Specifications on the implementation of the Stability and Growth Pact

and

Guidelines on the format and content of Stability and Convergence Programmes

5 July 2016

Disclaimer: *At the Informal meeting of the ECOFIN Council on 22-23 April 2016, Ministers invited the Economic and Financial Committee (EFC) to work on improving the predictability and transparency of the Stability and Growth Pact, and to report back to the ECOFIN Council in autumn 2016. This work strand might in particular affect the assessment of effective action. Therefore, this document might be updated in autumn 2016 and/or thereafter to reflect progress on this ongoing work by the EFC.*

TABLE OF CONTENTS

SECTION I – SPECIFICATIONS ON THE IMPLEMENTATION OF THE STABILITY AND GROWTH PACT *Page 4*

A. THE PREVENTIVE ARM OF THE STABILITY AND GROWTH PACT *Page 4*

1) The Medium term budgetary objective (MTO) *Page 4*

2) The adjustment path toward the medium-term budgetary objective and deviations from it *Page 5*

3) A significant deviation from the appropriate adjustment path *Page 10*

B. THE EXCESSIVE DEFICIT PROCEDURE *Page 11*

1) Commission report under Article 126(3) TFEU *Page 11*

2) The decision on the existence of an excessive deficit *Page 13*

3) The correction of an excessive deficit *Page 13*

4) Conditions of abrogation of Council decisions in the context of the EDP *Page 17*

5) Abrogation of Council decisions in the context of the EDP based on the deficit criterion for Member States having implemented multi-pillar pension reforms *Page 17*

SECTION II - GUIDELINES ON THE FORMAT AND CONTENT OF STABILITY AND CONVERGENCE PROGRAMMES *Page 17*

1) Status of the programme and of the measures *Page 18*

2) Content of Stability and Convergence Programmes *Page 18*

ANNEX 1 - MODEL STRUCTURE FOR THE STABILITY AND CONVERGENCE PROGRAMMES *Page 22*

ANNEX 2 - TABLES TO BE CONTAINED IN THE STABILITY AND CONVERGENCE PROGRAMMES *Page 23*

ANNEX 3 – NON-TECHNICAL SUMMARY OF ASSESSMENT OF EFFECTIVE ACTION UNDER THE EXCESSIVE DEFICIT PROCEDURE *Page 31*

ANNEX 4 – IMPROVING THE ASSESSMENT OF EFFECTIVE ACTION IN THE CONTEXT OF THE EXCESSIVE DEFICIT PROCEDURE – A SPECIFICATION OF THE METHODOLOGY *Page 36*

ANNEX 5 – A COMMONLY AGREED POSITION ON FLEXIBILITY WITHIN THE STABILITY AND GROWTH PACT: FLEXIBILITY FOR CYCLICAL CONDITIONS, STRUCTURAL REFORMS AND INVESTMENT *Page 55*

INTRODUCTION

This Opinion updates and replaces the opinion of the Economic and Financial Committee of 3 September 2012 on the content and format of the Stability and Convergence Programmes. This updated Opinion has been adopted by the Economic and Financial Committee on 5 July 2016.

The Stability and Growth Pact fully entered into force on 1 January 1999 and consists of a rules-based framework with both preventive and corrective elements. It initially consisted of 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, Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure and the Resolution of 17 June 1997 on the Stability and Growth Pact. On 20 March 2005 the Council adopted a report entitled "Improving the implementation of the Stability and Growth Pact". The report was endorsed by the European Council in its conclusions of 22 March 2005, which stated that the report updates and complements the Stability and Growth Pact, of which it is now an integral part. On 27 June 2005 the Pact was complemented by two additional Regulations 1055/05 and 1056/05, amending the Regulations 1466/97 and 1467/97.

The Stability and Growth Pact is an essential part of the macroeconomic framework of the Economic and Monetary Union, which contributes to achieving macroeconomic stability in the EU and safeguarding the sustainability of public finances. A rules-based system is the best guarantee for commitments to be enforced and for all Member States to be treated equally. The two nominal anchors of the Stability and Growth Pact - the 3% of GDP reference value for the deficit ratio and the 60% of GDP reference value for the debt ratio - and the medium-term budgetary objectives are the centrepiece of multilateral surveillance.

On 16 November 2011 and 8 November 2011, Regulations 1466/97 and 1467/97 were further amended by Regulation (EU) No 1175/2011 of the European Parliament and of the Council and Council Regulation (EU) No 1177/2011 and flanked by Regulation (EU) No 1173/2011 of the European Parliament and of the Council, which endowed the Stability and Growth Pact with effective enforcement mechanisms for euro-area Member States and on 8 November 2011, the Council adopted Directive 2011/85/EU on requirements for budgetary frameworks of the Member States. While not a part of the Stability and Growth Pact, this Directive is instrumental to the achievement of its objectives.

On 27 November 2015, the Economic and Financial Committee agreed on a "Commonly agreed position on Flexibility within the Stability and Growth Pact" (see Annex 5), which was endorsed by the ECOFIN Council on 12 February 2016[1]. The common position on flexibility complements this Opinion by providing comprehensive guidance on the best 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.

Member States, the Commission and the Council are committed to deliver on their respective responsibilities, applying the Treaty and the Stability and Growth Pact in an effective and timely manner. In addition, since effectiveness of peer support and peer pressure is an integral part of the Stability and Growth Pact, the Council and the Commission are expected to motivate and make public their positions and decisions at all relevant stages of the procedure of the Stability and Growth Pact, also by means of economic dialogue with the European Parliament, where appropriate. The Council is expected to, as a rule, follow the recommendations and proposals of the Commission or explain its position publicly. Member States are expected to take into account guidance and recommendation(s) from the Council in particular when preparing their budgets, and to appropriately involve national Parliaments in the EU procedures, taking into account national parliamentary and budgetary procedures.

In order to enhance ownership of the EU budgetary framework, national budgetary rules and procedures should ensure compliance with the Stability and Growth Pact[2]. Without prejudice to the balance between national and Community competences, implementation of provisions going beyond the minimum requirements established by Directive 2011/85/EU, should be discussed at the European level in the context of the assessment of Stability and Convergence Programmes. The effectiveness of national budgetary frameworks is also a relevant factor to consider in the context of the Excessive Deficit Procedure.

These Guidelines for the implementation of the Stability and Growth Pact consist of two sections. The first section elaborates on the implementation of the Stability and Growth Pact. The second section consists of guidelines on the content and format of the Stability and Convergence programmes.

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

[2] As a result of Protocol 15 and Article 7(bis) of the Council Directive on requirements for budgetary frameworks of the Member States, articles 5 to 7 (on country-specific numerical fiscal rules) of the Directive do not apply to the United Kingdom.

SECTION I

SPECIFICATIONS ON THE IMPLEMENTATION OF THE STABILITY AND GROWTH PACT

A. THE PREVENTIVE ARM OF THE STABILITY AND GROWTH PACT

1) The Medium term budgetary objective (MTO)

Definition of the MTO

The MTO is defined in cyclically adjusted terms, net of one-off and other temporary measures. The reference method for the estimation of potential output is the one adopted by the Council on 12 July 2002.[3] One-off and temporary measures are measures having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position.[4]

The MTO pursues a triple aim:

(i) *providing a safety margin with respect to the 3% of GDP deficit limit.* This safety margin is assessed for each Member State taking into account past output volatility and the budgetary sensitivity to output fluctuations.

(ii) *ensuring rapid progress towards sustainability.* This is assessed against the need to ensure the convergence of debt ratios towards prudent levels taking into account the economic and budgetary impact of ageing populations.

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

The MTOs are differentiated for individual Member States to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances, also in face of prospective demographic changes. The country-specific MTOs may diverge from the requirement of a close to balance or in surplus position.

Specifically, the country-specific MTOs should take into account three components:

i) the debt-stabilising balance for a debt ratio equal to the (60% of GDP) reference value (dependent on long-term potential growth), implying room for budgetary manoeuvre for Member States with relatively low debt;

ii) a supplementary debt-reduction effort for Member States with a debt ratio in excess of the (60% of GDP) reference value, implying rapid progress towards it; and

iii) a fraction of the adjustment needed to cover the present value of the future increase in age-related government expenditure.

according to the formula

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

where the components MTO^{MB} and $MTO^{Euro/ERM2}$ refer to the "minimum benchmark" as agreed by the EFC and to the Pact obligation for euro area Member States and Member States participating in ERM II to have an MTO not lower than –1% of GDP, respectively, while the component MTO^{ILD} relates to implicit and explicit liabilities:

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

The first term on the right hand-side is the budgetary balance that would stabilise the debt ratio at 60% of GDP. The second term is the budgetary adjustment that would cover an agreed fraction of the present value of the increase in the age related expenditure. Alternatively, Member States can choose a fraction of the cost of ageing corresponding to the pre-financing of age-related expenditure up to an agreed number of years before the end of the AWG projections. The third term represents a supplementary debt-reduction effort, specific to countries with gross debt above 60% of GDP. In order to operationalize this formula, explicit parameters will be made public through a Commission services paper, endorsed by the EFC.

This methodology implies a partial frontloading of the budgetary cost of ageing irrespective of the current level of debt. In addition to these criteria, MTOs should provide a safety margin with respect to

[3] Due to data problems, a different method may be used for the estimation of potential output in the case of recently acceded member states (RAMS). The method used should be agreed by the Economic Policy Committee on the basis of a proposal of the Output Gap Working Group.

[4] Examples of one-off and temporary measures are the sales of non-financial assets; receipts of auctions of publicly owned licenses; short-term emergency costs emerging from natural disasters; tax amnesties; revenues resulting from the transfers of pension obligations and assets.

the 3% of GDP deficit reference value and, for euro area Member States and Member States participating in ERM II, in any case not exceed a deficit of 1% of GDP. The examination of the country-specific MTOs by the Commission and the Council in the context of the assessment of Stability and Convergence programmes should indicate whether they adequately reflect the objectives of the Stability and Growth Pact on the basis of the above criteria. Potential growth and the budgetary cost of ageing should be assessed in a long-term perspective on the basis of the projections produced by the EPC.

Member States may present more ambitious MTOs than implied by the formula above if they feel their circumstances call for it.

For Member States outside of the euro area and not participating in ERM II, country-specific MTOs would be defined with a view to ensuring the respect of the triple aim mentioned above.

Art. 2a of Regulation (EC) No 1466/97 states that the respect of the MTO shall be included in the national budgetary framework in accordance with Chapter IV of Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States.[5]

Procedure for defining and revising the MTOs

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

Taking into account the results of these discussions, Member States present their MTO in their Stability or Convergence programme. The MTOs are examined by the Commission and the Council in the context of the assessment of the Stability and Convergence Programmes. In accordance with Article 121(3) of the Treaty and Articles 5(2) and 9(2) of Regulation 1466/97, where the Council considers that the MTO presented in a Stability or Convergence programme should be strengthened, it shall, in its opinion, invite the Member State concerned to adjust its programme.

The MTO shall be revised every three years, preferably following the publication of the "Ageing Report". The MTOs could be further revised in the event of the implementation of a structural reform with a major impact on the sustainability of public finances. In particular, the MTO should be revised in the special case of systemic pension reforms with an impact on long term fiscal sustainability in line with the provision foreseen in section 2 below for major structural reforms.

2) The adjustment path toward the medium-term budgetary objective and deviations from it

Fiscal behaviour over the cycle and adjustment path toward the MTO

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.

Sufficient progress towards the MTO shall be evaluated on the basis of an overall assessment with the structural balance as the reference, including an analysis of expenditure net of discretionary revenue measures. The presumption is to use revenue windfalls, namely revenues in excess of what can normally be expected from economic growth, for deficit and debt reduction, while keeping expenditure on a stable sustainable path over the cycle. For that purpose, the Commission and the Council will assess the growth path of government expenditure against a reference medium-term rate of potential GDP growth.

The reference-medium-term rate of potential GDP growth is updated annually and based on forward-looking projections and backward-looking estimates, taking into account the relevant calculation method provided by the EPC. The reference-medium-term rate of potential GDP growth will be the average of the estimates of the previous 5 years, the estimate for the current year and the projections for the following 4 years.

