

EB: expenditure benchmark; ΔEB: change in expenditure benchmark.

*The maximum of the structural balances (i.e. most favourable) estimated by the Commission since the freezing (at spring t-1) based on COM forecast vintages. The value at t-1 is used to define the Member State`s position vis-à-vis the MTO.

**Requirement corrected for the clauses (investment, pension), the allowed deviation and the margin (if applicable).

Compliance = the adjustment required or a higher adjustment is being observed.

Some deviation = a deviation from the requirement is being observed but it is below the threshold for significance

Significant deviation = deviation which has reached or breached the threshold for a significant deviation (i.e. 0.5 pp. of GDP over one year, 0.25 pp. of GDP over two years on average).

Guide for reading the table

Please note, that ex post assessment (for 2013) is carried out on the basis of Commission 2014 spring forecast (i.e. assessment is frozen). Consistently the change in the structural balance is indicated based on the Commission 2014 spring forecast for 2013. Please also note, that the average deviation from the requirement over two years cannot be directly used to determine the additional fiscal effort to ensure compliance.

Let us consider, for example, the case of EE **in 2014**:

The first stage is to consider if this Member State reached or not its MTO and so to identify the applicable requirements. Then we compare the structural balance in 2013 with the country's MTO. In order to identify the initial SB position, at each forecast round the most favourable SB at *t-1* (where *t* is the year assessed) coming from the forecasts since the freezing for a given year - named SB (used to define initial position) in our table - is taken as a basis.

In our example this refers to 2013 spring forecast, as the SB estimated for 2013 at that time was -0.2% of GDP.

This implies that at the start of 2014, EE is at its MTO thanks to the tolerance of margin: 0-(-0.2) <0.25

Step 1: Assessment of budgetary execution for year 2014:

- **first pillar (ΔSB):** the structural balance improves by 0.9 of GDP (ΔSB = 0.9% of GDP). As the corrected requirement is equal to 0.2 this implies the effort impmeneted is larger than required by 0.7% of GDP. EE is assessed to be compliant by 0.7% of GDP (green cell).

- **second pillar (EB):** EE is assessed to breach the threshold of significance (0.5) on the expenditure benchmark (-2.0 % of GDP, red cell).

➔ *Conclusion:* **overall assessment** (which can lead to a significant deviation)

Step 2: A two-years average assessment of budgetary execution in 2013-2014 is then conducted:

- **first pillar (ΔSB):** Based on the average of the annual deviation from required adjustment (i.e the average of the annual deviation identified in 2013 and 2014) EE is assessed to be compliant by 0.2% of GDP (green cell);

- **second pillar (EB):** Based on the average of the yearly deviation from the expenditure benchmark (i.e the average of the annual deviation identified in 2013 and 2014) EE is assessed to breach the threshold of significance (0.25) on the expenditure benchmark (-1.4% of GDP, red cell)

➔ **2.** *Conclusion*: **an overall assessment is required** (which can lead to a significant deviation)

3. step: If any of the steps above point to significant deviation conclude for significant deviation

ANNEX 15
A NUMERICAL EXAMPLE OF THE FLEXIBILITY CLAUSES IN THE PREVENTIVE ARM

The aim of this annex is to guide the reader through the use of "flexibility" clauses within the rules of the SGP. It illustrates how the adjustment path towards the MTO or the adherence to the MTO is impacted by the temporary deviation allowed under i) the structural reform clause (introduced in Section 1.3.2.3) , ii) the investment clause (introduced in Section 1.3.2.4) and iii) the cumulation of both clauses.

The methodology applied to determine the eligibility to the clauses and the impact of flexibility clauses on the achievement of the MTO is displayed in the two Sections mentioned above. These conditions are summarized in the table below.

Table A15.1: **Overview of conditions displayed in Section 1.3.2.3 and 1.3.2.4 related to the Structural reform clause and the Investment Clause**

<table>
<tr><th></th><th>Structural Reform Clause</th><th>Investment Clause</th></tr>
<tr><td rowspan="2">Eligibility criteria</td><td colspan="2">▪ Remain in the preventive arm
▪ Safety margin with respect to the 3% of GDP reference value for the deficit (minimum benchmark)</td></tr>
<tr><td>▪ Major structural reform with positive long-term budgetary effects</td><td>▪ Negative GDP growth or output gap inferior to -1.5% of GDP
▪ Additionality principle: total public investments are not reduced, i.e. co-financed expenditure should not substitute for nationally financed investments</td></tr>
<tr><td>Integrity of the MTO</td><td colspan="2">▪ Achievement of the MTO within the 4-year horizon of the current SCP should be sought (less than 1.5% deviation from MTO in initial year)
▪ Additional application of the clauses restricted until achievement of the MTO</td></tr>
<tr><td rowspan="3">Temporary deviation from the MTO (or adjustment path)</td><td>▪ The deviation cannot exceed 0.5% of GDP, except in the case of pension reforms introducing a mandatory fully-funded pillar</td><td>▪ The deviation cannot exceed 0.5% of GDP
▪ Applies to national expenditure on projects co-financed by the EU under the Structural and Cohesion policy (including the YEI), TEN, CEF, EAFRD, EMFF and the EFSI</td></tr>
<tr><td colspan="2">▪ The cumulated deviation for the two clauses cannot exceed 0.75% of GDP</td></tr>
<tr><td colspan="2">▪ The temporary deviation remains valid over a period of three years</td></tr>
</table>

1. The low output gap condition: eligibility criterion specific to the Investment Clause

While the temporary deviation stemming from the structural reform clause does not depend on the economic situation of a Member State, this is not the case for the investment clause. The application of the investment clause is only possible for a Member State in bad (or worse) economic times (output gap below -1.5% of GDP or negative growth).

2. The safety margin (i.e. respect of the minimum benchmark): a constraint on the temporary deviation for both clauses

When benefitting from the temporary deviation, Member States should preserve a safety margin with respect to the 3% reference value. This means that the structural balance should always be equal to or above the minimum benchmark, a measurement which is detailed in Annex 2.([172]) In other words, the temporary deviation stemming from the application of the clauses should not imply that the structural balance goes below the minimum benchmark. According to the 2015 European Commission spring forecast, only 8 Member States in the preventive arm were fulfilling this criterion in 2016 before any temporary deviation is even applied.

Table A15.2: **Respect of the safety margin and available fiscal scope – spring forecast 2015 (forecast available when assessing eligibility of the clauses at the occasion of the 2015European Semester)**

	Minimum Benchmark	Structural Balance	Respect of the safety margin	Fiscal scope		Minimum Benchmark	Structural Balance	Respect of the safety margin	Fiscal scope
BE	-1.7	-2.1	No	0.0	HU	-1.5	-2.6	No	0.0
BG	-1.7	-2.4	No	0.0	MT	-1.9	-1.7	Yes	0.2
CZ	-1.7	-1.4	Yes	0.3	NL	-1.4	-1.4	No	0.0
DK	-0.7	-1.4	No	0.0	AT	-1.8	-1.0	Yes	0.8
DE	-1.5	0.7	Yes	2.2	PL	-1.9	-2.6	No	0.0
EE	-1.8	0.2	Yes	2.0	PT	-1.8	-2.3	No	0.0
IE	-1.2	-2.1	No	0.0	RO	-1.8	-2.7	No	0.0
IT	-1.7	-1.5	Yes	0.2	SI	-1.7	-2.5	No	0.0
LV	-1.8	-1.9	No	0.0	SK	-1.5	-2.0	No	0.0
LT	-1.8	-1.4	Yes	0.4	FI	-0.5	-1.5	No	0.0
LU	-1.7	0.9	yes	2.6	SE	-0.9	-1.0	No	0.0

Source : European Commission spring forecast 2015. Note: Minimum benchmarks as updated in 2012.

3. The Maximum initial distance to the MTO: the starting point for considering eligibility to both clauses

In order to respect the requirement to return to the MTO within the four year timeframe, while assuring for a maximum deviation of 0.5% of GDP under the Structural Reform Clause, it is necessary to introduce

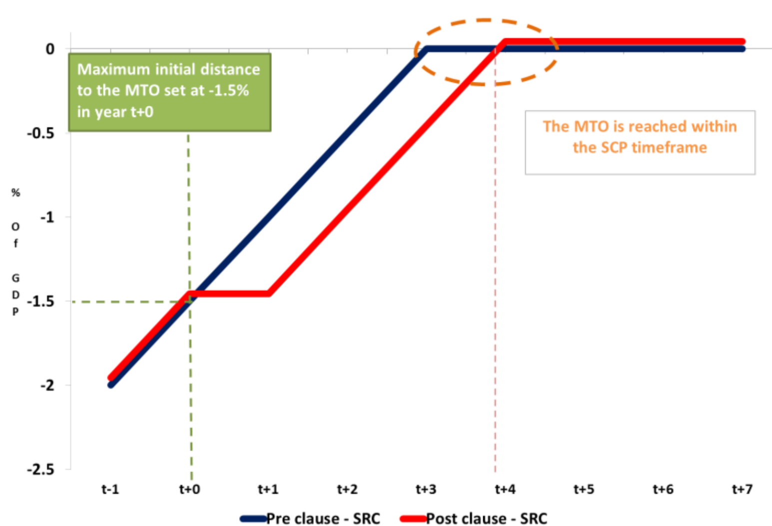
([172]) The minimum benchmark is a level of structural balance which takes into account past output volatility and budgetary sensitivity to output fluctuations.

a maximum initial distance that a Member State's structural balance can be from the MTO when applying for the clause. The following considerations must be allowed for in determining this distance:

The year that a Member State is required to reach their MTO will be a function of, amongst other things, the adjustment that they are required to make in each individual year as defined by the matrix (displayed in Box 1.6). Consequently, it is not possible to define ex-ante a year in which a Member State, whether availing of the structural reform clause or not, must reach their MTO. It was therefore proposed to make the simplifying assumption that the requirement to return to MTO within the four year timeframe should be based on the benchmark adjustment being applied.