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

[5] As a result of Protocol 15 and Article 7(bis) of the Council Directive on requirements for budgetary frameworks of the Member States, articles 5 to 7 (on country-specific numerical fiscal rules) of the Directive do not apply to the United Kingdom.

account as appropriate in the ex post analysis under the preventive arm of the SGP.

The government expenditure aggregate to be assessed should exclude interest expenditure, expenditure on EU programmes fully matched by EU funds revenue, and non-discretionary changes in unemployment benefit expenditure. Due to the potentially very high variability of investment expenditure, especially in the case of small Member States, the government expenditure aggregate should be adjusted by averaging investment expenditure over 4 years.

- Member States that have already reached their MTO could let automatic stabilisers play freely over the cycle. They should in particular avoid pro-cyclical fiscal policies in 'good times'. Avoidance should be expected to result in annual expenditure growth not exceeding the reference medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures.

- 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 reasons for differences between the results yielded by the two benchmarks should be carefully assessed.

- A Member State that has overachieved the MTO could temporarily let annual expenditure growth exceed a reference medium-term rate of potential GDP growth as long as, taking into account the possibility of significant revenue windfalls, the MTO is respected throughout the programme period.

- The "Commonly agreed position on flexibility within the SGP" endorsed by the ECOFIN Council of 12 February 2016 (see Annex 3) provides a modulation of the required annual adjustment in the following matrix of requirements:

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

The 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. In addition, the required effort is also greater for Member States with unfavourable overall fiscal positions, i.e. where fiscal sustainability is at risk[6] or the debt-to-GDP ratio is above the 60% of GDP reference value of the Treaty.

Member States that do not follow the appropriate adjustment path will explain the reasons for the deviation in the annual update of their Stability/Convergence Programme.

Based on the principles mentioned above and on the explanations provided by Member States, the Commission and the Council, in their assessments of the Stability or Convergence Programmes, should examine whether the adjustment effort is consistent with the fiscal adjustment requirements set out in the matrix above.

In case of 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 periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed to temporarily depart from the adjustment path towards the medium-term objective implied by the benchmarks for the structural balance and expenditure, on condition that this does not endanger fiscal sustainability in the medium-term.

In case the Council considers that the adjustment path towards the MTO should be strengthened, it shall, in accordance with Article 121(3) of the Treaty and

[6] 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.

Articles 5(2) and 9(2) of Regulation 1466/97, invite the Member State concerned to adjust its programme.

The reference for the estimation of potential output is the methodology adopted by the Council on 12 July 2002.[7]

Differences between the adjustment implied by the structural balance and the expenditure benchmarks should be duly taken into account in the assessment of the adjustment effort in different economic times.

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.

Only major reforms (as defined in the commonly agreed position on flexibility) that have direct long-term positive budgetary effects, including by raising potential growth, and therefore a verifiable positive impact on the long-term sustainability of public finances will be taken into account. For instance, major health, pension and labour market reforms may be considered.

Special attention will be paid to pension reforms introducing a multi-pillar system that includes a mandatory fully funded pillar, which have a direct negative impact on the general government deficit (as defined in Article 1 of Regulation 3605/93). This impact stems from the fact that revenue, which used to be recorded as government revenue, is diverted to a pension fund, which is fully-funded and classified in a sector other than general government, and that some pensions and other social benefits, which used to be government expenditure, will be, after the reform, paid by the pension scheme.[8] In this specific case, the allowed deviation from the adjustment path to the MTO or the objective itself should reflect 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 deficit reference value is preserved.

The direct impact of a pension reform that involves a transfer of pension obligations to or from general government is made up of two elements[9]: 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.

Following such reforms, the MTO should be adjusted to reflect the new situation, in line with the procedures for defining and revising MTO in section 1 above.

The reforms must be fully implemented**.** Only adopted reforms should be considered, provided that sufficient, detailed information is provided. 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.

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.

The flexibility is granted in the context of the assessment of the SCPs, specifically in the relevant Country Specific Recommendation. The 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

[7] See footnote 3.

[8] For more information on the classification of pension schemes, see *'Eurostat's Manual on Government Deficit and Debt'.*

[9] Such transfer of pension obligations occurs when a mandatory fully funded pillar is introduced, enhanced or scaled down with an equivalent change in the outstanding pension obligations of the public pension scheme. Therefore, a transfer of pension obligation effectively takes place between a pension scheme classified outside general government and another scheme that is classified inside.

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[10]. 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

Major structural reforms as identified above 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, provided that:

(i) *the reforms meet the above criteria;*

(ii) *the temporary deviation for structural reforms does not exceed 0.5 % of GDP;*

(iii) *the cumulative temporary deviation granted for structural reforms and investments (see below) does not exceed 0.75 % of GDP;*

(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;*

(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. This safety margin will be assessed for each Member State taking into account past output volatility and the budgetary sensitivity to output fluctuations.*

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

[10] 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.

agreed reforms, the temporary deviation from the MTO, or from the adjustment path towards it, will be considered as not warranted.

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.

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, 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.

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 (this safety margin will be assessed for each Member State taking into account past output volatility and the budgetary sensitivity to output fluctuations);*

(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*[11]*, 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;*

[11] Including eligible projects co-financed through the Youth Employment Initiative.

(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.) *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*.

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. 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

The "investment clause" 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. The 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[12]. 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 (as set out on page 10 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 investment clause 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 for flexibility for investment, Member States should include in their SCPs the information requested in Section 4.4 of the "Commonly agreed position on Flexibility within the Stability and Growth Pact".

3) A significant deviation from the appropriate adjustment path

The identification of a significant deviation from the medium-term budgetary objective or the appropriate adjustment path towards it should be based on outcomes as opposed to plans. It should follow an overall assessment, with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures.

For a Member State that has not reached its MTO, the deviation will be considered significant if:

both

(i) the deviation of the structural balance from the appropriate adjustment path is at least 0.5% of GDP in one single year or at least 0.25% of GDP on average per year in two consecutive years; and

(ii) an excess of the rate of growth of expenditure net of discretionary revenue measures over the

[12] 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.

appropriate adjustment path defined in relation to the reference medium-term rate of growth has had a negative impact on the government balance of at least 0.5 of a percentage point of GDP in one single year, or cumulatively in two consecutive years;

or if one of the two conditions (i) and (ii) is verified and the overall assessment evidences limited compliance also with respect to the other condition.

The government expenditure aggregate to be assessed should exclude interest expenditure, expenditure on EU programmes fully matched by EU funds revenue, and non-discretionary changes in unemployment benefit expenditure. Due to the potentially very high variability of investment expenditure, especially in the case of small Member States, the government expenditure aggregate should be adjusted by averaging the investment expenditure over four years. The excess of expenditure growth over the medium-term reference will not be counted as a breach of the expenditure benchmark to the extent that it is fully offset by revenue increases mandated by law.

For a Member State that has overachieved the MTO, the occurrence of condition (ii) is not considered in the assessment of the existence of a significant deviation, unless significant revenue windfalls are assessed to jeopardise the MTO over the programme period.

A deviation may not be considered significant in the case of severe economic downturn for the euro area or the EU as a whole or when resulting from an unusual event outside of the control of the Member State concerned which has a major impact on the financial position of the general government, provided that this does not endanger fiscal sustainability in the medium-term.

B. THE EXCESSIVE DEFICIT PROCEDURE

In line with the provisions of the Treaty, the Commission has to examine compliance with budgetary discipline on the basis of both the deficit and the debt criteria.

1) Preparation of a Commission report under Article 126(3)

The Commission will always prepare a report under Article 126(3) of the Treaty when at least one of the conditions (a) or (b) below holds:

(a) a reported or planned government deficit exceeds the reference value of 3% of GDP;

(b) a reported government debt ratio is above the reference value of 60% of GDP and

(i) its differential with respect to the reference value has not decreased over the past three years at an average rate of one-twentieth as a benchmark, which is measured by an excess of the debt ratio reported for the year t over a backward-looking element of a benchmark for debt reduction computed as follows[13]

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

(ii) the budgetary forecasts as provided by the Commission services indicate that, at unchanged policies, the required reduction in the differential will not occur over the three-year period encompassing the two years following the final year for which the data is available, which is measured by an excess of the debt ratio forecast by the Commission services for the year t+2 over a forward-looking element of a benchmark for debt reduction computed as follows

$bb_{t+2}=60\%+0.95/3(b_{t+1}-60\%)$
$+0.95^2/3(b_t-60\%)+0.95^3/3(b_{t-1}-60\%)$, where bb_t stands for the benchmark debt ratio in year t and b_t stands for the debt-to-GDP ratio in year t

(iii) the breach of the benchmark cannot be attributed to the influence of the cycle, to be assessed according to a common methodology to be published by the Commission.

The Commission may, in accordance with Article 126(3), also prepare a report notwithstanding the fulfilment of the requirements under the criteria laid down in Article 126(2)(a) of the Treaty if it is of the opinion that there is a risk of an excessive deficit in a Member State.

For a Member State that is subject to an excessive deficit procedure on 8 November 2011 and for a period of three years from the correction of the excessive deficit, occurrence of condition (b) above will not trigger the preparation of a report under Article 126(3) of the Treaty, provided that the Member States concerned makes sufficient progress towards compliance with the debt reduction benchmark as assessed in the Opinion adopted by the Council on its Stability and Convergence Programmes. Specifically, the Member State concerned should present in its Stability or Convergence Programme budgetary objectives

[13] bb_t stands for the benchmark debt ratio in year t and b_t stands for the debt-to-GDP ratio in year t

consistent with the respect of the debt reduction benchmark, including the forward-looking element, by the end of the three-year transitional period. The assessment should in particular consider whether the budgetary plans are adequate to the task of avoiding breaching the benchmark by the end of the programme period.

In order to define "sufficient progress towards compliance" during the transition period, the Commission will identify a minimum linear structural adjustment 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 will be built taking into account both the influence of the cycle and the forward-looking nature of the debt benchmark. Also, in order to ensure continuous and realistic progress towards compliance during the transition period, Member States should respect simultaneously the two below conditions:

- First, the annual structural adjustment should not deviate by more than ¼ % of GDP from the minimum linear structural adjustment ensuring that the debt rule is met by the end of the transitional period.

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

When the deficit ratio exceeds the reference value, the Commission shall examine in its report if one or more of the exceptions foreseen in Article 126(2)(a) apply. In particular, the Commission shall consider whether the deficit ratio has declined substantially and continuously and reached a level that comes close to the reference value.

The Commission shall also consider whether the excess of the deficit ratio over the reference value is only exceptional and temporary and whether the ratio remains close to the reference value. In order to be considered as exceptional, the excess has to result from an unusual event outside the control of the Member State concerned and with a major impact on the financial position of the general government, or it has to result from a 'severe economic downturn'. The Commission and the Council may consider an excess over the reference value resulting from a 'severe economic downturn' as exceptional in the sense of the second indent of Article 126(2)(a) of the Treaty if the excess over the reference value results from a negative annual GDP volume growth rate or from an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential. The indicator for assessing accumulated loss of output is the output gap, as calculated according to the method agreed by the Council on 12 July 2002.[14] The excess over the reference value shall be considered as temporary if the forecasts provided by the Commission indicate that the deficit will fall below the reference value following the end of the unusual event or the severe economic downturn.

The Commission report under Article 126(3) shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors.

Before establishing that an excessive deficit exists on the basis of the debt criterion, the whole range of relevant factors covered by the Commission report under Article 126(3) should be taken into account.

The Commission report should appropriately reflect the following relevant factors:

- the developments in the medium-term economic position (in particular potential growth, including the different contributions provided by labour, capital accumulation and total factor productivity, cyclical developments and the private sector net savings position);

- the developments in the medium-term budgetary position (in particular, the record of adjustment towards the medium-term budgetary objective, the level of the primary balance and developments in primary expenditure, both current and capital, 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 and the overall quality of public finances, in particular the effectiveness of national budgetary frameworks);

- the developments in the medium-term government debt position, its dynamics and sustainability (in particular, risk factors including the maturity structure and currency denomination of the debt, stock-flow adjustment and its composition, accumulated reserves and other financial assets, guarantees, notably linked to the financial sector, and any implicit liabilities related to ageing and private debt, to the extent that it may represent a contingent implicit liability for the government);

Furthermore, due consideration will be given in the report to any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess compliance with the deficit and debt criteria. To this end, the Member State concerned may put forward to the Council and to the Commission the specific factors that it considers

[14] See footnote 3.

relevant, in due time for the preparation of the report under Article 126(3) and as a rule within one month of the reporting dates established in Article 3 (2) and (3) of Regulation (EC) No 479/2009. The Member State shall provide the information necessary for the Commission and the Council to make a comprehensive assessment of the budgetary impact of these factors. In that context, special consideration will be given to: budgetary efforts towards increasing or maintaining at a high level financial contributions to fostering international solidarity and to achieving Union policy goals; the debt incurred in the form of bilateral and multilateral support between Member States in the context of safeguarding financial stability; the debt related to financial stabilisation operations during major financial disturbances. A balanced overall assessment has to encompass all these factors.

The Commission report will give due consideration to the implementation of pension reforms introducing a multi-pillar system that includes a mandatory fully funded pillar and to the net cost of the publicly managed pillar. The net cost of the reform is measured as its direct impact on the general government deficit (as defined in Article 1 of Regulation 479/2009). This impact stems from the fact that revenue, which used to be recorded as government revenue, is diverted to a pension fund, which is fully-funded and classified in a sector other than general government, and that some pensions and other social benefits, which used to be government expenditure, will be, after the reform, paid by the pension scheme. Thus, net costs do not include interest expenditure that is 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.

2) The decision on the existence of an excessive deficit

When assessing compliance on the basis of the deficit criterion, if the debt ratio exceeds 60% of GDP, the relevant factors assessed in the Commission report under Article 126(3) will also be taken into account in the steps leading to the decision on the existence of an excessive deficit foreseen in paragraphs (4), (5) and (6) of Article 126 of the Treaty only if the double condition of the overarching principle – that, before the relevant factors mentioned in Article 2 (3) of Regulation 1467/97 are taken into account, the general government deficit remains close to the reference value and its excess over the reference value is temporary – is fully met. However, the relevant factors assessed in the Commission report under Article 126(3) will be taken into account in the steps leading to a decision on the existence of an excessive deficit foreseen in paragraphs (4), (5) and (6) of Article 126 of the Treaty when assessing compliance on the basis of the debt criterion**.** The balanced overall assessment to be made by the Council in accordance with Article 126(6) shall encompass all these factors.

Where the excess of the deficit over the reference value reflects the implementation of a pension reform introducing a multi-pillar system that includes a mandatory fully funded pillar, the Commission and the Council shall also consider the net cost of the reform to the publicly managed pillar when assessing developments in EDP deficit figures as long as the general government deficit does not significantly exceed a level that can be considered close to the 3% of GDP reference value and the debt ratio does not exceed the 60% of GDP reference value, on condition that overall fiscal sustainability is maintained.

The Council shall decide on the existence of an excessive deficit in accordance with Article 126 (6) of the Treaty, on the basis of a Commission recommendation, as a rule within four months of the reporting dates established in Article 3 (2) and (3) of Regulation (EC) No 479/2009. The Council may decide later on the cases in which the budgetary statistical data have not been validated by the Commission (Eurostat) shortly after the reporting dates established in Regulation (EC) No 479/2009.

3) The correction of an excessive deficit

Minimum fiscal effort for countries in excessive deficit and initial deadline for its correction

The Council recommendations under Article 126(7) and notices under Article 126(9), based on recommendations of the Commission, will request that the Member State concerned achieves annual budgetary targets that, on the basis of the underlying forecast, are consistent with a minimum annual improvement in its cyclically adjusted balance net of one-off and temporary measures of at least 0.5 of a percentage point of GDP as a benchmark, in order to correct the excessive deficit within the deadline set in the recommendation.

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.

Further steps in the excessive deficit procedure and clarifying the conditions for abeyance

The Council recommendation made in accordance with Article 126(7) of the Treaty shall establish a deadline of no longer than six months for effective action to be taken by the Member State concerned. When warranted by the seriousness of the situation, the deadline to take effective action to comply with a recommendation in accordance with Article 126(7) may be three months.

Following the expiry of the deadline established for taking effective action in a recommendation under Article 126(7) or the four months period following the adoption of a notice under Article 126(9), the Commission shall assess whether the Member State concerned has acted in compliance with the recommendation or notice. This 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.

The assessment should take into account the report on action taken in response to the Council recommendation or notice that, within the deadline provided for, the Member State concerned should submit to the Commission and the Council. The report on action taken in response to the Council recommendation in accordance with Article 126(7) should include the targets for the government expenditure and revenue and for the discretionary measures, on both the expenditure and the revenue side, consistent with the Council recommendation as well as information on the measures taken and the nature of those envisaged to achieve the targets. The report on action taken in response to a notice in accordance with Article 126(9), should include the targets for the government expenditure and revenue and for the discretionary measures, on both the expenditure and the revenue side, as well as information on the actions being taken in response to specific Council recommendations, so as to allow the Council to take, if necessary, a decision to impose sanctions in accordance with Article 126(11) of the Treaty. Any such decision shall be taken no later than four months after the Council decision giving notice to the euro area Member State concerned to take measures in accordance with Article 126 (9) TFEU.

In case it appears that the Member State concerned has not acted in compliance with the recommendation or notice, the following step of the procedure provided by Article 126 of the Treaty, as clarified by Regulation (EC) No 1467/97, shall be activated.

If the Commission considers that the Member State has acted in compliance with the recommendation or notice, it shall inform the Council accordingly, and the procedure shall be held in abeyance. If, thereafter, it appears that action by the Member State concerned is not being implemented or is proving to be inadequate and if the possibility of repeating the same step does not apply, the following step of the procedure provided by Article 126 of the Treaty, as clarified by Regulation (EC) No 1467/97, shall be immediately activated. When considering whether the following step of the procedure should be activated, the Commission and the Council should take into account whether the measures required in the recommendation or notice are fully implemented and whether other budgetary variables under the control of the government, in particular expenditure, are developing in line with what was assumed in the recommendation or notice.

In the specific case of recommendations or notices which have set a deadline for the correction of the excessive deficit more than one year after its identification, the assessment of the action taken made by the Commission after the expiry of the deadline established in the recommendation under Article 126(7) or the four month period following a notice under Article 126(9) should mainly focus on the measures taken in order to ensure the achievement of the recommended budgetary targets in the year following the identification of the excessive deficit. The Commission should, during the period of abeyance, assess whether the measures already announced or taken are being adequately implemented and whether additional measures are announced and implemented in order to ensure adequate progress toward the correction of the excessive deficit within the time limits set by the Council.

Clarifying the concept of effective action and repetition of steps in the excessive deficit procedure

On 12-13 June 2014, the Economic and Financial Committee agreed on a "non-technical summary of

assessment of effective action under the excessive deficit procedure" (see Annex 3) and on a more detailed methodological note titled "improving the assessment of effective action in the context of the excessive deficit procedure – a specification of the methodology" (see Annex 4). The non-technical summary (Annex 3) was endorsed by the ECOFIN Council on 20 June 2014. These two notes complement this Opinion by providing comprehensive guidance on the assessment of effective action in the context of the excessive deficit procedure.

If effective action has been taken in compliance with a recommendation under Article 126(7) (or notice under Article 126(9)) of the Treaty and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that recommendation or notice, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 126(7) (or notice under Article 126(9)) of the Treaty. The revised recommendation (or notice) may, taking into account the relevant factors mentioned in Article 2 (3) of Regulation 1467/97, notably extend the deadline for the correction of the excessive deficit by one year as a rule. The occurrence of unexpected adverse economic events with major unfavourable budgetary effects shall be assessed against the economic forecast underlying the Council recommendation or notice.

For the assessment of effective action, a decision-tree sets out the order of logical and procedural steps (see below for a schematic overview). First, the changes in the nominal and structural balances are assessed. When a Member State achieves both its headline deficit target and the recommended improvement in the structural balance, the Member State is considered to have delivered effective action and the EDP is put into abeyance – meaning it is put on hold until the excessive deficit is eventually corrected, as long as it continues to comply with the headline and structural targets. When this is not achieved, the Commission engages in a more detailed examination, known as a careful analysis, based on (i) the 'top-down' approach, which is used to gauge the corrected change of the structural fiscal balance (S^*), and (ii) the 'bottom-up' approach, which is an instrument evaluating the effect of concrete fiscal measures (FE).

In the case where both approaches indicate that the Member State delivered the required policy effort, there is a presumption that effective action has been taken. Conversely, if both the top-down and bottom-up approaches indicate that the policy effort was insufficient, then there is a presumption of non-delivery of effective action. In the case where the top-down and bottom-up approaches come to different conclusions there is no prior presumption. In case of unexpected revenue shortfalls due to forecasting errors of the budgetary impact of (new) revenue measures, the estimates of their budgetary impact as well as the adequacy of their implementation will be assessed and taken into account in the conclusions of the careful analysis. Moreover, to enhance the quality of the revenue measures' budgetary impact estimates, the National Fiscal Councils are invited to conduct and send their estimates – when available – to the Commission. All relevant data, including data about the yields of discretionary fiscal measures, used by the Commission will be shared with the Member States in a timely manner, enabling them to replicate the calculation underlying the Commission's assessments and recommendations in the context of the EDP.

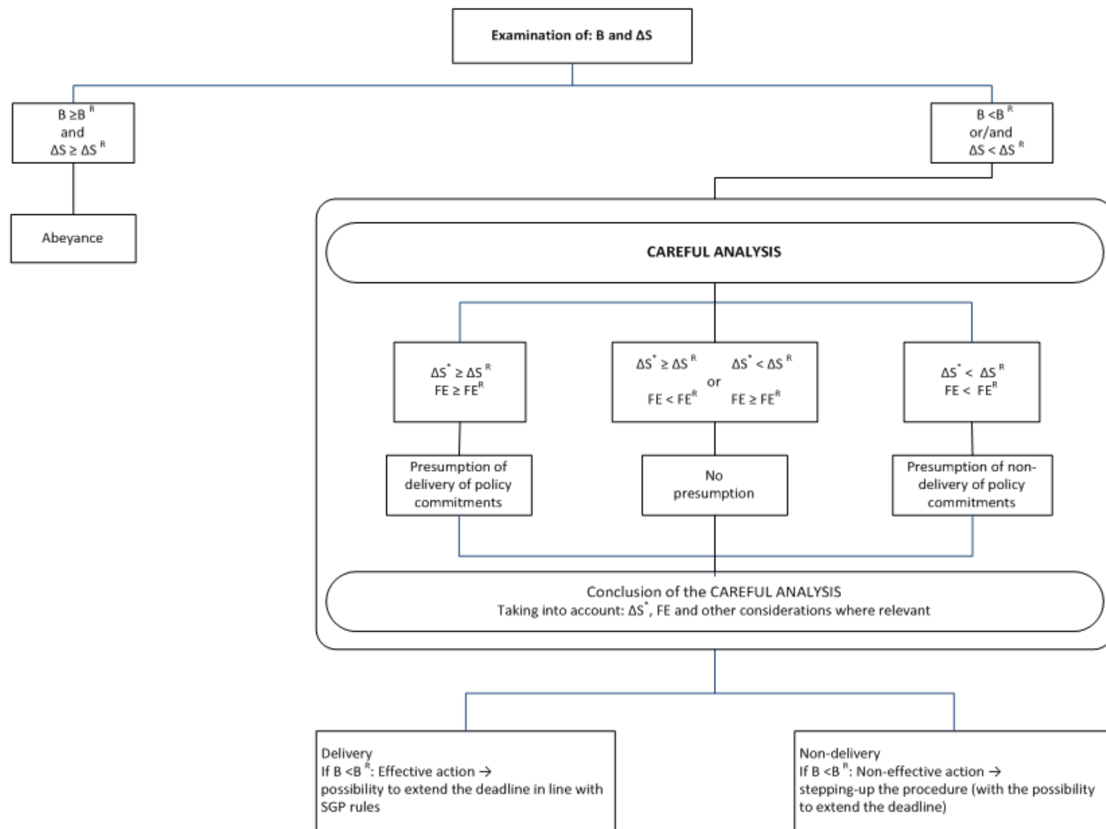
The Commission uses qualitative economic judgement in making its final assessment where relevant, in particular where the top-down and bottom-up approaches come to different conclusions, as part of the "careful analysis" which the Commission uses to determine whether the Member State concerned has delivered or not on its policy commitments. In case the Commission concludes, on the basis of the careful analysis, that the policy commitments have not been delivered, then the procedure will be stepped-up.