On this basis, the maximum initial distance which the structural balance of a Member State applying for the structural reform clause can be from the MTO is 1.5% of GDP in year t. This limit will ensure that, in the benchmark case of an annual adjustment of 0.5% of GDP, the Member State can regain its MTO within the required four year timeframe. (173)

Benchmark simulation: Member State with a Structural balance of -1.5% of GDP the year prior to the application of the Structural Reform Clause



(173) For the investment clause, the maximum initial distance to the MTO is set at 1.5% of GDP, in order to ensure consistency with the structural reform clause. However, benefiting from the investment clause is only possible in bad economic times, which is associated with a lower fiscal effort stemming from the matrix. This may imply that a maximum initial distance from the MTO of 1.5% of GDP does not necessarily ensure the attainment of the MTO within the SCP time frame.
When both clauses are cumulated, the maximum initial distance to the MTO is also set 1.5% of GDP for consistency purposes. Such cumulation is only possible in bad economic times (otherwise the investment clause cannot apply), implying here again that the maximum initial distance from the MTO of 1.5% does not necessary ensure the attainment of the MTO within the SCP time frame.

4. Underlying working assumptions for further simulations

To undertake credible simulations, some working assumptions are necessary.

a. The MTO

The MTO is illustratively set at 0% of GDP.

b. The size of the temporary deviation

For the structural reform clause, the illustrative requested temporary deviation (by a Member State) has been set at 0.5% of GDP.

For the investment clause, the illustrative requested temporary deviation (by a Member State) has been set at 0.5% of GDP.

For the cumulation of the Structural Reform Clause and the Investment Clause, the illustrative requested temporary deviation (by a Member State) has been set at 0.75% of GDP.

In the three cases, the requested temporary deviation corresponds to the maximum temporary deviation that can be granted and corresponds to the individual caps of 0.5% of GDP (for the structural reform clause and the investment clause) and to the cap on the cumulated temporary deviation (0.75% of GDP). These assumptions are conservative as the temporary deviation could be lower.

c. The benchmark adjustment stemming from the Matrix

The benchmark adjustment represents the adjustment path stemming from the Matrix and which should be implemented when adjusting towards MTO. It depends on the level of debt and the cyclical conditions.

For the structural reform clause, the benchmark adjustment has been set at 0.5% of GDP for each and every year under consideration. This corresponds to the situation of a Member State with low debt and in normal economic times.

For the investment clause as well as for the cumulation of both clauses, the benchmark adjustment has been set at 0% of GDP the year the clause(s) apply and 0.5% of GDP for the other years. This reflects the fact that a Member State needs to be in bad economic times in order to benefit from the investment clause or the cumulation of both clauses. Being in bad economic conditions implies a lower adjustment effort stemming from the Matrix.

These adjustments have been chosen for illustrative purposes. Member States with high debts (above 60%) can be subject to higher adjustment requirements under the Matrix. The underlying assumptions are here again conservative: the benchmark adjustment from the Matrix could thus be higher in practice than in the simulations below.

5. The simulations

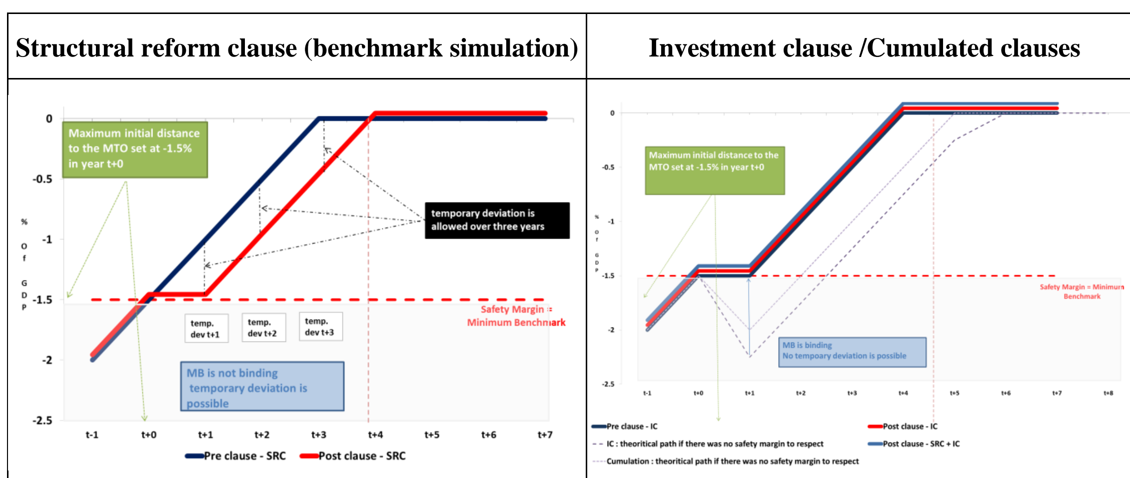
A set of four simulations are displayed. They aim at covering a wide range of potential cases under realistic assumptions for the structural balance and the safety margin.

The simulations are performed for four initial level of structural balances (-1.5%, -1%, -0.5% and 0%). This aims at illustrating the impact of the initial position of the structural balance on the adjustment path towards MTO both with and without the application of the clauses. In economic terms, this sets out the adjustment path towards MTO for two different types of Member States:

- Member States faced with a relatively deteriorated fiscal situation with respect to their MTO (SB of -1.5% , -1% and -0.5% of GDP)
- Member States with sound public finances, i.e. Member States at MTO (SB of 0% of GDP).

Each simulation takes into account the need to preserve the safety margin with respect to the 3%. For illustrative purposes, the minimum benchmark is assumed to be at -1.5% of GDP, which is the average minimum benchmark for the European Union.In the simulations, the clause is applied for in year t+0 with the temporary deviation to be implemented in t+1.

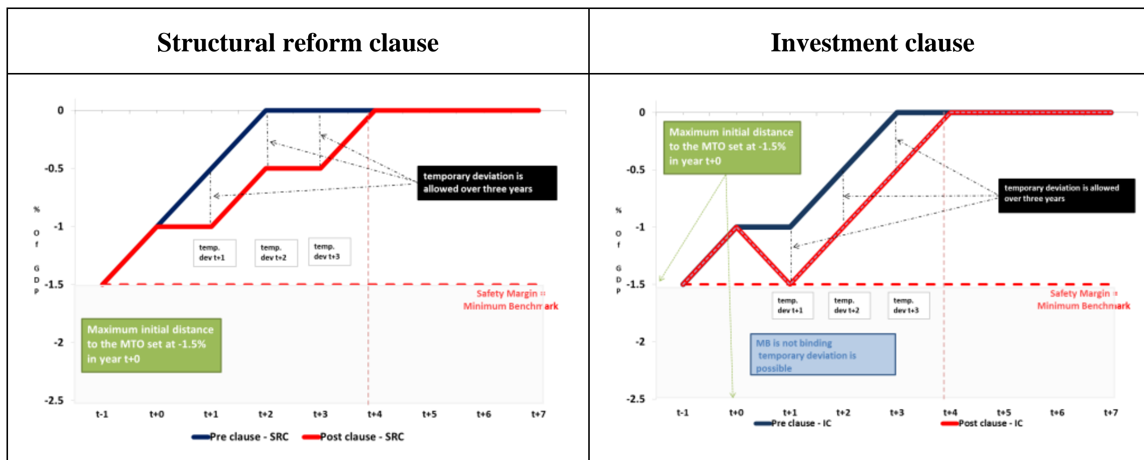
Simulation 1: **Member State with a Structural balance of -1.5% of GDP the year prior to the application of the clause**

<table>
<tr><th>Structural reform clause (benchmark simulation)</th><th>Investment clause /Cumulated clauses</th></tr>
<tr><td colspan="2">
</td></tr>
<tr><td colspan="2">Comment:
1. <u>Maximum initial distance to the MTO</u>: the initial structural balance is at the maximum initial distance from the MTO in t+0 (1.5% of GDP). The Member State is eligible for the clauses on this basis.</td></tr>
<tr><td>2. <u>Safety margin</u>: the temporary deviation stemming from the application of the clause in t+1 does not imply that the structural balance goes below the minimum benchmark. The Member State preserves the safety margin.

3. <u>Integrity of the MTO</u>: Following the new adjustment path, the MTO is reached in t+4 instead of t+3.</td><td>2. <u>Safety margin</u>: the temporary deviation stemming from the application of the clause in t+1 implies that the structural balance goes below the minimum benchmark. The Member State would not preserve the safety margin.

3. <u>Integrity of the MTO</u> : The adjustment path remains unchanged and the MTO is reached in t+4 (consequence of the absence of adjustment when the Member State is in bad economic times)</td></tr>
</table>

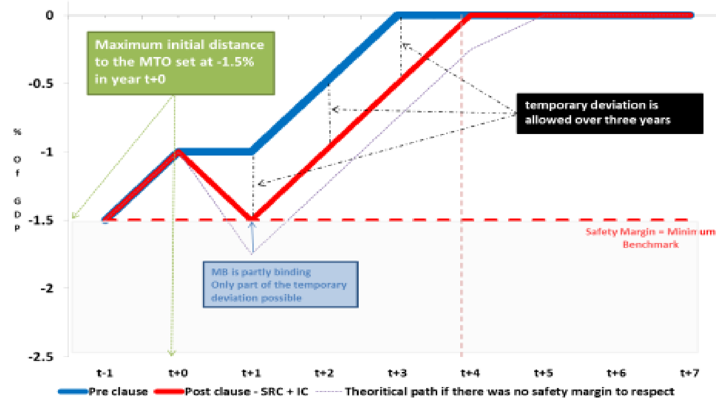
Simulation 2: **Member State with a Structural balance of -1% of GDP the year prior to the application of the clause**



Comment:

1. Maximum initial distance to the MTO : The Member State is eligible for the clauses on this basis.
2. Safety Margin : The Member State preserves the safety margin.
3. Integrity of the MTO: Following the new adjustment path, the MTO is reached in t+4 instead of t+3.

Cumulated clauses



Comment:

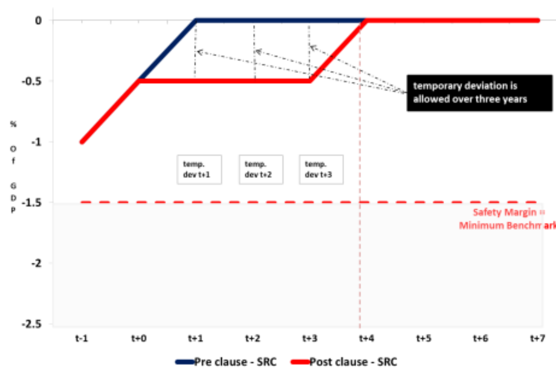
1. Maximum initial distance to the MTO : The Member State is eligible for the clauses on this basis.