For legal reasons, a deficit-based EDP cannot be stepped up if the Member State achieves its intermediate headline deficit target, even when the recommended change in the structural balance is not achieved. At the same time, though, a careful analysis should still be conducted to better understand the nature of the underlying budgetary developments. The decision tree is used to illustrate the procedural steps undertaken.

An effective action assessment based only on a forecast showing compliance with nominal targets in real-time should be considered as preliminary and needs to be reassessed based on actual outcomes. If ex-post the reassessment of effective action based on notified data points to non-compliance with the headline deficit target in addition to insufficient structural effort, the procedure could be stepped-up.

With respect to multi-annual EDPs it is considered more appropriate to assess the fiscal policy effort over the entire correction period. In this way, a Member State cannot be unduly punished for a front-loaded effort. At the same time, it ensures that a Member State meeting its nominal target in the first year without delivering the recommended annual fiscal policy effort would only be found compliant with the recommendation in the later years if it delivers the cumulative fiscal effort over the correction period concerned, in case the nominal deficit falls short of the targets later on.

Decision-Tree Used for Assessing Effective Action



Definitions
Observed Budget balance (deficit) = B
Recommended Budget balance (deficit)= B^R
<u>Top-down approach:</u>
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^*
<u>Bottom-up approach:</u>
Required new fiscal measures = FE^R
Observed budget impact of the new measures implemented = FE

4) Conditions of abrogation of Council decisions in the context of the EDP

When considering whether an excessive deficit procedure should be abrogated, the Commission and the Council should take a decision on the basis of notified data.

Moreover, the excessive deficit procedure should only be abrogated if the Commission forecasts indicate that:

- the deficit will not exceed the 3% of GDP threshold over the forecast horizon; and

- the debt ratio fulfils the forward-looking element of the debt benchmark.

5) Abrogation of Council decisions in the context of the EDP based on the deficit criterion for Member States having implemented multi-pillar pension reforms

When considering under Article 126 (12) whether some or all of the Council decisions under Article 126(6) to (9) and (11) related to excessive deficit procedures based on the deficit criterion should be abrogated, the Commission and the Council, take into account the net cost of a pension reform introducing a multi-pillar system that includes a mandatory fully-funded pillar only if the general government deficit has declined substantially and continuously and has reached a level that comes close to the reference value.

SECTION II

GUIDELINES ON THE FORMAT AND CONTENT OF STABILITY AND CONVERGENCE PROGRAMMES

The Stability and Growth Pact requires Member States to submit Stability or Convergence Programmes, which are at the basis of the Council's surveillance of budgetary positions and its surveillance and co-ordination of economic policies. The Council, on a recommendation from the Commission, and after consulting the Economic and Financial Committee, will, if necessary, adopt an opinion on the programmes. If it considers that its objectives and contents should be strengthened, in particular with regard to the adjustment path towards the MTO, the Council will, in its opinion, invite the Member State concerned to adjust its programme.

Member States are expected to take the policy measures they deem necessary to meet the objectives of their Stability or Convergence Programmes, whenever they have information indicating actual or expected significant divergence from those objectives.

The submission and assessment of Stability and Convergence Programmes is an important component of the "European Semester" of economic policy coordination and surveillance. Under the European Semester, the Commission and the Council shall assess Stability and Convergence Programmes before key decisions on the national budgets for the following years are taken, to provide policy advice on fiscal policy intentions. Member States shall align the timing of submissions and assessments of Stability and Convergence Programmes and National Reform Programmes.[15] For reasons of expediency, a copy of the programmes should be submitted to a single electronic email addressed at the Commission.[16]

Under the European Semester the policy surveillance and coordination cycle starts with a horizontal review under which the European Council, based on input from the Commission and the Council, identifies the main economic challenges facing the EU and the euro area and give strategic guidance on policies. Member States are expected to take into account the horizontal guidance by the European Council when preparing their Stability and Convergence Programmes and justify any departure from it. Similarly, the Commission and Council are expected to take due account of the guidance from the European Council when assessing the individual programmes.

In view of the strengthened role of the Stability and Convergence Programmes in the process of multilateral surveillance under the European Semester, it is important that their information content is suitable and allows for comparison across Member States. Whilst acknowledging that the programmes are the responsibility of national authorities and that the possibilities and practices differ across countries, Council Regulation (EC) No 1466/97, as amended by Council Regulation (EC) No 1055/05 and by Regulation (EU) Y of the European Parliament and of the Council, sets out the essential elements of these programmes. In particular, Stability and Convergence Programmes include the necessary information for a meaningful discussion on fiscal policy for the short and the medium term, including a fully-fledged multi-annual macroeconomic scenario,

[15] In the case of the UK, which has a different fiscal year, submission will follow the presentation of the Spring Budget and be as close as possible to its publication.

[16] ec-european-semester@ec.europa.eu

projections for the main government finances variables and the relevant components, and a description and quantification of the envisaged budgetary strategy.

The experience gathered during the first years of implementation of the Pact with the Stability and Convergence Programmes shows that guidelines on the content and format of the programmes not only assist the Member States in drawing up their programmes, but also facilitate their examination by the Commission, the Economic and Financial Committee and the Council, thus providing for a consistent implementation of the Stability and Growth Pact.

The guidelines set out below should be considered as a code of good practice and checklist to be used by Member States in preparing Stability or Convergence Programmes. Member States are expected to follow the guidelines, and to justify any departure from them. Member States under financial programme assistance could submit only the tables as in annex 2.

1) Status of the programme and of the measures

Each programme mentions its status in the context of national procedures, notably whether the programme was presented to the national Parliament and whether there has been parliamentary approval of the programme. The programme also indicates whether the national Parliament had the opportunity to discuss the Council opinion on the previous programme and, if relevant, any recommendation, decision, or warning.

The state of implementation of the measures (enacted versus planned) presented in the programme should be specified.

2) Content of Stability and Convergence Programmes

In order to facilitate comparison across countries, Member States are expected, as far as possible, to follow the model structure for the programmes in Annex 1. The standardisation of the format and content of the programmes along the lines set below will substantially improve the conditions for equality of treatment.

The quantitative information should be presented following a standardised set of tables (Annex 2). Member States should endeavour to supply all the information in these tables. The tables could be complemented by further information wherever deemed useful by Member States.

In addition to the guidelines set out below, the programmes should provide information on the consistency with the broad economic policy guidelines and the National Reforms Programmes of the budgetary objectives and the measures to achieve them, as well as on the measures to enhance the quality of public finances and to achieve long-term sustainability.

Objectives and their implementation

Member States will present in their Stability and Convergence Programmes budgetary targets for the general government balance in relation to the MTO, and the projected path for the general government debt ratio. Convergence programmes shall also present the medium-term monetary policy objectives and their relationship to price and exchange rate stability.

Member States, when preparing the first Stability or Convergence Programme after a new government has taken office, are invited to show continuity with respect to the budgetary targets endorsed by the Council on the basis of the previous Stability/Convergence Programme and - with an outlook for the whole legislature - to provide information on the means and instruments envisaged to reach these targets by setting out its budgetary strategy.

Member States will provide in their Stability or Convergence Programme an update of the fiscal plans for the year of submission of the programme, based on the April notification, including a description and quantification of the policies and measures. The Stability or Convergence Programme will explain revisions of general government balance and expenditure targets set in the programmes submitted in year t-1.

To permit a comprehensive understanding of the path of the government balance and of the budgetary strategy in general, information should be provided on expenditure and revenue ratios and on their main components, as well as on one-off and other temporary measures. Bearing in mind the conditions and criteria to establish the expenditure growth under Article 5(1) of Regulation 1466/97, the programmes should also present the planned growth path of government expenditure, including the corresponding allocation for gross fixed capital formation, the planned growth path of government revenue at unchanged policy and a quantification of the planned discretionary revenue measures.

To permit a comprehensive understanding of the path of the debt ratio, information should be provided, to the extent possible, on components of the stock-flow adjustment, planned privatisation receipts, and other financial operations. In order to assess the extent of possible risks to the budgetary outlook, information should also be provided on implicit liabilities related to ageing and private debt, to the extent that it may represent a contingent implicit liability for the government, and other contingent liabilities, such as public guarantees, with potentially large impact on the general government accounts.

The budget balances should be broken down by sub-sector of general government (central government, state government for Member States with federal or quasi-federal institutional arrangements, local government and, social security).

Assumptions and data

Stability and Convergence programmes should be based on realistic and cautious macroeconomic forecasts. The Commission forecasts can provide an important contribution for the coordination of economic and fiscal policies. Member States are free to base their Stability/Convergence Programmes on their own projections. Budgetary planning shall be based on the most likely macro-fiscal scenario or on a more prudent scenario. Particular caution should be used in including the effects of recently implemented structural reforms. If such effects are included in the projections, these should be explicitly quantified together with the underlying assumptions and/or model, including variables and parameters. Significant divergences between the national and the Commission services' forecasts should be explained in some detail. This explanation will serve as a reference when forecast errors are assessed ex post.

The programmes should present the main assumptions about expected economic developments and important economic variables that are relevant to the realisation of their budgetary plans, such as government investment expenditure, real GDP growth, employment and inflation. The assumptions on real GDP growth should be underpinned by an indication of the expected demand contributions to growth. The possible upside and downside risks to the outlook should be brought out.

Furthermore, the programmes should provide sufficient information about GDP developments to allow an analysis of the cyclical position of the economy and the sources of potential growth. The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance should be analysed.

As regards external macroeconomic developments, euro area Member States and Member States participating in ERM II in particular should use the "common external assumptions" on the main extra-EU variables used by the Commission in its spring forecast, which shall be provided in due time by the Commission (on the basis of the final table in Annex 2), or, for comparability reasons, present sensitivity analysis based on the common assumptions for these variables when the differences are significant.

Assumptions about interest rates and exchange rates, if not presented in the programme, should be provided to the Commission services to allow for the technical assessment of the programmes.

In order to facilitate the assessment, the concepts used shall be in line with the standards established at European level, notably in the context of the European system of accounts (ESA). The programmes should ensure the formal and substantial consistency of the required information on budgetary aggregates and economic assumptions with ESA concepts. This information may be complemented by a presentation of specific accounting concepts that are of particular importance to the country concerned.

Measures, structural reforms and long-term sustainability

The programmes should describe the budgetary and other economic policy measures being taken, envisaged or assumed to achieve the objectives of the programme, and, in the case of the main budgetary measures, an assessment of their quantitative effects on the general government balance. Measures having significant 'one-off' effects should be explicitly identified. The further forward the year of the programme, the less detailed the information could be, but could contain quantified examples of measures that would allow reaching the programme targets.

However, in order to allow a meaningful discussion the programmes should provide concrete indications on the budgetary strategy for year t+1, including preliminary projections under unchanged policy and targets for the general government balance, expenditure and revenue and their main components, and a description and quantification of the policies taken, envisaged or assumed to reach the fiscal targets. Should the Council consider that the information provided in the programme is insufficient, it shall, in its opinion, invite the Member State concerned to submit a revised programme, in line with the provisions of Articles 5(2) and 9(2) of regulation 1466/97.

As implied by the Commission services for the purpose of forecasting, the 'no-policy change' assumption involves the extrapolation of revenue and expenditure trends and the inclusion of measures that are known in sufficient detail. In particular, only measures that have been specified and committed to by governments will be taken into account. Each Member State should appropriately define a scenario at unchanged policies and make public the involved assumptions, methodologies and relevant parameters.

Structural reforms should be specifically analysed when they are envisaged to contribute to the achievement of the objectives of the programme. In particular, given the relevance of 'major structural reforms' in defining the adjustment path to the medium-term objective for Member States that have not yet reached it and allowing a temporary deviation from the MTO for Member States that have already reached it (see Section I), the programmes should include comprehensive information on the budgetary and economic effects of such reforms. Programmes should notably include a quantitative cost-benefit analysis of the short-term costs – if any – and of the direct long-term benefits of the reforms from the budgetary point of view. They should also analyse the projected impact of the reforms on economic growth over time while explaining the used methodology.

The programmes should also provide information on measures taken or envisaged to improve the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).

The programmes could further include information on existing and envisaged national budgetary rules (expenditure rules, etc.) as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.

Finally, the programmes should outline the countries' strategies to ensure the sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations and the fiscal risks stemming from contingent liabilities.

The Working Group on Ageing (AWG) of the Economic Policy Committee (EPC) is responsible for producing common budgetary projections on: public spending on pensions; health-care; long-term care; education; unemployment transfers; and where possible and relevant, age-related revenues, such as pension contributions. These common projections will provide the basis for the assessment by the Commission and the Council of sustainability of the Member States' public finances within the context of the SGP. They should be included in the programmes.

The programmes should include all the necessary additional information, both of qualitative and quantitative nature, so as to enable the Commission and the Council to assess the sustainability of Member States' public finances based on current policies. To this end, information included in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections. For example, Member States might want to include information on the latest demographic trends and major policy changes in pension and health-care systems. Programmes should clearly distinguish between measures that have been enacted and measures that are envisaged.

Given the uncertainty surrounding long-term projections, the assessment by the Commission and the Council should include stress tests that provide an indication of the risks to public finance sustainability in the event of adverse demographic, financial, economic or budgetary developments.

In addition to the requirements mentioned above, Member States may present different projections, based on national calculations. In such a case, Member States should explain in detail the underlying assumptions of these projections, the used methodology, the policies implemented or planned to meet the assumptions, and the divergences between the national projections and the common projections produced by the AWG.

These national projections and their assumptions, including their plausibility, will enter the basis for the assessment by the Commission and the Council of sustainability of the Member States' public finances within the context of the SGP.

Sensitivity analysis

Given the inevitability of forecast errors, Stability and Convergence Programmes include comprehensive sensitivity analyses and/or develop alternative scenarios, in order to enable the Commission and the Council to consider the complete range of possible fiscal outcomes.

In particular, the programmes shall provide an analysis of how changes in the main economic assumptions would affect the budgetary and debt position and indicate the underlying assumptions about how revenues and expenditures are projected to react to variations in economic variables. This should include the impact of different interest rate assumptions and, for non-participating Member States, of different exchange rate assumptions, on the budgetary and debt position. Countries that do not use the common external assumptions should endeavour

to provide a sensitivity analysis also on main extra-EU variables when the differences are significant.

In the case of 'major structural reforms' (see section I), the programmes shall also provide an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.

Time horizon

The information about paths for the general government surplus/ deficit ratio, the expenditure and revenue ratios and their components, in particular the planned growth of government expenditure, the planned growth path of government revenue at unchanged policy and the planned discretionary revenue measures, appropriately quantified, as well as for debt ratio and the main economic assumptions should be on an annual basis and should cover, as well as the current and preceding year, at least the three following years (Article 3(3) and Article 7(3)), leaving it open to Member States to cover a longer period if they so wish.

The horizon for the long-term projections on the budgetary implications of ageing should cover the same period as the EPC projections.

Updating of programmes

In order to ensure proper ex ante coordination and surveillance of economic policies, submissions of Stability and Convergence Programmes should take place each year preferably by mid–April, but in any case not later than the end of April.

The whole process should be completed with the adoption of Council Opinions on the programmes as a rule before the end of July each year.

Stability and Convergence Programmes should show how developments have compared with the budgetary targets in the previous programme or update, including the information on how the last year's policy guidance in the Council Opinions on the Stability and Convergence Programmes and country-specific recommendations have been reflected in national budgets. When applicable, they should explain in detail the reasons for the deviations from the budgetary targets (with a special focus on developments in government expenditure). When significant deviations occur, the update should mention whether measures are taken to rectify the situation, and provide information on these measures. The Commission and the Council will assess the implementation of the commitments announced by the Member States in their previous Stability and Convergence programmes and of the policy guidance provided by the Council on the previous programme. The outcome of this assessment will be duly taken into account when addressing new policy guidance to Member States.

ANNEX 1

MODEL STRUCTURE FOR THE STABILITY AND CONVERGENCE PROGRAMMES

1. Overall policy framework and objectives

2. Economic outlook
(on the basis of Tables 1a-1d, 5 and 8)

- *World economy/technical assumptions*
- *Cyclical developments and current prospects*
- *Medium-term scenario*
- *Sectoral balances*
- *Growth implications of "major structural reforms"*

3. General government balance and debt
(on the basis of Tables 2, 3, 4 and 5)

- *Policy strategy*
- *Medium-term objectives*
- *Actual balances and updated budgetary plans for the current year*
- *Medium-term budgetary outlook, including description and quantification of fiscal strategy*
- *Structural balance (cyclical component of the balance, one-off and temporary measures), fiscal stance, including in terms of expenditure benchmark*
- *Debt levels and developments, analysis of below-the-line operations and stock-flow adjustments*
- *Budgetary implications of "major structural reforms"*

4. Sensitivity analysis and comparison with previous programme
(on the basis of Table 6)

- *Alternative scenarios and risks*
- *Sensitivity of budgetary projections to different scenarios and assumptions*
- *Comparison with previous programme*

5. Sustainability of public finances
(on the basis of Table 7 and 7a)

- *Policy strategy*
- *Long-term budgetary prospects, including the implications of ageing populations*
- *Contingent liabilities.*

6. Quality of public finances
(on the basis of Tables 2 and 3)

- *Policy strategy*
- *Composition, efficiency and effectiveness of expenditure*
- *Structure and efficiency of revenue systems*

7. Institutional features of public finances

- *National budgetary rules*
- *Budgetary procedures, incl. public finance statistical governance*
- *Other institutional developments in relation to public finances*

ANNEX 2

TABLES TO BE CONTAINED 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 consumption expenditure	P.3						
4. Government consumption expenditure	P.3						
5. Gross fixed capital formation	P.51						
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. Public 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 private sector	B.9					
3. Net lending/borrowing of general government	EDP 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 (EDP B.9) by sub-sector							
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 (S13)							
6. Total revenue	TR						
7. Total expenditure	TE[1]						
8. Net lending/borrowing	EDP B.9						
9. Interest expenditure	EDP D.41						
10. Primary balance[2]							
11. One-off and other temporary measures[3]							
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)							
12a. Taxes on production and imports	D.2					optional	optional
12b. Current taxes on income, wealth, etc	D.5					optional	optional
12c. Capital taxes	D.91					optional	optional
13. Social contributions	D.61					optional	optional
14. Property income	D.4					optional	optional
15. Other [4]						optional	optional
16=6. Total revenue	TR						
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]							
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2						
17a. Compensation of employees	D.1						
17b. Intermediate consumption	P.2						
18. Social payments (18=18a+18b)							
of which **Unemployment benefits**[6]							
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131						
18b. Social transfers other than in kind	D.62						
19=9. Interest expenditure	EDP D.41						
20. Subsidies	D.3						
21. Gross fixed capital formation	P.51						
22. Capital transfers	D.9						
23. Other[7]							
24=7. Total expenditure	TE[1]						
p.m.: Government consumption (nominal)	P.3						

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.
[2]The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).
[3]A plus sign means deficit-reducing one-off measures.
[4] P.11+P.12+P.131+D.39+D.7+D.9 (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 cash benefits (D.621 and D.624) and in kind benefits (D.631) related to unemployment benefits.
[7] D.29+D4 (other than D.41) + D.5+D.7+P.52+P.53+K.2+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 7=24 in Table 2a)	TE[1]		

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

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]						
4. Interest expenditure[3]	EDP 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 Regulation 3605/93 (not an ESA concept).

[2]Cf. item 10 in Table 2a.

[3]Cf. item 9 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]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.

[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]AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

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	EDP B.9					
3. Interest expenditure	EDP 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)	EDP 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 *(this was earlier included in the health 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.

ANNEX 3

NON-TECHNICAL SUMMARY OF ASSESSMENT OF EFFECTIVE ACTION UNDER THE EXCESSIVE DEFICIT PROCEDURE

(adopted by the Economic and Financial Committee on 12-13 June 2014 and endorsed by the ECOFIN Council on 20 June 2014)

1. INTRODUCTION

Under the Excessive Deficit Procedure (EDP), the Council makes recommendations to Member States whose General Government deficit exceeds 3% of GDP or whose General Government debt is higher than 60% of GDP and not decreasing at a sufficient pace, with a view to correcting the excessive deficit.

The Economic and Financial Committee has reviewed the tools and methods which the Commission uses when assessing whether a Member State in EDP has complied with these Council recommendations. The methodology, including certain refinements to the existing methodology, is specified in the attached background document[17]. One of the main improvements brought about by this exercise was the enhancement of transparency. To this end all relevant data, including data about the yields of discretionary fiscal measures, used by the Commission will be shared with the Member States in a timely manner, enabling them to replicate the calculation underlying the Commission's assessments and recommendations in the context of the EDP.

This note provides a non-technical summary of the methodology. It is meant to highlight the main elements of the Commission assessment.

2. COMPLIANCE WITH THE EDP RECOMMENDATION[18]

The 2005 reform of the SGP recognised that Member States taking policy measures designed to bring their deficit back below 3% of GDP may struggle to meet the headline fiscal targets as given by Council Recommendations if economic circumstances were worse than anticipated, or conversely, have an easier time to meet them when the circumstances turn out better than expected. In cases where the nominal targets have not been met, we need to assess whether a Member State had taken sufficient policy measures to meet its obligations, or whether the failure was due to insufficient action. This concept is known as the *assessment of effective action* and is important as it will essentially determine whether an EDP will be stepped-up.

The structural budget balance was introduced as a measure of the action taken by a Member State. The structural balance attempts to remove the changes in a budget balance that are due

[17] 'Improving the Assessment of effective action in the context of the excessive deficit procedure – A specification of the methodology ' (ecfin.cef.cpe(2014)1736337).

[18] See section 1 (page 4) of the background note.

to the movements of the economic cycle and one-off measures, revealing the underlying budgetary position. Hence, changes in the structural balance better reflect, in principle, policy actions, not economic circumstances.

When assessing the efforts of a Member State to correct its excessive deficit, the Commission examines both the changes in the headline deficit and the structural balance against the annual (intermediary) targets that are set in the EDP recommendation.

3. THE STRUCTURAL BALANCE AND THE 'TOP-DOWN' AND 'BOTTOM UP' APPROACH

A sanctions-based system would be difficult to credibly implement if Member States were penalised for factors that are beyond their control. Therefore the change in the structural balance needs to be further analysed to see whether such factors play a role. Two tools have been developed to show the effective policy efforts taken by a Member State. These are the 'top-down' and 'bottom-up' approaches.

Top-Down Assessment of Effective Action[19]

While the estimation of changes in the structural balance is intended to help identify genuine fiscal policy efforts on the part of Member States, its measurement is not problem-free. The purpose of the top down approach is to correct differential growth and revenue outturns relative to expectations at the time of Recommendation.

First, potential GDP growth may turn out lower or higher than foreseen in the forecast underlying the Council Recommendations for correcting the excessive deficit. As a result, the observed change in the structural balance will then be affected in the same direction, for a given level of the "real" policy action. Consequently, in cases of negative growth surprises, the Commission adjusts upward the observed change in the structural balance, and vice versa for positive growth surprises.

Second, there may be unexpected changes in revenues. Revenues can turn out higher or lower than could be foreseen based on economic growth developments. The Commission forecasts underlying the Council Recommendations are based on projections for revenue developments that assume a certain relationship between revenues and growth, i.e. the elasticity of revenues to growth. However, these elasticities can vary over time, and can also change when the composition of growth changes. For instance, if growth turns out to be fuelled more by domestic demand than was expected, a revenue windfall is likely to occur. The change in the structural balance is therefore also adjusted for such windfalls or shortfalls in revenue compared to what was expected at the time of the Council Recommendations. In exceptional cases, the change in the structural balance is also adjusted to take account of large-scale unexpected events requiring a budgetary response, such as natural disasters.