2. Safety Margin : : the temporary deviation stemming from the application of the clause in t+1 implies that the structural balance goes partly below the minimum benchmark. To preserve the safety margin, the cumulated deviation needs to be limited to 0.5% of GDP (i.e. the difference between the structural balance, -1% of GDP, and the minimum benchmark, -1.5% of GDP.

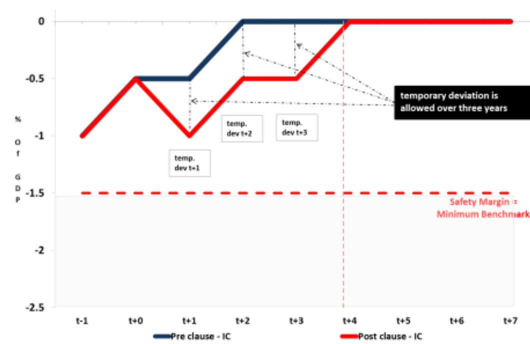
3. Integrity of the MTO: Following the new adjustment path, the MTO is reached in t+4 instead of t+3.

Simulation 3: **Member State with a Structural balance of -0.5% of GDP the year prior to the application of the clause**

Structural reform clause



Investment clause

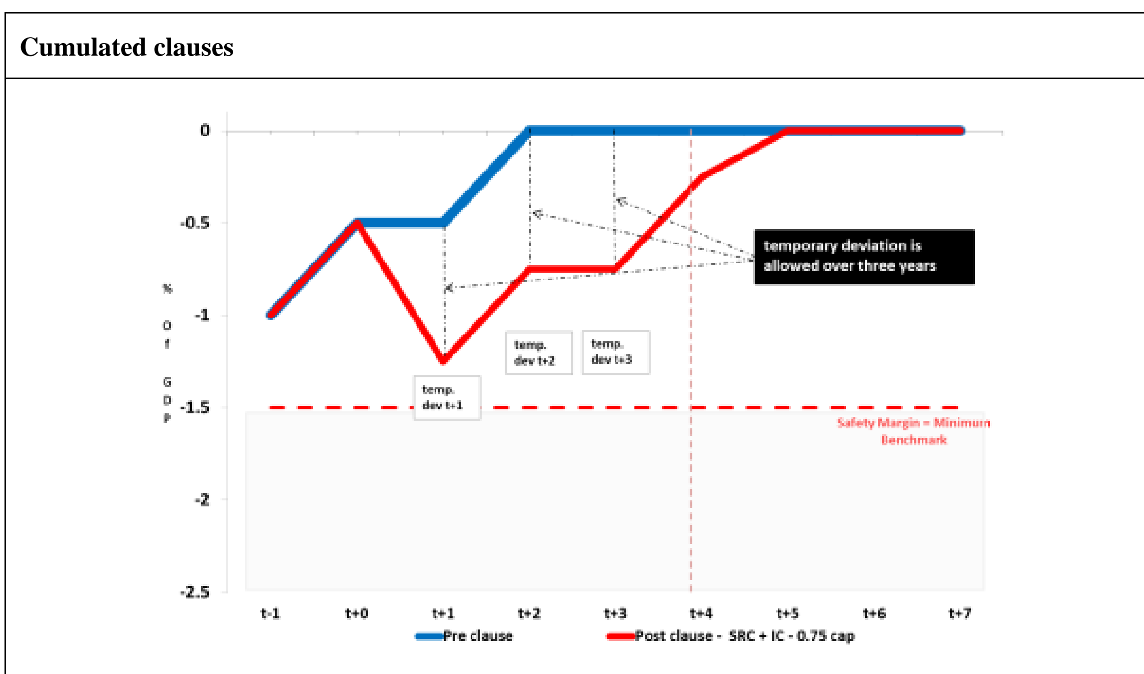


Comment:

1. Maximum initial distance to the MTO : The Member State is eligible for the clauses on this basis.

<table>
<tr><td colspan="2">2. Safety Margin : The Member State preserves the safety margin.</td></tr>
<tr><td>3.Integrity of the MTO: Following the new adjustment path, the MTO is reached in t+4 instead of t+1.</td><td>3.Integrity of the MTO: Following the new adjustment path, the MTO is reached in t+4 instead of t+2.</td></tr>
</table>

Cumulated clauses



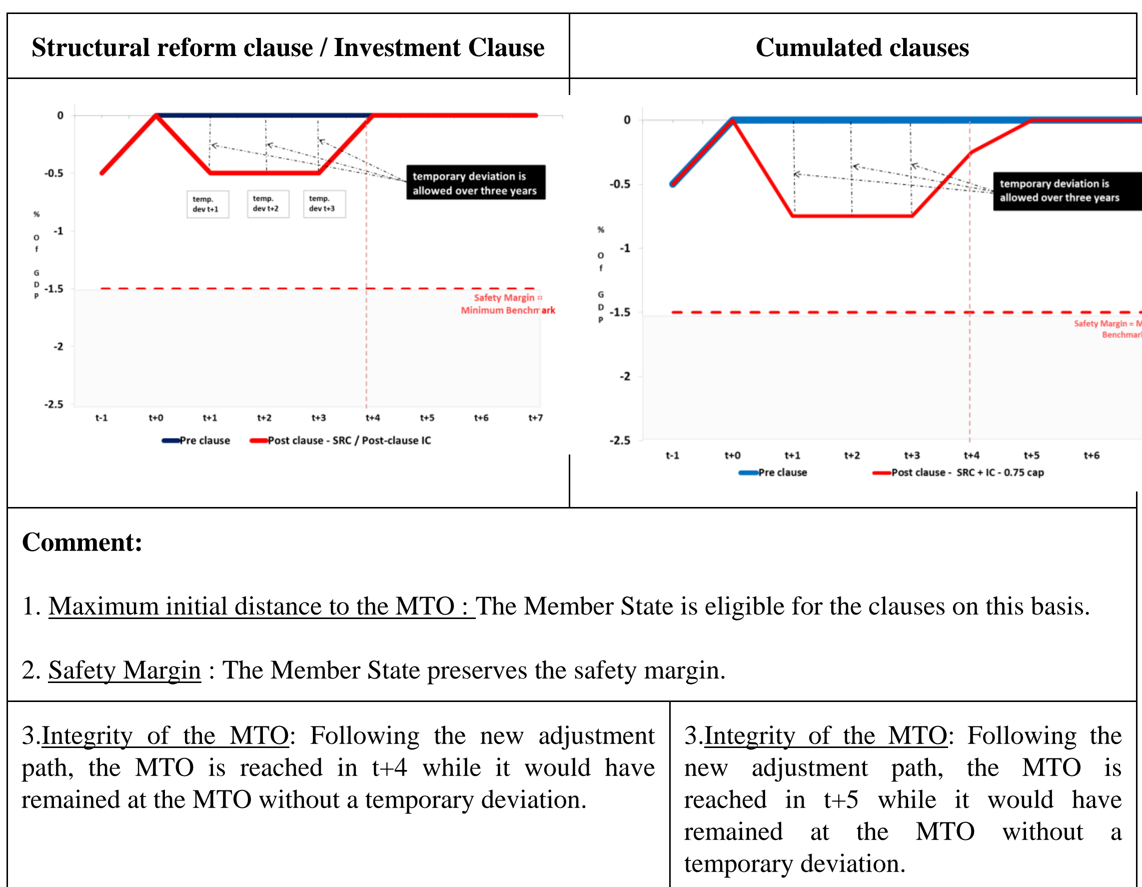
Comment:

1. Maximum initial distance to the MTO : The Member State is eligible for the clauses on this basis.

2. Safety Margin : The Member State preserves the safety margin.

3.Integrity of the MTO: Following the new adjustment path, the MTO is reached in t+5 instead of t+2.

Simulation 4: **Member State with a Structural balance at MTO (Structural balance at 0% of GDP) the year prior to the application of the clause**



Structural reform clause / Investment Clause	Cumulated clauses
Comment: 1. Maximum initial distance to the MTO : The Member State is eligible for the clauses on this basis. 2. Safety Margin : The Member State preserves the safety margin.	
3.Integrity of the MTO: Following the new adjustment path, the MTO is reached in t+4 while it would have remained at the MTO without a temporary deviation.	3.Integrity of the MTO: Following the new adjustment path, the MTO is reached in t+5 while it would have remained at the MTO without a temporary deviation.

7. Conclusions

The MTO would be met in t+4 or before in most of the cases presented.

In a limited number of cases, the MTO would be met in t+5. This is the case when a Member States is allowed to cumulate both clauses and benefits from the maximum allowed temporary deviation (0.75% of GDP), while at the same time having sound public finances, i.e. initial structural balance close to (-0.5% of GDP) or at MTO.

All in all, the simulations show that under some specific circumstances, it is possible to extend the deadline to reach the MTO by one year. This is justified by the need to encourage structural reforms and preserve public investments in Member States faced with difficult economic conditions (sole eligible to the investment clause and consequently allowed to cumulated clauses).

ANNEX 16
PLAUSIBILITY ANALYSIS FOR ESTIMATING IMPACT OF STRUCTURAL REFORMS

The Commission Communication of 13 January 2015 on "Making the best use of the flexibility within the existing rules of the Stability and Growth Pact", provided additional guidance on how the Commission would operationalise the so-called 'structural reform clause' of Regulation 1466/97. On this basis, the Council decided on the implementation of the flexibility within the SGP, as reflected in the commonly agreed position confirmed by the ECOFIN Council of 12 February 2016.

Under the Regulation, Member States implementing major structural reforms with positive long-term budgetary impacts are allowed to deviate temporarily from the MTO or from the adjustment path towards it.

An intuitive way to formalize the eligibility criterion for Member States applying for use of the structural reform clause is to require that the reform produces significant sustainability gains in net present value terms, taking into account both the direct fiscal impact of the reform (including savings and/or costs, where applicable) and their indirect budgetary effects *via* higher output.