[19] See section 3 (page 9) of the background note.

Bottom-Up Assessment of Effective Action[20]

While the top-down approach takes the change in the structural balance as a starting point, the bottom-up approach revolves around the actual fiscal policy measures the Member State has taken. This is done by estimating the budgetary impact of (new) measures the Member State has introduced to raise revenue[21] and the savings it has made on public expenditure since the Recommendations was issued. The total revenue package is measured by adding up all the individual revenue measures. The expenditure savings are measured by estimating the impact of the measures on total expenditure (excluding expenditures which are not under the control of the government, in particular the changes in interest expenditure, expenditures linked to cyclical unemployment and public investment matched by EU funds) in the no-policy change scenario, i.e. the expenditure impact in case no additional policy measures had been taken.

4. THE STEPS OF THE ASSESSMENT OF EFFECTIVE ACTION [22]

For the assessment of effective action, a decision-tree sets out the order of logical and procedural steps (see annex for a schematic overview). First, the changes in the nominal and structural balances are assessed. When a Member State achieves both its headline deficit target and the recommended improvement in the structural balance, the Member State is considered to have delivered effective action and the EDP is put into abeyance – meaning it is put on hold until the excessive deficit is eventually corrected, as long as it continues to comply with the headline and structural targets. When this is not achieved, the Commission engages in a more detailed examination, known as a careful analysis, based on (i) the 'top-down' approach, which is used to gauge the corrected change of the structural fiscal balance (S^*), and (ii) the 'bottom-up' approach, which is an instrument evaluating the effect of concrete fiscal measures (FE).

In the case where both approaches indicate that the Member State delivered the required policy effort, there is a presumption that effective action has been taken. Conversely, if both the top-down and bottom-up approaches indicate that the policy effort was insufficient, then there is a presumption of non-delivery of effective action. In the case where the top-down and bottom-up approaches come to different conclusions there is no prior presumption. In case of unexpected revenue shortfalls due to forecasting errors of the budgetary impact of (new) revenue measures, the estimates of their budgetary impact as well as the adequacy of their implementation will be assessed and taken into account in the conclusions of the careful analysis. Moreover, to enhance the quality of the revenue measures' budgetary impact estimates, the National Fiscal Councils are invited to conduct and send their estimates – when available- to the Commission.

---

[20] See section 4 (page 12) of the background note.

[21] Prudent revenue estimates by the Commission are key in this context.

[22] See section 2 (page 6) of the background note.

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" which the Commission uses to determine whether the Member State concerned has delivered or not on its policy commitments. In case the Commission concludes, on the basis of the careful analysis, that the policy commitments have not been delivered, then the procedure will be stepped-up.

For legal reasons, a deficit-based EDP cannot be stepped up if the Member State achieves its intermediate headline deficit target, even when the recommended change in the structural balance is not achieved. At the same time, though, a careful analysis should still be conducted to better understand the nature of the underlying budgetary developments. The decision tree is used to illustrate the procedural steps undertaken.

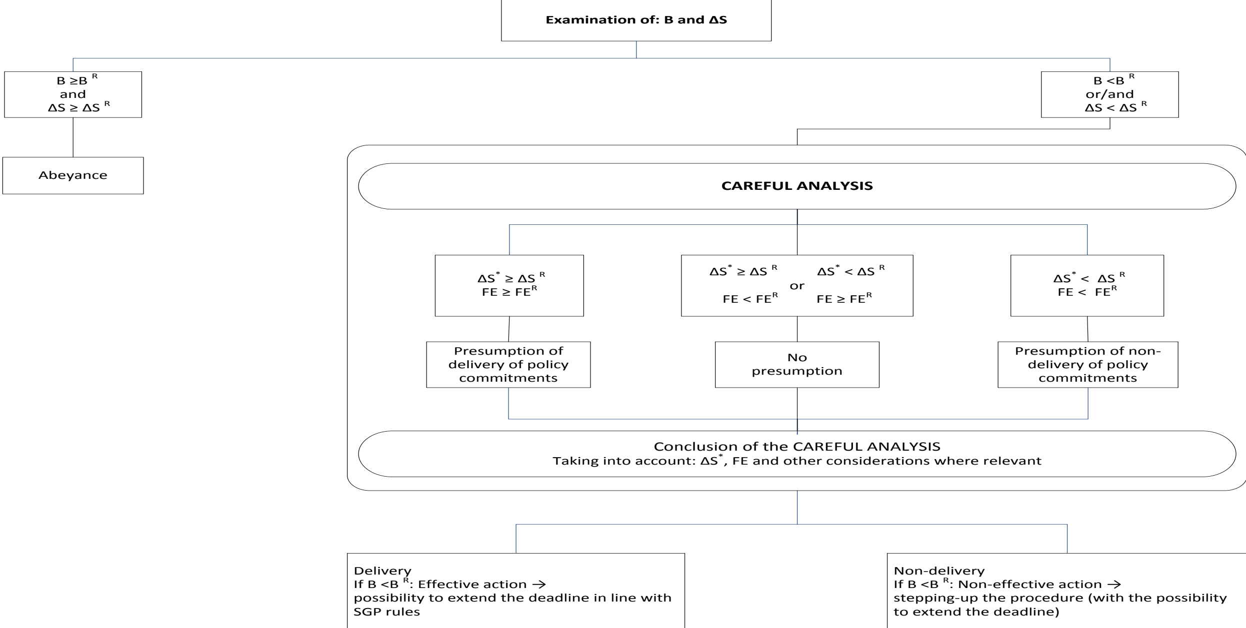
An effective action assessment based only on a forecast showing compliance with nominal targets in real-time should be considered as preliminary and needs to be reassessed based on actual outcomes. If ex-post the reassessment of effective action based on notified data points to non-compliance with the headline deficit target in addition to insufficient structural effort, the procedure could be stepped-up.

With respect to multi-annual EDPs it was considered more appropriate to assess the fiscal policy effort over the entire correction period. In this way, a Member State cannot be unduly punished for a front-loaded effort. At the same time, it ensures that a Member State meeting its nominal target in the first year without delivering the recommended annual fiscal policy effort would only be found compliant with the recommendation in the later years if it delivers the cumulative fiscal effort over the correction period concerned, in case the nominal deficit falls short of the targets later on.

5. CONCLUSIONS

The methodology as summarised above and as described in detail in the attached note will from now on be used by the Commission when assessing effective action in the context of the Excessive Deficit Procedure.

ANNEX: Decision-Tree Used for Assessing Effective Action



Definitions
Observed Budget balance (deficit) = B
Recommended Budget balance (deficit)= B^R
<u>Top-down approach:</u>
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^*
<u>Bottom-up approach:</u>
Required new fiscal measures = FE^R
Observed budget impact of the new measures implemented = FE

ANNEX 4

IMPROVING THE ASSESSMENT OF EFFECTIVE ACTION IN THE CONTEXT OF THE EXCESSIVE DEFICIT PROCEDURE – A SPECIFICATION OF THE METHODOLOGY

(adopted by the Economic and Financial Committee on 12-13 June 2014)

Executive summary

The 2011 reform of the Stability and Growth Pact brought along important innovations to the functioning of the Excessive Deficit Procedure (EDP). Since then, Council recommendations under Article 126(7) TFEU and notices under 126(9) TFEU include annual nominal and structural targets that, on the basis of the underlying forecast, should be consistent with a minimum annual improvement of the structural balance of at least 0.5% of GDP as a benchmark. In an effort to increase transparency, the Commission services spelled out a methodology for assessing effective action a year ago, enforcing the principle of conditional compliance, which requires that policy errors be distinguished from forecast errors in the implementation of the EDP.

In the context of the EFC-A discussions last year, it was agreed that a review of the effective action methodology should be conducted in early 2014. To this end, the Commission prepared a note to the EFC-A, which presented its assessment of the methodology together with some further improvements. This Secretariat note builds on the initial Commission note and reflects the outcome of the discussions in the EFC-A on 27 February, 17 March, 8 April and 24 April, as well as the discussion in the EFC of 24 April.

In particular, this note:

- *First, describes in detail the "EDP decision tree", which sets-out the systematic sequencing of the effective action assessment. The assessment starts by evaluating the compliance with the recommended nominal deficit targets and the uncorrected change in the structural balance. In case of non-compliance with either of these, a careful analysis of the reasons for the shortfall is undertaken based on the "top-down" and "bottom-up" approaches together with other relevant considerations, mostly of qualitative nature. If the careful analysis concludes that the Member State concerned has delivered on its policy commitments then it is considered to have taken effective action and the EDP is put in abeyance. If the policy commitments have not been delivered, the assessment will conclude on non-effective action and lead to the stepping up of the EDP. Unless the nominal deficit target has been met, in which case, the procedure would be held in abeyance.*
- *Second, this note reviews the operation of the "top-down" approach as agreed with the EFC Alternates in January 2013. The evaluation shows that the α and β corrections to*

the structural balance have generally improved the estimations of the fiscal effort, especially in a context where several Member States were undergoing significant structural breaks in their economies. Moreover, for Member States entering the recovery phase, these corrections will act symmetrically on the corrected structural balance. The note presents the results of the appraisal exercise and details the refinements to the β methodology as agreed.

- *Third, this note clarifies the role of the "bottom-up" approach in the assessment of effective action and puts forward a horizontal methodology to compute the fiscal effort from this perspective. This methodology builds on the estimated budgetary impact of discretionary measures on the revenue side and takes into account both explicit and implicit measures on the expenditure side.*
- *Fourth, the note explains how the interplay of the "top-down" and "bottom-up" measures of the fiscal effort should be considered in the careful analysis, describing the potential sources of discrepancies between both metrics. When both indicators point to the same direction there is a presumption that the Member State concerned has or has not implemented sufficient consolidation actions to comply with the EDP recommendation. By taking together quantitative and qualitative elements, where relevant, the careful analysis will conclude whether a Member State has or has not delivered on its policy commitments.*
- *Finally, focusing on the evolution of fiscal variables in a given year can lead to an asymmetry in the assessment of compliance with EDP recommendations. Therefore, it is agreed to assess effective action on the basis of the cumulative fiscal effort for a given year over the EDP lifetime. In order to facilitate this assessment, it was also agreed that the annual recommended fiscal effort be expressed in cumulative terms in future EDP recommendations.*

1. INTRODUCTION

Once a Member State is subject to an Excessive Deficit Procedure (EDP), the Commission regularly assesses whether it is acting in compliance with the EDP recommendation or notice.[23] That is, it regularly assesses whether effective action has been taken. In particular, according to Regulation 1467/97/EC, the Commission has to do so following the expiry of the deadline set by the Council for the Member State to take effective action.[24] Thereafter, the assessments take place alongside the regular monitoring of budgetary developments, based on the same methodology.[25]

The need to distinguish between fiscal consolidation actions and fiscal consolidation outcomes implies that a Member State can be found to be compliant with the EDP recommendation even if the nominal targets are not attained (consolidation outcome), provided that it is assessed to have taken sufficient measures (consolidation actions) to ensure adequate progress towards the correction of the excessive deficit situation, in the face of unexpected events with a significant impact on the public finances.[26] Accordingly, since the 2005 reform of the Stability and Growth Pact (SGP), the change in the structural balance

[23] Hereinafter both referred to as "recommendation".

[24] Article 9(3) of Council Regulation (EC) 1467/97.

[25] See "*The assessment of effective action in the context of the excessive deficit procedure", Note for the Alternates of the Economic and Financial Committee.* Ref. Ares(2012)1546431 – 21/12/2012.

[26] Article 3(5) of Regulation 1467/97/EC.

plays a central role in the fiscal surveillance framework, approximating the extent of the consolidation actions implemented by the concerned Member State.

Despite the known advantages of the structural balance as a measure of the fiscal effort, its endogenous relation with GDP may distort the estimations of governments' fiscal actions. In other words, the structural balance is frequently affected by non-policy effects. Acknowledging the latter, the methodology for the assessment of effective action already (i) corrects the structural balance from forecast errors and unexpected events (as per α, β and γ, presented to the EFC-A in January 2013), and (ii) is then considered within the context of a careful analysis.