Noting that:

- B_j represents the direct primary budgetary savings in period j, while C_j denotes the possible budgetary costs, the direct net savings thus amounts to B_j-C_j;
- A_j denotes the possible output effect of a reform in period j, implying indirect budgetary effects essentially on the revenue side. Given a semi-elasticity of the budget balance equal to τ, the indirect budgetary gain is thus τA_j;

A reform would yield a net gain $D_j = \tau A_j + B_j - C_j$ for the primary balance in period j (assuming a horizon of 25 years and that the reform kicks in in the first period). Noting β_j the actualisation rate[174], the inter-temporal sum of these effects is equivalent in actuarial terms to a permanent annuity Z:

$$Z = (\Sigma_j \beta_j D_j) / \Sigma_j \beta_j$$

A major reform could then be expected to result in a significant improvement in the long-term sustainability of a Member State's public finances as measured by Z.

Box 1 provides further detail on how to get some preliminary order of magnitude associated with the effect of structural reforms. This is presented with an illustrative purpose and does not limit the kind of reforms that can be considered nor the models or the parameter values used to assess their impact. It should be highlighted that the translation of a specific reform into a policy shock that can be incorporated by the model may remain the most significant challenge. Therefore any assessment by the Commission will have to be of qualitative nature and will necessarily build on elements of judgment over the plausibility of the estimates of the reforms. The plausibility exercise may help in some cases to frame this judgement. In particular, it could be the case when the measure being considered appears to be far below the standard shock used in the simulation but is claimed to provide a much larger impact.

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(174) The actualisation rate is: $\beta_j = 1/\Pi_{k=1,...j}(1+r_k)$, with r_k the growth corrected interest rate (i.e. the difference between the nominal interest rate and the nominal growth rate) at date k. Figures for the growth and interest rates can be taken from the Aging Working Group assumptions which are regularly used to compute long-term costs of aging.

Box 1.: How to calculate the indirect impact of structural reforms? A method for a plausibility assessment

Beyond their direct effect, structural reforms can have an indirect impact on the budget balance, via their effect on potential output. The purpose of this box is to outline a transparent methodology to provide some first order of magnitude of this indirect effect.

First, we focus on the lasting effect of the reforms on GDP, which corresponds more technically to the impact of the reforms on potential output. Therefore, we do not consider the short-term effects on GDP, which are transitory by nature and difficult to measure, owing to implementation lags and complex dynamics in domestic demand. As a result, we estimate the effects of reforms on GDP as of 5 years and then every 5 years (10, 15 and 20 years). Between these years, we interpolate the effects linearly.

Table A16.1: Effect of stylised structural reforms on GDP (% deviation from baseline)

Stylised policy impulse	Size	GDP effect (% deviation from baseline)			
		5 years	10 years	15 years	20 years
Product market					
Reduction of the final goods market mark-up	-1 p.p.	0.5	0.7	0.8	0.9
Reduction of the intermediate goods market mark-up	-1 p.p.	0.3	0.3	0.3	0.2
Reduction in final good firms' administrative burdens	10%	0.4	0.4	0.4	0.4
Reduction of tangible capital costs	-50 b.p.	0.9	1.5	2.0	2.4
Reduction of intangible capital costs	-50 b.p.	0.0	0.0	0.1	0.1
Labour market					
Reduction in the benefit replacement rate	5 p.p.	0.4	0.4	0.5	0.5
Wage mark-up reduction	5 p.p.	0.9	1.0	1.0	1.0
Tax shift from labour to VAT	1% GDP	0.2	0.3	0.3	0.3
Knowledge and innovation					
Wage subsidy to the R&D sector	0.1% GDP	0.0	0.1	0.2	0.2
Increase of the share of medium skilled workers	1 p.p.	0.1	0.1	0.2	0.3
Increase of the share of high skilled workers	1 p.p.	0.1	0.2	0.3	0.4

Second, we simulate the impact of a set of stylised structural reforms using the DSGE model QUEST for the whole EU. This is technically captured by the parameter A referred to above. These reforms are standard policy "shocks" affecting key economic parameters in the product market, the labour market or knowledge and innovation (see Röger et al., 2008 for more details) . Some of these parameters correspond to performance indicators (e.g. tangible capital costs), while others refer to policy instrument indicators, such as a tax shift of 1% or R&D wage subsidies of 0.1% GDP. Every concrete reform planned by Member States would then need to be "translated" into one (or several) of these policy shocks, which would require a judgement - or analysis - on how the reform is expected to modify these parameters. This translation of concrete reforms into standard shocks could be very tricky in practice, especially for some concrete measures and would anyway require some informed judgement on the impact of the measure on the performance of labour, product or innovation markets. Moreover, the standard policy shocks are not fully comparable across types of reforms and the estimates are surrounded by large uncertainties and should be interpreted with a great deal of caution. For instance, the estimates could vary from country to country and depend on baseline values of structural reform indicators or on the macroeconomic conditions (e. g. monetary policy stance and size of public debt). However, they provide a ballpark proxy of significant reforms in each of the areas considered, which can be used in the context of this plausibility exercise. As set out in the table above, some reforms, in particular those reducing the cost of tangible capital, improving the functioning of the labour market (leading to a wage mark-up reduction) or increasing competition (reflected by a cut in the final good mark-up), seem to lead to a long- term increase in potential GDP by around 1% or more, compared with a no policy change baseline. These reforms already display some non-negligible effects after 5 years. Some other reforms have more moderate effects, such as a reduction in the benefit replacement rate or in firms' administrative burden, a tax shift from labour to indirect taxes or an

increase in the share of low- and medium-skilled workers. The effects of the other stylised reforms appear more marginal, although slightly positive.

Third, we compute the reaction of the output effect to the budget balance. This corresponds to the parameter τ above, with $A\tau$ being the indirect effect of a structural reform. This parameter differs slightly from country to country. The approach presented below largely builds on the methodology to compute the cyclically-adjusted budget balance (see Mourre et al., 2014) . We compute the semi-elasticity of the budget balance, which measures the change in the budget balance brought about by a 1% increase in GDP. Four relevant factors influence the results. First, all tax elasticities (which are different across countries in the short term) are assumed to converge to unity after 10 years, which is in line with the theoretical expectation of revenue moving along with economic activity after some time. Second, we assume that non-tax revenue follows GDP as well after 5 years. These two assumptions mean that, in the long term, structural reforms are neutral regarding the revenue-to-GDP ratio. Third, public spending (except the unemployment-related expenditures) is frozen in real terms, only following inflation. Therefore, an increase in output due to a reform would automatically decrease the spending-to-GDP ratio, by raising the denominator, which leads to a reduction in the budget balance. As shown in Mourre et al. (2014), this effect increases with the size of public spending as percentage of GDP in a given country. Fourth, the reduction of unemployment-related expenditure in case of output increase will add slightly to this effect. This additional impact depends upon the share of unemployment-related expenditures in GDP and upon the reactivity of unemployment to output. We assume for simplicity that the elasticity of unemployment to potential output is the same as the reaction of unemployment to short-term output fluctuation. An alternative method, more complicated, would have been to estimate the impact of each structural reform on unemployment. This may be done as a robustness check.

Table A16.2: Reaction of the output effect to the budget balance (varying across countries)

	Semi-elasticity of the budget balance	
	5 years	from 10 years onwards
BE	0.61	0.59
BG	0.39	0.39
CZ	0.47	0.45
DK	0.65	0.62
DE	0.58	0.56
EE	0.46	0.41
IE	0.54	0.51
EL	0.52	0.51
ES	0.55	0.53
FR	0.63	0.60
HR	0.50	0.48
IT	0.53	0.50
CY	0.52	0.45
LV	0.43	0.41
LT	0.43	0.39
LU	0.46	0.44
HU	0.54	0.51
MT	0.48	0.45
NL	0.65	0.58
AT	0.60	0.57
PL	0.54	0.49
PT	0.55	0.53
RO	0.38	0.38
SI	0.51	0.48
SK	0.42	0.40
FI	0.64	0.60
SE	0.63	0.61
UK	0.55	0.47

ANNEX 17
A COMMONLY AGREED POSITION ON FLEXIBILITY WITHIN THE STABILITY AND GROWTH PACT

The annex contains the text of the "Commonly agreed position on Flexibility within the SGP", which the ECOFIN Council formally endorsed on 12 February 2016.([175]) This text builds on the interpretative Commission's Communication on *Flexibility within the SGP* of January 2015,([176]).

Preamble

On 13 January 2015 the Commission adopted its Communication on flexibility within the Stability and Growth Pact (SGP). Between January and April 2015, the Economic and Financial Committee (EFC) and the EFC-Alternates (Alternates) discussed three Commission notes on the operationalisation of the Communication, namely on the new matrix of required adjustment under the preventive arm, the structural reform clause and the investment clause. On 7 April, the Council Legal Service provided to the EFC its Opinion on flexibility in the SGP. At the meeting of the EFC on 8 April 2015, the President noted that for the preparation of the 2015 European Semester Council Recommendations, the Commission would use its interpretation of the rules of the SGP as expressed in its Communication on flexibility. On 29 April 2015, the EFC agreed that the EFC-Alternates would work on preparing a commonly agreed position on the flexibility in the SGP for cyclical conditions, structural reforms, and government investments aiming at, ancillary to, and economically equivalent to major structural reforms. The commonly agreed position should preferably be reflected in an updated Code of Conduct (CoC).

This document presents the commonly agreed position on flexibility in the SGP, as agreed by the EFC on 27 November 2015, taking into account the Commission Communication and the Commission notes on the operationalisation of the Communication, the above-mentioned discussions by the Alternates and the members of the EFC between January and April 2015, and the opinion of the Council Legal Service on flexibility in the SGP. The concession of such flexibility is without prejudice to the requirement for Member States to reduce their government debt at a satisfactory pace, thereby contributing to the long-term sustainability of their public finances, in accordance with Article 126.2 of the Treaty on the functioning of the European Union and Article 2 of Regulation 1467/97. This document is intended to serve as a basis for the codification in the Code of Conduct of a commonly agreed position on flexibility in the SGP.

1. Introduction

A commonly agreed position on flexibility in the SGP would provide guidance on the best possible use of the flexibility that is built into the existing rules of the preventive arm of the SGP, without changing or replacing the existing rules. The preventive arm aims at guaranteeing a sound budgetary position in all Member States: its core is the attainment by each Member State of its medium-term sound budgetary position (so-called Medium-Term Objective or MTO), which is established according to the commonly agreed principles set out in Sub-section A(1) of Section I of the *Specifications on the Implementation of the Stability and Growth Pact*[177] (hereafter "the Code of Conduct").

([175]) http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf
([176]) Communication from the Commission *Making the best use of the flexibility within the existing rules of the Stability and Growth Pact*, COM(2015) 12 of 13.01.2015: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/2015-01-13_communication_sgp_flexibility_guidelines_en.pdf
[177] http://ec.europa.eu/economy_finance/economIC_governance/sgp/pdf/coc/code_of_conduct_en.pdf

The corrective arm of the Pact deals with situations in which the government deficit and/or the debt are above the reference values set in the Treaty: in these cases, Member States are then subject to an Excessive Deficit Procedure ("EDP"), which entails stricter conditions and monitoring. The commonly agreed principles on the implementation of the corrective arm of the SGP remain those established in the Code of Conduct endorsed by the ECOFIN in September 2012 and complemented by the effective action methodology endorsed by the ECOFIN in June 2014.

Subject to the rules of the SGP and without modifying existing legislation, the commonly agreed position clarifies how three specific policy dimensions can best be taken into account in applying the rules. These relate to: (i) cyclical conditions; (ii.) structural reforms; and (iii.) government investments aiming at, ancillary to, and economically equivalent to major structural reforms.

2. FLEXIBILITY FOR CYCLICAL CONDITIONS

2.1 MATRIX SPECIFYING THE ANNUAL FISCAL ADJUSTMENT TOWARDS THE MEDIUM-TERM OBJECTIVE

Member States should achieve a more symmetrical approach to fiscal policy over the cycle through enhanced budgetary discipline in periods of economic recovery, with the objective to avoid pro-cyclical policies and to gradually reach their medium-term budgetary objective, thus creating the necessary room to accommodate economic downturns and reduce government debt at a satisfactory pace, thereby contributing to the long-term sustainability of public finances.

Member States that have not yet reached their MTO should take steps to achieve it over the cycle. Their adjustment effort should be higher in good times; it could be more limited in bad times. In order to reach their MTO, Member States of the euro area or of ERM-II should pursue an annual adjustment in cyclically adjusted terms, net of one-off and other temporary measures, of 0.5 of a percentage point of GDP as a benchmark. In parallel, the growth rate of expenditure net of discretionary revenue measures in relation to the reference medium-term rate of potential GDP growth should be expected to yield an annual improvement in the government balance in cyclically adjusted terms net of one-offs and other temporary measures of 0.5 of a percentage point of GDP.

The following matrix clarifies and specifies the fiscal adjustment requirements under the preventive arm of the Pact. This matrix is symmetrical, differentiating between larger fiscal effort to be undertaken during better times and a smaller fiscal effort to be undertaken during difficult economic conditions.

Matrix for specifying the annual fiscal adjustment
towards the Medium-Term Objective (MTO)
under the preventive arm of the Pact

		Required annual fiscal adjustment*	
	Condition	Debt below 60 and no sustainability risk	Debt above 60 or sustainability risk
Exceptionally bad times	Real growth < 0 or output gap < -4	No adjustment needed	
Very bad times	-4 ≤ output gap < -3	0	0.25
Bad times	-3 ≤ output gap < -1.5	0 if growth below potential, 0.25 if growth above potential	0.25 if growth below potential, 0.5 if growth above potential
Normal times	-1.5 ≤ output gap < 1.5	0.5	> 0.5
Good times	output gap ≥ 1.5	> 0.5 if growth below potential, ≥ 0.75 if growth above potential	≥ 0.75 if growth below potential, ≥ 1 if growth above potential

* all figures are in percentage points of GDP

Given the volatility of the output gap estimates and of the structural balance level, the requirements for annual fiscal adjustment will be frozen on the basis of the vintage data available at spring *t*-1.

In order to avoid unwarranted consequences in the event of worsened economic conditions or when it is not necessary anymore to progress towards the medium-term objective (MTO), the following shall apply:

- first, in case the actual data signal a worsening of the economic situation so that the country is considered to be in either exceptionally (OG <-4% or negative real growth) or very bad times (OG < -3%), the requirements based on the most recent data will prevail over the frozen requirements, allowing to consider exceptionally and very bad economic circumstances;

- second, in case the actual data are revised so that the country has already achieved its MTO in year t, the assessment of the country as being at or above its MTO will prevail over the frozen requirements.

– The "sustainability risk" in the matrix specifying the annual fiscal adjustment refers to the medium-term overall debt sustainability as measured by the S1 indicator, among other information[178].

Progress towards the MTO is assessed on the basis of two pillars, with the structural balance being complemented by the expenditure benchmark. The expenditure benchmark establishes a maximum growth rate (i.e. the reference rate) for government spending net of discretionary revenue measures. The medium-term reference rate (as well as the share of government primary expenditure used in the convergence margin) will be updated on a yearly basis, as from spring 2015. In practice, this means that each spring of year t, when setting the required adjustment towards the MTO for the year to come t + 1, an updated medium-term reference rate is computed as the 10-year average potential GDP growth on the period [t-5, t+4]. The budgetary process in some MS requires identification of the reference rate for the expenditure benchmark before spring. A Member State may ask the Commission to provide for indicative purposes an update of its reference rate for the expenditure benchmark already in the winter of year t. However, the Commission assessments and recommendations under the framework of the European Semester will be based on the reference rate for the expenditure benchmark as calculated in the spring of year t. Should significant differences between the winter and spring computations of the reference rate materialise, these would be taken into account as appropriate in the ex post analysis under the preventive arm of the SGP.

2.2 Review of the flexibility clause for cyclical conditions

The Commission shall submit a review report to the Council before 30 June 2018 on the effectiveness of the matrix specifying the annual fiscal adjustment towards the Medium-Term budgetary Objective (MTO). In particular, the review will examine the success of the matrix in promoting counter-cyclical fiscal policies and the achievement by the Member States of their MTOs, thereby creating the necessary room to accommodate economic downturns. The review will also assess whether the new matrix has ensured a reduction in government debt at a satisfactory pace, thereby contributing to the long-term sustainability of public finances, in line with the requirements under the debt rule as specified in Sub-section B(1) of Section I of the Code of Conduct.

3. Structural Reforms

In order to enhance the growth oriented nature of the Pact, structural reforms will be taken into account when defining the adjustment path to the medium-term objective for countries that have not yet reached this objective and in allowing a temporary deviation from this objective for countries that have already reached it.

3.1 Criteria for eligible reforms

To be fully operational, the “structural reform clause” has to rely on well-defined principles regarding the eligibility of such reforms. The Commission and the Council will base their assessment on the following criteria:

[178] S1 shows the adjustment effort required, in terms of a steady improvement in the structural primary balance to be introduced till 2020 and then sustained for a decade, to bring debt ratios to 60% of GDP in 2030, taking also into account the costs arising from an ageing population.

(i) The reforms must be **major**. While there are some individual reforms with a major positive impact on growth and the long-term sustainability of public finances, such as pension reforms, well-designed and comprehensive packages of reforms addressing structural weaknesses may also have a major positive impact. This is notably the case when the reforms reinforce each other's impact through an appropriate choice of policy mix and sequencing of implementation. The assessments by the Commission and the Council on whether a reform or set of reforms can be considered as major will take into account available Commission quantitative estimates on the long-term positive budgetary effects of those reforms. In any case the Commission will provide an explanation of its judgement that the reforms are to be considered as major.

(ii) The reforms must have direct **long-term positive budgetary effects**, including by raising potential sustainable growth, and therefore a verifiable impact on the long-term sustainability of public finances. The sustainability effects can stem either from direct budgetary savings from the reforms (such as in pensions or healthcare), or from the increased revenues drawn in the medium to long-run from a more efficient economy with a higher potential output (e.g. due to lower structural unemployment or an increased labour force), or from a combination of both kinds of effects. The long-term positive budgetary effects could be measured as the improvement in the primary budget balance in net present value equivalent terms. The budgetary effects of the reforms over time are assessed by the Commission and the Council in a prudent way, making due allowance for the margin of uncertainties associated to such an exercise.

iii) The reforms must be **fully implemented**. The reforms must be adopted by the national authorities through provisions of binding force, whether legislative or not, in accordance with the applicable domestic laws and procedures. In case the structural reform is not yet fully implemented, the Member State should also submit a dedicated structural reform plan – subsumed, as relevant, in the National Reform Programme (NRP) or Corrective Action Plan (CAP). A plan announcing upcoming reforms as a simple manifestation of political intentions or of wishes would not fulfil the requirements for the application of Article 5(1) of Regulation 1466/97. While it is understood that all the reforms should be adopted through provisions of binding force before being considered as eligible for the clause, it is also true that the effective implementation of adopted reforms may take time and may be subject to delays and setbacks. This raises the question of introducing strong safeguards against the risk of implementation failures.

3.2 Activation of the structural reform clause

Member States that want to benefit from the structural reform clause should apply for it in their Stability or Convergence Programmes (SCPs). The flexibility is granted in the context of the assessment of the SCPs, specifically in the relevant Country Specific Recommendation. This Country Specific Recommendation could make the granting of flexibility conditional on the subsequent fulfilment of certain eligibility criteria (e.g. the respect of the safety margin). Euro area Member States may request to benefit from the Structural Reform Clause at the time of the Draft Budgetary Plans to be submitted by 15 October. Non-euro area Member States may also apply for the structural reform clause by 15 October

through an *ad hoc* application[179]. The structural reform clause may be granted provided it is endorsed by the Council in the autumn of the same year as an updated Country Specific Recommendation. The Commission and the Council will consider that the criterion related to the implementation of reforms is in part fulfilled *ex ante* when:

- The Member State presents a medium-term structural reform plan which is comprehensive and detailed and includes well-specified measures and credible timelines for their adoption and delivery. The implementation of the reforms will be monitored closely in the context of the European Semester.

- In the specific case of a Member State in the Excessive Imbalances Procedure (EIP), it has submitted a Corrective Action Plan (CAP) providing the necessary information. The implementation of the reforms will then be monitored through the EIP.