In the context of the EFC-A discussions in early 2013, it was agreed that a review of the effective action methodology should be conducted after one year of implementation. For that matter, the Commission prepared a note for the EFC-A which presented its assessment of the methodology and proposed further improvements.[27] The original note was complemented by an additional note on transparency[28], a more detailed note on the formulation of the refinement to the beta[29] parameter and a revised "decision tree" for assessing effective action.[30] The EFC-A extensively discussed the Commission notes in its meetings on 27 February, 17 March, 8 April and 24 April and the EFC on 24 March and 24 April. A final discussion took place on the review and the proposed changes to the methodology in the EFC of 24 April. This note updates the original Commission note reflecting the outcome of the discussions, in particular concerning the revised "EDP decision tree" for assessing effective action together with a clarification on the scope and content of the careful analysis and the agreed refinements to the beta parameter. This note is structured as follows: Section 2 describes the "decision tree" for assessing effective action in the excessive deficit procedure. Section 3 presents the results of the appraisal exercise of the effective action methodology and shows the agreed refinements to the β computation. Section 4 details the "bottom-up" approach methodology. In turn, Section 5 describes the "careful analysis" and finally, Section 6 proposes to assess the fiscal effort in cumulative terms to overcome asymmetry problems.

In order to increase transparency of the exercise, the Commission will supply EFC Alternates with all data needed to replicate the Commission estimates of structural effort (adjusted structural balance; bottom-up approach including data on the yields of fiscal measures as included in the Commission's assessments) as well as the calculations underlying the debt-reduction benchmark for all concerned Member States for each vintage of the Commission forecasts, starting with the spring 2014 forecast. These data would be made available on a dedicated website after the publication of the Commission forecast, with access restricted to the EFC Alternates. At a later stage consideration could be given to make this data available to the broader public.

As of autumn 2014, in order to increase further transparency, the Commission will complement the data provided on the yields of fiscal measures by a quantification of the main discretionary tax measures incorporated in the bottom-up approach of the assessment of effective action. This list will be updated with every forecast.

---

[27] See Note for the EFC-A: *Improving the assessment of effective action in the context of the Excessive Deficit Procedure*.

[28] See Note for the EFC-A: *Transparency in the context of the Excessive Deficit Procedure.*

[29] See Note for the EFC-A: *The revision of the beta parameter*.

[30] Circulated to the EFC-A members on 15 April 2014.

2. THE EDP DECISION TREE FOR ASSESSING EFFECTIVE ACTION

The "decision tree" for assessing effective action sets-out the systematic sequencing for the implementation of the methodology for assessing effective action, which plays a central role in different phases of the excessive deficit procedure (EDP).

The process, which is described in Figure 1, reads as follows:

If the Member State concerned is compliant with the nominal deficit target and the underlying improvement in the structural balance, the procedure is held in abeyance.

If the Member States fails or is at risk of failing to meet the headline deficit target or the required improvement in the structural balance, a careful analysis of the reasons of the shortfall will be undertaken.[31] The careful analysis is, therefore, a centrepiece in the assessment of effective action.

The careful analysis first builds on the two complementary fiscal effort measures provided by the "top-down" and "bottom-up" approaches. All in all, the aim of the careful analysis is to provide an adequate estimation of the extent of policy action to evaluate whether the Member State concerned has delivered on its policy commitments set in the recommendation. The weaknesses of the structural balance as a fiscal effort measure imply that, by itself, it does not always provide an adequate estimation of the extent of policy actions. Thus, the "bottom-up" approach can usefully complement it. However, it should be acknowledged that these estimates of the budgetary impact of the measures can be as unobservable as the structural balance.

The interaction between the two estimates of the fiscal effort (i.e. the corrected change in the structural balance and the "bottom-up") will result in one of the following scenarios:

(i) If the corrected change in the structural balance (ΔS^*) shows an effort equal or above what was recommended (ΔSR) and the "bottom-up" measure of fiscal effort is also equal or above the recommended effort, then there is a presumption that the Member State concerned has delivered on its policy commitments.

(ii) Conversely, when both the "top-down" (ΔS^*) and the "bottom-up" measure of fiscal effort are below the recommended effort, there is a presumption of non-delivery on its policy commitments.

(iii) In the intermediate cases, when both metrics send conflicting messages, there is no presumption.

In all cases, the careful analysis needs to be complemented by a qualified economic judgement of the outcome of both algorithms in order to conclude whether the Member State has delivered or not on its policy commitments. In other words, the careful analysis evaluates

[31] The Code of Conduct states in this respect that: *'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 of the shortfall will be made'.*

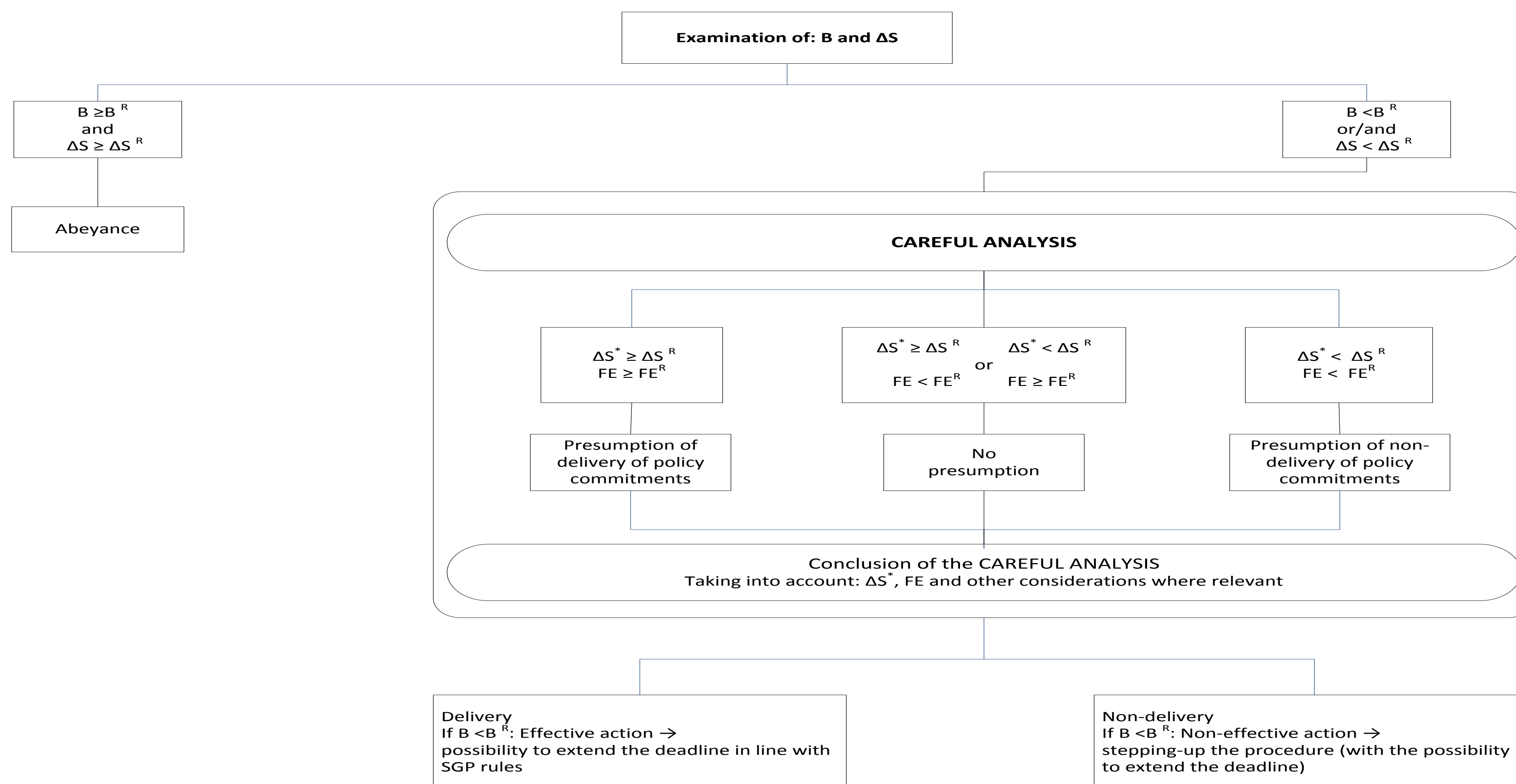
whether the Member State concerned has put in place enough actions to comply with the EDP recommendation. Any conclusion needs to take into consideration the quantitative information from the 'top-down' and 'bottom-up' measures of fiscal effort together with other considerations mostly of qualitative nature that do not emerge from the formulae.

If the careful analysis concludes that the Member State concerned has delivered on its policy commitments, the assessment will conclude that effective action has been taken, with a possibility to extend the deadline, even if the headline deficit target has not been met.

If the careful analysis concludes that policy commitments have not been delivered and that the headline deficit target is not met, the assessment will conclude on non-effective action and the procedure should be stepped up including by setting a new correction deadline as appropriate.

It must be emphasized that if the intermediate nominal deficit target has been met, the procedure will not be stepped up even if the policy commitments have not been delivered. However, it should be stressed that 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.

Figure 1. The EDP decision tree for assessing effective action



Definitions
Observed Budget balance (deficit) = B
Recommended Budget balance (deficit)= B^R
<u>Top-down approach:</u>
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^*
<u>Bottom-up approach:</u>
Required new fiscal measures = FE^R
Observed budget impact of the new measures implemented = FE

3. THE "TOP-DOWN" APPROACH

3.1. The "top down" methodology for assessing effective action was supported by the EFC in January 2013 with a review-clause in a year's time.

The Commission proposed a methodological framework for assessing effective action in January 2013 based on the "top down" approach.[32] This compares the actual change in the structural balance (ΔS) to the recommended change in the structural balance, adjusting the former for forecast errors that are assumed to be outside the control of the government. The change in the structural balance is corrected for three effects:

- The effect of revision of potential output growth compared to the forecasts underlying the Council recommendations (α):

  $$\alpha_t = \frac{G_{t-1}^S}{GDP_{t-1}^{potential}}\left(y_t^{potential} - y_t^{potential^{rec}}\right)$$

  where $\frac{G_{t-1}^S}{GDP_{t-1}^{potential}}$ is the expenditure to GDP ratio net of cyclical factors in year t -1 – that is the year in which the Council recommendation was issued, and $y_t^{potential}$ is potential GDP growth in year *t*. All variables refer to outturn or current forecast figures, except where the superscript *rec* denotes the value given at the time of the recommendation.[33]

- The effect of revision in revenue windfalls/shortfalls relative to the forecasts underlying the Council recommendations (β):

  $$\beta_t = \frac{\overbrace{\left(\Delta R_t - DM_t - g_t^r R_{t-1}\right) - \left(\Delta R_t^{rec} - DM_t^{rec} - g_t^{r\,rec} R_{t-1}^{rec}\right)}^{\text{Revenuegap}}}{GDP_t^{potential}\left(GDP_t^{nom} / GDP_t^{real}\right)}$$

  where R_t, DM_t, and g_t^r respectively stand for the level of government revenues, the level of discretionary revenues measures and the mechanical annual growth in revenue. $GDP_t^{potential}$ stands for the potential output and $GDP_t^{nom} / GDP_t^{real}$ is the ratio of GDP at current prices over the GDP at constant prices (this ratio being the price deflator of the GDP). $GDP_t^{potential}\left(GDP_t^{nom} / GDP_t^{real}\right)$ can then be interpreted as a nominal potential output.

  The mechanical annual revenue growth is defined as $g_t^r = \eta^R \; y_t^{nom}$, where y_t^{nom} and ε^* stand for GDP growth at current values and the revenue elasticity embedded in the computation of the cyclical component of the headline balance.

---

[32] See Note for the EFC-A: *The assessment of the effective action in the context of the Excessive Deficit Procedure*, and Note for the EFC-A: *The assessment of the effective action in the context of the Excessive Deficit Procedure – A follow-up of the 8th January discussion* of *25.1.2013*.

[33] A detailed explanation is provided in the notes referenced in footnote 27.

- In exceptional cases, the impact of other unexpected events such as natural disasters (γ).[34]

This, then, gives the adjusted change in the structural balance: $\Delta S^* = \Delta S - (\alpha+\beta+\gamma)$, which is compared to the fiscal effort required in the recommendation.