In both cases, Member States will be expected to provide in-depth and transparent documentation, providing quantitative analysis of the short-term costs – if any – and of both their medium-term budgetary and potential growth impact. The documentation must also include details on the timetable of implementation of the reforms. Concurrently, Member States will provide an independent evaluation of the information provided to support their application for a temporary deviation under the reform clause, including on the estimated short and medium-term impact on the budgetary position and on the timetable for the implementation of the reforms. Alternatively, Member States should provide comprehensive independent information to support the estimated impact and planned timetable. The Commission will when possible also provide to the Council its estimate of the quantitative impact of the reforms on the long-term positive budgetary effects and on potential growth.

3.3 Operationalisation of the structural reform clause

In the specific case of pension reforms consisting in introducing a multi-pillar system that includes a mandatory, fully-funded pillar, the methodology to allow them to be taken into account in the preventive arm of the Pact is outlined in Article 5 of Regulation (EC) No 1466/97.

For other structural reforms, the Commission and the Council will base themselves on the information contained in the dedicated structural reform plan (or Corrective Action Plan). In this case, the Council will grant eligible Member States additional time to reach the MTO, hence allowing temporary deviations from the structural adjustment path towards it, or to deviate temporarily from the MTO for Member States that have reached it, provided that:

(i) the reforms meet the above criteria;

(ii) the temporary deviation does not exceed 0.5 % of GDP;

(iii) the cumulative temporary deviation granted under the structural reform clause and the investment clause (see Section 4) does not exceed 0.75 % of GDP;

[179] In order to ensure equal treatment of all Member States, the Commission and the Council shall have regard to the different budgetary year of the United Kingdom, with a view to taking decisions with regards to the United Kingdom at a point in its budgetary year similar to that at which decisions have been or will be taken in the case of other Member States.

(iv.) In case the structural reform is planned but not yet fully implemented, the Commission and the Council - when setting via the CSR the required structural effort for the year t+1 - will base themselves on the requirements as per the matrix of the preventive arm, i.e. without any deviation from the adjustment path from the MTO or from the MTO itself. However, the CSR will also state that if the planned reform is fully implemented, the *ex post* assessment of compliance with the requirements of the preventive arm will incorporate the allowed deviation, i.e. by subtracting it from the requirement set by matrix of adjustment;

(v.) the MTO is reached within the four year horizon of the Stability or Convergence Programme of the year in which the clause is activated. In order to ensure that, in the benchmark case of an annual adjustment of 0.5% of GDP, the Member State can regain their MTO within the required four year timeframe, the maximum initial distance which the structural balance of a Member State applying for the structural reform clause can be from the MTO is 1.5% of GDP in year t;

(vi.) the application of the structural reform clause is restricted to one single time per period of adjustment towards the MTO. In other words, once a Member State has benefitted from the structural reform clause, it will not be allowed to benefit from the clause again until it has attained its MTO. This restriction maintains the integrity of the MTO as the central target of the Preventive Arm of the Pact, as to allow multiple or concurrent applications of the clauses could effectively negate the requirement for Member States to achieve their MTO in the medium-term. This conclusion is supported by the record of Member States since the inception of the SGP evidencing in several cases a 100% failure rate in terms of achieving the MTO;

(vii.) an appropriate safety margin is continuously preserved so that the deviation from the MTO or the agreed fiscal adjustment path does not lead to an excess over the 3 % of GDP reference value for the deficit.

While the Pact does not provide the tools for monitoring the enforcement of structural reforms, the legal framework in which the Pact operates – notably the European Semester process and the new Excessive Imbalances Procedure (EIP) – allows the Commission and the Council to assess challenges and imbalances requiring structural reforms, and for monitoring action taken by the Member States. When a Member State is granted a temporary deviation under the reform clause, the Commission shall prepare an assessment of the progress or full adoption and delivery of the reforms in line with the agreed timetable of implementation.

The Council shall grant the temporary deviation after the Commission assessment confirms the full implementation of the agreed reforms. In case a Member State fails to implement or reverses the agreed reforms, the temporary deviation from the MTO, or from the adjustment path towards it, will be considered as not warranted. If such a failure results in a significant deviation from the MTO or the path towards it, the Commission will apply the procedure envisaged in Article 6(2) and Article 10(2) of Regulation (EC) No 1466/97. This means that the Commission will issue a warning to that Member State, followed by a proposal for a Council recommendation, to ensure that the Member State takes the

appropriate policy measures within five months to address that deviation. For euro area Member States, continued failure to comply can ultimately lead to a requirement to lodge an interest-bearing deposit[180].

3.4 Trajectory of the temporary deviation

Member States qualifying of the structural reform clause will be granted a temporary deviation of up to 0.5% of GDP in year t+1 which permits their structural balance to worsen by this amount from the balance that would have prevailed in the absence of the structural reform clause. In order to provide equality of treatment among Member States that are both at and on a path towards the MTO, it is necessary to require the Member States to adjust on a trajectory that is parallel to their original path, but to halt that adjustment if, while being entitled to the deviation, they reach the point where they are within 0.5% of GDP of their MTO (i.e. their MTO minus the temporary deviation). In the fourth year of the adjustment period covered by the structural reform clause, the deviation is no longer applied and the Member State is then required to adjust according to the matrix. In the benchmark case, this will return the Member State to its MTO. Therefore, a Member State which is at the MTO will be allowed to depart from the MTO for three years. A Member State that starts out at 1.0% of GDP from the MTO in the year the clause is applied for, will not be required to adjust in year t+1, implement an adjustment in year t+2, apply no adjustment in year t+3 and finally adjust again in year t+4. A Member State that starts out at 1.5% of GDP from the MTO in the year the clause is applied for will not be required to adjust in year t+1 and will implement the adjustment in years t+2, t+3, and t+4.

4. Government investments aiming at, ancillary to, and economically equivalent to the implementation of major structural reforms

Under the preventive arm of the Pact, some investments aiming at, ancillary to, and economically equivalent to the implementation of major structural reforms may, under certain conditions, justify a temporary deviation from the MTO of the concerned Member State or from the adjustment path towards it.

4.1 Legal framework

Regulation (EC) No 1466/97, in Article 5(1) and Article 2a of the Regulation, recognises "major structural reforms" and "public investment" as two different concepts.

Article 5(1) of Regulation 1466/97 (also known as the "flexibility clause") provides that "*When defining the adjustment path to the medium-term budgetary objective for Member States that have not yet reached this objective, and in allowing a temporary deviation from this objective for Member States that have already reached it, provided that an appropriate safety margin with respect to the deficit reference value is preserved and that the budgetary position is expected to return to the medium-term budgetary objective within the programme period, the Council and the Commission shall take into account the implementation of major structural reforms which have direct long-term positive budgetary effects, including by raising potential sustainable growth, and therefore a verifiable impact on the long-term sustainability of public finances."*

[180] Article 4 of Regulation (EU) No 1173/2011.

Article 2a of Regulation (EC) 1466/97 states that "*The medium-term budgetary objectives shall ensure the sustainability of public finances or a rapid progress towards such sustainability while allowing room for budgetary manoeuvre, considering in particular the need for public investment.*" Such a room of manoeuvre is however limited by the Code of Conduct to Member States with relatively low debt.

Public investments cannot be assimilated "*tout court"* as structural reforms, unless it is duly shown that they are instrumental to the achievement and implementation of the said reforms. It is not legally feasible to establish ex ante that all co-financing expenditure by Member States in investment projects amounts to structural reforms and that such expenditure qualifies for the application of Article 5(1) of Regulation 1466/97.

Government investments that can be eligible for a temporary deviation must be national expenditures on projects that are to a large extent financed by co-funding by the EU under the European Structural and Investment Funds[181], Trans-European Networks and the Connecting Europe Facility, as well as national co-financing of projects also co-financed by the European Fund for Strategic Investments. The temporary deviation for such investments will be subject to a plausibility assessment by the Commission and the Council, where consideration is given to whether the priority or project in question aims at, is ancillary to, and economically equivalent to the implementation of structural reforms. An investment can be considered economically equivalent to a major structural reform only if it can be shown that the investment has a major net positive impact on potential growth and on the sustainability of public finances.

The Commission's plausibility assessment will be based on the detailed information on the contribution of the investment projects to the implementation of structural reforms and their economic equivalence to a structural reform, including on the positive, direct and verifiable long-term budgetary effect of the expenditure covered by the temporary deviation. This information is necessary to ensure compatibility with Article 5(1) and Article 9(1) of Regulation 1466/97, i.e. the SGP provisions which allow temporary deviations from the MTO or the adjustment path towards it to accommodate structural reforms with positive, direct and verifiable effect on fiscal sustainability, including via potential growth. Therefore the Member State should present information by main category of projects co-financed by the EU (including the EFSI), the size of the expenditure involved, the key features and objectives of the investment project and specifying how it will contribute to boost potential growth and the long-term sustainability of public finances.

4.2 European Fund for Strategic Investments (EFSI)

On 25 June 2015, the Council adopted a regulation on a European Fund for Strategic Investments (EFSI) aimed at stimulating the economy. The Fund will offer a new risk-bearing capacity which will allow the EIB to invest in equity, subordinated debt and higher risk tranches of senior debt, and to provide credit enhancements to eligible projects. An initial contribution to this risk-bearing capacity will be made from the EU budget, in the form of a new guarantee fund, and from the EIB's own resources. The use of this EU guarantee and of EIB funds has no impact on the deficit or debt levels of Member States.

[181] See Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006.

The capacity of the EFSI can be further increased through additional financial contributions from Member States. In addition to contributing to the EFSI, Member States will have the possibility to co-finance individual projects also co-financed by it.

4.2.1 Financial contributions from Member States to the EFSI

In their assessment of the necessary fiscal adjustment under the preventive and corrective arms, the Council and the Commission will consider that:

- Initial deficit increasing contributions into the EFSI can be considered as one-off expenditures. Under the preventive arm of the Pact, one-off expenditures will not affect the MTO or the required fiscal adjustment towards it, as these are set in structural terms.

- Under the corrective arm of the Pact (the EDP), compliance with the fiscal adjustment effort recommended by the Council would not be affected, since this is also measured in structural terms. A contribution to the EFSI should therefore not lead to a Member State being found non-compliant with its EDP recommendation.

- In case of a non-respect of the deficit reference value, when preparing the report envisaged under Articles 126(3) and 126(4) TFEU, the Commission and the Council will consider the contribution to the EFSI to be a “relevant factor” in line with Article 2(3) of Regulation (EC) No 1467/97. This means that an EDP will not be launched if this non-respect is due to the contribution, and if the excess over the reference value is small and is expected to be temporary.

- In case of a non-respect of the debt reference value, when preparing the report envisaged under Articles 126(3) and 126(4) TFEU, the Commission and the Council will consider the contribution to the EFSI to be a “relevant factor” in line with Article 2(3) of Regulation (EC) No 1467/97. This means that an EDP will not be launched if the non-respect is due to the contribution.

4.2.2 Co-financing by Member States of investment projects also co-financed by the EFSI

From the point of view of the implementation of the Pact, the Commission and the Council will take into account national co-financing of investment projects that are to a large extent financed by co-financing by the EFSI in the application of a temporary deviation under the conditions set out in Section 4.3 below.

4.3 Criteria for eligible investments under the EFSI and other investment under the preventive arm of the Pact

Under the preventive arm of the Pact, some other investments aiming at, ancillary to, and economically equivalent to the implementation of major structural reforms may, under certain conditions, justify a temporary deviation from the MTO of the concerned Member State or from the adjustment path towards it. An investment can be considered economically equivalent to a major structural reform only if it can be shown that the investment has a major net positive impact on potential growth and on the sustainability of public finances.

For such investments, a Member State will benefit from a temporary deviation of up to 0.5% of GDP from the structural adjustment path towards the MTO, or from the MTO for Member States that have reached it, if the following conditions are met:

(i.) its GDP growth is negative or GDP remains well below its potential (resulting in a negative output gap greater than 1.5 % of GDP);

(ii.) the deviation from the MTO or the agreed fiscal adjustment path towards it does not lead to an excess over the reference value of 3 % of GDP deficit and an appropriate safety margin is preserved;

(iii.) subject to a total maximum temporary deviation of 0.5% of GDP for an application for flexibility for investment by a Member State, the deviation is equal to the national expenditure on eligible projects that are to a large extent financed by co-funding by the EU under the European Structural and Investment Funds [182], Trans-European Networks and Connecting Europe Facility, and to national co-financing of eligible investment projects also co-financed by the EFSI, which have direct long-term positive and verifiable budgetary effects;

(iv.) the cumulative temporary deviation granted under the structural reform clause and the investment clause does not exceed 0.75 % of GDP;

(v.) co-financed expenditure should not substitute for nationally financed investments, so that total public investments are not decreased. In order to evaluate the respect of this condition, the Commission will assess the change in gross fixed capital formation for the year of the application of the clause on the basis of the Commission forecasts to check that there is no fall in overall investment;

(vi.) the Member State must compensate for any temporary deviations and the MTO must be reached within the four-year horizon of its current Stability or Convergence Programme.

(vii.) As with the Structural Reform Clause, in order to preserve the integrity of the MTO, the full temporary deviation (corresponding to the total amount of the national part of eligible co-financed expenditure but not exceeding 0.5% of GDP) will be granted for one single time per period of adjustment towards the MTO. For the following years, only positive incremental changes would be added to the initial temporary deviation. In other words, once a Member State has benefitted from a total temporary deviation of 0.5% of GDP under the "investment clause", it will not be allowed to benefit from the clause again until it has attained its MTO.

The trajectory of the temporary deviation stemming from the application of the "investment clause" should be established in line with the "structural reform clause".

The country-specific temporary deviation will depend on several factors. Ex-ante, the potential deviation will depend on the commitments of the EU structural funds towards each Member State as well as on the

[182] Including eligible projects co-financed through the Youth Employment Initiative.

level of planned co-financing. Ex-post, the allowed deviation will depend on the effective payments of EU structural funds and on the correspondent effective co-financing. In case the actual co-financing falls short of projected co-financing, a correction will be added to the required change in the structural balance, which could potentially lead to the opening of a significant deviation procedure.

4.4 Activation of a temporary deviation for eligible investments

The "investment clause" (IC) is activated ex-ante upon request from Member States in their Stability or Convergence Programmes (SCPs). The flexibility is granted in the context of the assessment of the SCPs, specifically in the relevant Country Specific Recommendation. This Country Specific Recommendation could make the granting of flexibility conditional on the subsequent fulfilment of certain eligibility criteria (e.g. the respect of the safety margin). Euro area Member States may request to benefit from the "investment clause" also at the time of the Draft Budgetary Plans to be submitted by 15 October. Non-euro area Member States may also apply for the "investment clause" by 15 October through an *ad hoc* application[183]. The "investment clause" may be granted provided it is endorsed by the Council in the autumn of that same year as an updated Country Specific Recommendation. The application should be submitted in the year ahead of the application of the clause. That is, in the SCP or at the time of the DBP (or the ad hoc application by a non-euro area MS) submitted in year t for an application of the clause in year t+1.

Ex-ante, the Commission will assess the eligibility of such investments where on the basis of the detailed information provided by the Member States (see Section 4.1 above), consideration is given to whether the priority or project in question aims at, is ancillary to, and economically equivalent to the implementation of structural reforms. The Commission will conclude that an investment can be considered as being economically equivalent to a major structural reform if it can be shown that the investment has a major net positive impact on potential growth and on the sustainability of public finances. The Commission will also assess ex-ante whether the projects satisfy the requirement that they are to large extent financed by EU co-funding.

Ex-ante, the Commission will also assess eligibility to the IC with respect to the spring forecast of year t and will factor it in the ex-ante guidance it provides at the occasion of the European Semester. Ex-post assessment will be based on outturn data available in year t+2, as it is usually the case. The temporary deviation will be reviewed in order to reflect the effective co-financing of the Member States. The (downward) revision of this temporary deviation shall not imply that a Member State implements an effort superior to the one necessary to reach its MTO.

When requesting the application of the IC, Member States should include in their SCPs the following information (for the years t to t+4):

- The forecast path of co-financing expenditure, including for EFSI projects (as a % of GDP).

[183] In order to ensure equal treatment of all Member States, the Commission and the Council shall have regard to the different budgetary year of the United Kingdom, with a view to taking decisions with regards to the United Kingdom at a point in its budgetary year similar to that at which decisions have been or will be taken in the case of other Member States.

- The corrected path of its structural balance resulting from the application of the IC, while planning to reach the MTO within the timeframe of the SCP. Member States shall also take due consideration of the annual fiscal adjustment requirements towards the MTO as defined in Section 2.1 given their projections for GDP and the output gap in their SCPs.

- As specified in Section 4.1, detailed information on the contribution of the investment projects to the implementation of structural reforms and their economic equivalence to a structural reform, including the positive, direct and verifiable long-term budgetary effect of the expenditure covered by the temporary deviation. This information is necessary to ensure compatibility with Article 5(1) and Article 9(1) of Regulation 1466/97, i.e. the SGP provisions which allow temporary deviations from the MTO or the adjustment path towards it to accommodate structural reforms with positive, direct and verifiable effect on fiscal sustainability, including via potential growth.

- Member States will provide an independent evaluation of the information provided to support their application for a temporary deviation under the investment clause, including on the estimated long-term impact on the budgetary position. Alternatively, Member States should provide comprehensive independent information to support the estimated impact.

- The Member State should demonstrate that the eligible co-financed investment does not substitute for nationally funded investments, so that the total share of public capital expenditure is not decreased.

- Member States who have benefitted from the IC will also report in the SCPs on the actual level of co-financing, including for EFSI projects, following the year of application.

5. Review of the structural reform clause and the investment clause

By the end of June 2018, the Commission will carry out a review on the application of the structural reform and investment clauses, taking full account of the economic situation at that time and the achievement of its objectives. The review will examine the achievement by the Member States of their MTOs, thereby creating the necessary room to accommodate economic downturns. The review will examine to what extent the projects eligible for the investment clause were co-funded by the EU and whether the investment clause led to new investments. The review will also examine the implications of the continuation of the investment clause. The review may, as appropriate, be accompanied by proposals to the Economic and Financial Committee for a possible modification of the commonly agreed position on flexibility in the SGP.

GLOSSARY

Automatic stabilisers Features of the tax and spending regime which react automatically to the economic cycle and reduce its fluctuations. As a result, the budget balance in percent of GDP tends to improve in years of high growth, and deteriorate during economic slowdowns.

Bottom up fiscal effort A quantification of the fiscal impact of measures introduced, obtained by summing up the impact of the individual measures.See *Top down fiscal effort.*

Broad Economic Policy Guidelines (BEPGs) Annual guidelines for the economic and budgetary policies of the Member States. They are prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN).

Budget balance The balance between total public expenditure and revenue in a specific year, with a positive balance indicating a surplus and a negative balance indicating a deficit. For the monitoring of Member State budgetary positions, the EU uses *general government* aggregates. See also *structural budget balance*, *primary budget balance*, and *primary structural balance*.

Budgetary sensitivity The variation in the budget balance in percentage of GDP brought about by a change in the output gap. In the EU, it is estimated to be 0.5 on average.

Close-to-balance requirement A requirement contained in the 'old' *Stability and Growth Pact*, according to which Member States should, over the medium term, achieve an overall *budget balance* close to balance or in surplus; was replaced by country-specific *medium-term budgetary objectives* in the reformed *Stability and Growth Pact*.

Code of Conduct Policy document setting down the specifications on the implementation of the *Stability and Growth Pact* and the format and content of the *Stability* and *Convergence programmes*.

Convergence programmes Medium-term budgetary strategies and monetary policies presented by Member States that have not yet adopted the euro. They are updated annually, according to the provisions of the *Stability and Growth Pact*. See also *stability programmes*.

Crowding-out effects Offsetting effects on output due to changes in interest rates and exchange rates triggered by a loosening or tightening of fiscal policy.

Cyclical component of budget balance That part of the change in the *budget balance* that follows automatically from the cyclical conditions of the economy, due to the reaction of public revenue and expenditure to changes in the *output gap*. See *automatic stabilisers*, *tax smoothing* and *structural budget balance*.

Cyclically-adjusted budget balance See *structural budget balance*.

Defined-benefit pension scheme A traditional pension scheme that defines a benefit, i.e. a pension, for an employee upon that employee's retirement is a defined benefit plan.

Defined-contribution pension scheme A scheme providing for an individual account for each participant, and for benefits based solely on the amount contributed to the account, plus or minus income, gains, expenses and losses allocated to the account.

Demand and supply shocks Disturbances that affect the economy on the demand side (*e.g.* changes in private consumption or exports) or on the supply side (*e.g.* changes in commodity prices or technological innovations). They can impact on the economy either on a temporary or permanent basis.

Direct fiscal costs (gross, net) of a financial crisis The direct gross costs are the fiscal outlays in support of the financial sector that increase the level of public debt. They encompass, for example, recapitalisation, purchase of troubled bank assets, pay-out to depositors, liquidity support, payment when guarantees are called and subsidies. The direct net costs are the direct gross cost net of recovery payments, such as through the sale of acquired assets or returns on assets. Thus, the net direct fiscal costs reflect the permanent increase in public debt.

Discretionary fiscal policy Change in the *budget balance* and in its components under the control of government. It is usually measured as the residual of the change in the balance after the exclusion of the budgetary impact of *automatic stabilisers*.

Economic and Financial Committee (EFC) Formerly the Monetary Committee, the EFC is a Committee of the Council of the European Union set up by Article 134 of TFEU. Its main task is to prepare and discuss (ECOFIN) Council decisions with regard to economic and financial matters.

Economic Policy Committee (EPC) Group of senior government officials whose main task is to prepare discussions of the (ECOFIN) Council on structural policies. It plays an important role in the preparation of the *Broad Economic Policy Guidelines*, and it is active on policies related to labour markets, methods to calculate cyclically adjusted budget balances and ageing populations.

ESA2010 / ESA95 European accounting standards for the reporting of economic data by the Member States to the EU. As of September 2014, ESA2010 has replaced the earlier ESA95 standard with regard to the comparison and analysis of national public finance data.

European Financial Stability Facility is a company owned by Euro Area Member States created following the decisions taken in May 2010 by the Council. EFSF is able to issue bonds guaranteed by euro area Member States to lend to euro area Member States in difficulty, subject to conditions negotiated with the European Commission in liaison with the European Central Bank and International Monetary Fund and to be approved by the Eurogroup.

European semester is the yearly cycle of economic policy coordination which takes place over the first 6 months of the year. The European Commission undertakes a detailed analysis of EU Member States' programmes of economic and structural policies and the European Council and the Council of ministers provide policy advice before Member States finalise their draft budgets.

Excessive Deficit Procedure (EDP) A procedure according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in order to assess and/or correct the risk of an excessive deficit in each Member State. Its application has been further clarified in the *Stability and Growth Pact*. See also s*tability programmes* and *Stability and Growth Pact*.

Expenditure rules A subset of *fiscal rules* that target (a subset of) public expenditure.

Fiscal consolidation An improvement in the *budget balance* through measures of *discretionary fiscal policy*, either specified by the amount of the improvement or the period over which the improvement continues.

Fiscal governance Comprises all arrangements, procedures, rules and institutions that underlie the conduct of budgetary policies of general government. The terms fiscal governance and fiscal frameworks are used interchangeably in the document.

(Numerical) Fiscal rule A permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance, such as the government budget deficit, borrowing, debt, or a major component thereof. See also *expenditure rules*.

General government As used by the EU in its process of budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure*, the general government sector covers national government, regional and local government, as well as social security funds. Public enterprises are excluded, as are transfers to and from the EU Budget.

Government contingent liabilities Obligations for the government that are subject to the realization of specific uncertain and discrete future events. For instance, the guarantees granted by governments to the debt of private corporations bonds issued by enterprise are contingent liabilities, since the government obligation to pay depend on the non-ability of the original debtor to honour its own obligations.

Government implicit liabilities Government obligations that are very likely to arise in the future in spite of the absence of backing contracts or law. The government may have a potential future obligation as a result of legitimate expectations generated by past practice or as a result of the pressure by interest groups. Most implicit liabilities are contingent, i.e., depend upon the occurrence of uncertain future events.

Indirect taxation Taxes that are levied during the production stage, and not on the income and property arising from economic production processes. Prominent examples of indirect taxation are the value added tax (VAT), excise duties, import levies, energy and other environmental taxes.

Integrated guidelines A general policy instrument for coordinating EU-wide and Member States economic structural reforms embedded in the Lisbon strategy and which main aim is to boost economic growth and job creation in the EU.

Interest burden *General government* interest payments on public debt as a share of GDP.

Maastricht reference values for public debt and deficits Respectively, a 60 % *general government* debt-to-GDP ratio and a 3 % *general government* deficit-to-GDP ratio. These thresholds are defined in a protocol to the Maastricht Treaty on European Union. See also *Excessive Deficit Procedure*.

Medium-term budgetary framework An institutional fiscal device that lets policy-makers extend the horizon for fiscal policy making beyond the annual budgetary calendar (typically 3-5 years). Targets can be adjusted under medium-term budgetary frameworks (MTBF) either on an annual basis (flexible frameworks) or only at the end of the MTBF horizon (fixed frameworks).

Medium-term budgetary objective (MTO) According to the reformed *Stability and Growth Pact*, *stability programmes* and *convergence programmes* present a *medium-term objective* for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risks to the sustainability of public finances, and is defined in structural terms (see *structural balance*).

Minimum benchmarks The lowest value of the structural budget balance that provides a safety margin against the risk of breaching the *Maastricht reference value for the deficit* during normal cyclical fluctuations. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks. They are a lower bound for the *medium-term budgetary objectives (MTO)*.

One-off and temporary measures Government transactions having a transitory budgetary effect that does not lead to a sustained change in the budgetary position. See also *structural balance*.

Output gap The difference between actual output and estimated potential output at any particular point in time. See also *cyclical component of budget balance*.

Pension fund A legal entity set up to accumulate, manage and administer pension assets. See also *private pension scheme*.

Potential GDP The level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate. See also *output gap*.

Primary budget balance The *budget balance* net of interest payments on *general government* debt.

Primary structural budget balance The *structural budget balance* net of interest payments.

Private pension schemes The insurance contract specifies a schedule of contribution in exchange of which benefits will be paid when the members reach a specific retirement age. The transactions are between the individual and the insurance provider and they are not recorded as government revenues or government expenditure and, therefore, do not have an impact on government surplus or deficit.

Pro-cyclical fiscal policy A *fiscal stance* which amplifies the economic cycle by increasing the *structural primary deficit* during an economic upturn, or by decreasing it in a downturn. A neutral fiscal policy keeps the *cyclically-adjusted budget balance* unchanged over the economic cycle but lets the *automatic stabilisers* work.

Public debt Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by public institutions in the Member State, except that part of the debt which is owed to other public institutions in the same Member State.

Public investment The component of total public expenditure through which governments increase and improve the stock of capital employed in the production of the goods and services they provide.

Significant divergence/deviation A sizeable excess of the budget balance over the targets laid out in the *Stability or Convergence programmes*, that triggers the *warning* procedure of the *Stability and Growth Pact*.

'Snow-ball' effect The self-reinforcing effect of public debt accumulation or decumulation arising from a positive or negative differential between the interest rate paid on public debt and the growth rate of the national economy.

Sovereign bond spread The difference between risk premiums imposed by financial markets on sovereign bonds for different states. Higher risk premiums can largely stem from (i) the debt service ratio, also reflecting the countries' ability to raise their taxes for a given level of GDP, (ii) the fiscal track record, (iii) expected future deficits, and (iv) the degree of risk aversion.

Stability and Growth Pact (SGP) Approved in 1997 and reformed in 2005 and 2011, the SGP clarifies the provisions of the Maastricht Treaty regarding the surveillance of Member State budgetary policies and the monitoring of budget deficits during the third phase of EMU. The SGP consists of two Council Regulations setting out legally binding provisions to be followed by the European Institutions and the

Member States and two Resolutions of the European Council in Amsterdam (June 1997). See also *Excessive Deficit Procedure*.

Stability programmes Medium-term budgetary strategies presented by those Member States that have already adopted the euro. They are updated annually, according to the provisions of the *Stability and Growth Pact*. See also C*onvergence programmes*.

Stock-flow adjustment The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between the net borrowing (flow) and the variation in the stock of gross debt. It includes the accumulation of financial assets, changes in the value of debt denominated in foreign currency, and remaining statistical adjustments.

Structural budget balance The actual *budget balance* net of the *cyclical component and one-off and other temporary measures*. The structural balance gives a measure of the underlying trend in the budget balance. See also *primary structural budget balance*.

Sustainability A combination of budget deficits and debt that ensure that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

Tax elasticity A parameter measuring the relative change in tax revenues with respect to a relative change in GDP. The tax elasticity is an input to the *budgetary sensitivity*.

Top down fiscal effort A quantification of the fiscal impact of government policy, obtained by looking at the overall change in the structural balance. This may differ from the *bottom* up measure due to the incomplete coverage of the latter, second-order economic effects or different assumptions about the non-policy change assumption.

LIST OF ABBREVIATIONS

Member States

BE Belgium
BG Bulgaria
CZ Czech Republic
DK Denmark
DE Germany
EE Estonia
EI Ireland
EL Greece
ES Spain
FR France
IT Italy
HR Croatia
CY Cyprus
LV Latvia
LT Lithuania
LU Luxembourg
HU Hungary
MT Malta
NL The Netherlands
AT Austria
PL Poland
PT Portugal
RO Romania
SSI Slovenia
SK Slovakia
FI Finland
SE Sweden
UK United Kingdom
EA Euro area
EU European Union

Other

AGS	Annual Growth Survey
AMECO	Macro-economic database of the European Commission
CAPB	Cyclically-adjusted primary balance
COFOG	Classification of the functions of government
DG ECFIN	Directorate-General Economic and Financial Affairs
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
EDP	Excessive deficit procedure
EFC	Economic and Financial Committee
EFSF	European Financial Stability Facility
EMU	Economic and Monetary Union
EPC	Economic Policy Committee
ESA(2010)	European System of National and Regional Accounts
ESM	European Stability mechanism
GDP	Gross domestic product
LTC	Long-term budgetary cost of ageing
MTBF	Medium-term budgetary framework
MTO	Medium-term budgetary objective
OECD	Organisation for Economic Co-operation and Development
pp	Percentage points
SCPs	Stability and convergence programmes
SFA	Stock Flow Adjustments
SGP	Stability and Growth Pact
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance in the Economic and Monetary Union

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