The methodology has been implemented in the assessments of effective action made since November 2012. The application of the α and β corrections have played an important contribution in correcting for the forecast errors made at the time of the recommendations, particularly given the difficult economic circumstances that continued to prevail in many countries in 2013. In the absence of the α and β corrections, forecast errors would have contributed to reducing the perceived effort stemming from the observation of the structural balance. With the return to growth expected in 2014, the α and β corrections should start to operate in the opposite direction in an increasing number of cases due to the symmetry in their operation.

3.2. *Refining the methodology*

The implementation of the adjustment methodology has allowed the subtleties of its operation to be better understood. As a result of the experience gained, it was decided not to change the way in which potential output revisions are taken into account (i.e. the α correction). This section does, however, present the agreed two refinements to the methodology for calculating the β component so as to improve the consistency with respect to the theoretical expression of the change in structural balance. First, the revenue gap is divided by actual – and not potential – GDP. Second, the mechanical growth in revenue g_t^r is also revised. The detailed computations underpinning these proposals are shown in Annex 1.

As shown in the annex, taking the theoretical expression of the change in structural balance as the starting point for the derivation of the β component, the "natural" denominator associated to the windfall/shortfall that comes out from the calculation is not the potential output but the actual (nominal) output.

The windfall/shortfall is computed by comparing *the actual variation in revenue* with the *projected revenue*. The projected revenue is the sum of i) the estimated policy change, i.e. the discretionary tax measures, and ii) the expected change in revenue induced mechanically by the economic growth. The latter is estimated by multiplying the previous year's revenue with the mechanical growth in revenue g_t^r .

Yet, the mechanical growth in revenue g_t^r that was computed did not completely capture the automatic response of the revenue to a change in nominal GDP. Until now, g_t^r was estimated by multiplying nominal GDP growth with the elasticity of revenue to the output gap, a technical coefficient measuring the reaction of revenues to the change in cyclical conditions and denoted η^R. This elasticity is an approximation to the impact of nominal growth on revenues, as the change in the output gap explains in practice between one quarter and three quarters of the economic growth, depending of the country and the time period considered. However, as the remaining components that explain nominal growth may (and indeed are likely to) have a different impact on revenues, using the elasticity of revenues to the output gap on nominal growth is an approximation.

[34] However, it should be borne in mind that in case the response to these unexpected events is a one-off measure, it would already be netted out the computation of the structural balance.

An analytical decomposition of the theoretical expression of the change in structural balance shows that the following formula is more appropriate in order to fully capture the automatic response of the revenue to a change in nominal GDP:

$$g^{r}_{t\,new} = y^{nom}_{t} + (\eta^{R} - 1).\Delta OG_{t}$$

y^{nom}_{t} and ΔOG_{t} respectively stand for nominal GDP growth and the variation of the output gap expressed in real terms.

Therefore, the following refined formula to compute the β component will be used:

$$\beta^{new}_{t} = \frac{\left(\Delta R_{t} - DM_{t} - g^{r}_{t\,new}.R_{t-1}\right) - \left(\Delta R^{rec}_{t} - DM^{rec}_{t} - g^{r\,rec}_{t\,new}.R^{rec}_{t-1}\right)}{GDP^{nom}_{t}}$$

4. THE "BOTTOM-UP" APPROACH: METHODOLOGY

Traditionally the fiscal effort has been measured using the so-called "top-down" approach, by computing the change in the structural balance. Accordingly, this approach has also been so far the centrepiece in the effective action assessment as described above. However, the "top-down" approach, by itself, does not always provide an adequate estimation of the extent of consolidation actions. In particular, it does not provide a metric for "whether expenditure targets have been met and the planned discretionary measures on the revenue side have been implemented" as indicated in the Code of Conduct for the careful analysis.

The "bottom-up" approach aims at providing a direct estimation of the budgetary impact of the fiscal measures implemented by the government and, as such, serves as a complementary indicator of the fiscal effort. This approach though has its own weaknesses, mainly related to the difficulty in defining the impact of the measures and the benchmark of "unchanged policies" against which the government actions will be assessed. This section describes the agreed methodology for quantifying the fiscal effort from a "bottom-up" approach.

4.1. The methodology.

The "bottom-up" assessment of effective action aims at identifying the budgetary impact of the new fiscal measures implemented since the EDP recommendation was issued or since compliance with the EDP recommendation was last assessed: either of them, as appropriate in each case, is the cut-off date. While all measures implemented before that moment are already part of the baseline scenario and should not be included in the bottom-up analysis, all measures adopted afterward should be included in the assessment.

The different nature of public expenditures and revenues requires a separate treatment. While the total amount of revenues largely depends on exogenous factors, beyond the direct control of the government (e.g. changes in the tax bases – disposable income, overall consumption, production, etc. – or tax compliance), expenditures can be considered largely under the direct control of the government, except for a limited number of exogenously driven expenditure changes.[35] As such,

[35] 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 investment matched by EU funds.

with few exceptions, nominal changes in public expenditure can be broadly considered as resulting from autonomous decisions by the government. This fundamental difference has obvious implications for the way the developments on both sides of the budget balance are to be treated in the context of the "bottom-up" approach to the assessment of effective action.

Expenditure trends are influenced by active or explicit governmental decisions as well as by indirect ones, as governments can influence expenditures either through their action or their inaction. In this sense, estimating the fiscal effort on the expenditure side by adding up actions which are officially implemented or announced as expenditure measures, as done on the revenue side, will only capture part of the governments' decisions that determine expenditure: the explicit expenditure-related ones. The remaining share of the governments' choices, including not acting, which also affects expenditure outcomes, would be unduly left aside. Furthermore, a pure "bottom-up" approach to the expenditure side would in practice be subject to important information asymmetries between the Commission and the national authorities, which could raise cross-country comparability problems.

Therefore, from a "bottom-up" perspective, the fiscal effort can be defined as follows:

$$FE_t = \underbrace{\frac{DRM_t^{assessment}}{GDP_t^{assessment}}}_{(1)} - \underbrace{\frac{\left(\Delta E_t^{assessment} - \Delta E_t^{baseline}\right)}{GDP_t^{assessment}}}_{(2)}$$

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[36], as estimated at the time of the assessment, net of one-offs[37] implemented in year *t* (or under the relevant subperiod 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 investment matched by EU funds as estimated at the time of the assessment of effective action.
- $\Delta E_t^{baseline}$ 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 investment matched by EU funds as estimated at the time the recommendation was issued.
- $GDP_t^{assesment}$ is nominal GDP in year *t* as estimated at the time of the assessment of effective action.

[36] 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.

[37] 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 2006, Section 4. Measurement and statistical issues, European Economy 3/2006.

4.2. The revenue side.

Element (1) in the above formula represents the fiscal effort implemented on the revenue side and consists of the sum of the estimated budgetary impact of the additional discretionary revenue measures implemented in the period under scrutiny, that is as from the cut-off date.

Its full description requires the specification of the following three aspects: (i) the definition of discretionary measures with a permanent effect; (ii) how the estimated budgetary impact is computed, and finally, (iii) why is it expressed in terms of GDP in year *t* as forecast at the time of the assessment of effective action.

(i) For a government action to be considered as a discretionary revenue measure in terms of the bottom-up approach, it should fulfil the following criteria:

- autonomous interventions by the government;[38]
- enacted or credibly announced in sufficient detail;
- with a direct fiscal impact;

On the contrary, the following cases should not be considered discretionary revenue measures as a general rule:

- commitments or targets (e.g. deficit target, deficit rules) which are not underpinned by specific measures to achieve them;
- specific measures whose entry into force is conditional on reaching certain budgetary thresholds (e.g. automatic increase in a tax rate conditional on deficit breaching a deficit threshold), since those will be part of the baseline;

(ii) When estimating the budgetary impact of a discretionary revenue measure, any behavioural response or second round effects should also be factored in[39]. In this sense, it is the net impact of the discretionary revenue measure that should be added up.

(iii) Finally, the net budgetary impact of discretionary revenue measures - including second round effects - needs to be expressed in terms of an equivalent GDP. That is, one that also incorporates these second round effects so the ratio is consistent. This is GDP in year t as estimated at the time of the assessment of effective action. Otherwise, for positive multipliers, the net estimated impact of revenue increasing (decreasing) measures will be systematically underestimated (overestimated).

4.3. The expenditure side.

Element (2) in the formula compares the (almost) outturn expenditure ratio with the "no-policy change" scenario estimated at the time of the EDP recommendation at a given point in time. This

---

[38] In some specific cases, a government action triggered by an event beyond the direct control of the government can be also considered as a measure, e.g. exceptional events outside the control of government (like natural disasters), some court cases, rulings by international organisations, etc. However, often those events take the form of a one-off measure, in which case they would not be relevant for the bottom-up assessment of effective action.

[39] Note however that the bottom-up estimate does not take into account broader effects, such as for instance the one that a VAT increase may have on GDP, via its impact on consumption, and then further on employment, etc. This fully concurs with the principles of estimating the budgetary effect of discretionary measures in DG ECFIN.

comparison yields the impact of the measures – both explicit and implicit – that ended-up determining expenditure in that period. Therefore, as elaborated in Section 3.1, any expenditure slippage (or savings) as compared to the baseline scenario are taken into account in the "bottom-up" approach to the assessment of effective action along with the effect of discretionary measures.

Account should be taken of all non-discretionary expenditure items and revisions in historical data. Systematically, both $E_t^{assessment}$ and $E_t^{baseline}$ are adjusted for[40]:

(i) unemployment benefit payments related to the evolution of the number of unemployed,[41] changes in interest expenditure[42] and public investment matched by EU funds, and

(ii) one-offs.

Furthermore, $E_t^{baseline}$ is corrected for possible statistical revisions in the historical data including revisions in the expected (or actual) yield of measures and one-offs taken into account at the time of recommendation, which may have had an impact on the projected baseline level of expenditure.

Finally, the amount of measures on the expenditure side is expressed in terms of GDP at the time of the assessment, ensuring consistency between the revenue and expenditure components of the indicator, as opposed to the alternative of GDP as estimated at the time of the recommendation. In any case, the amount of the difference between the estimate of the GDP at the time of the recommendation and at the time of the assessment should be minimal. Simulations for increasing differences in the alternative denominators (nominal GDP at the time of the assessment *minus* nominal GDP at the time of the recommendation) show that, as a rule-of-thumb, every 5% difference between the two denominators yields between 0.01 and 0.05 of a percentage point difference in the estimated effort on the expenditure side, depending on the Member State. That is, for some Member States, only if GDP at the time of the assessment turns out to be more than 10% different to what was envisaged at the time of the recommendation, would the denominator effect have a significant impact (around a decimal point) on the estimation of the effort. For other Member States, the difference between both GDPs would need to be much larger for it to have a noticeable impact on the estimation of the effort. Taking into account that the EU-average Commission's forecast error in real GDP growth and inflation is around 1 and 0.8 p.p. respectively,[43] it seems extremely unlikely that the difference in the GDP estimation at the time of the recommendation and at the time of the assessment would be such as to actually matter for the computation of the expenditure effort.

5. THE CAREFUL ANALYSIS

[40] Where relevant, other country-specific expenditure items outside the control of the government could also be taken into account. This would be done explicitly and documented.

[41] These are gauged by applying a constant benefit ratio to the number of unemployed people. The constant benefit ratio is obtained as the ratio between total unemployment expenditure using the most recent COFOG data available and the number of unemployed people that year.

[42] Except changes due to measures directly affecting the level of the debt.

[43] See "*The accuracy of the European Commission's forecasts re-examined*". http://ec.europa.eu/economy_finance/publications/economic_paper/2012/pdf/ecp476_en.pdf

As per the "decision tree" described in section 2, a careful analysis is warranted when the Member State concerned fails or it is at risk of failing to meet the headline deficit target 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 outcome from the "top-down" and "bottom-up" measures of fiscal effort. Then, the careful analysis should, as indicated in the Code of Conduct, provide a qualified economic judgement of the outcome of both algorithms that will allow determining whether a Member State has put in place enough actions to comply with the EDP recommendation. It is, therefore, the final step in the assessment of effective action that aims at capturing any relevant factor that does not emerge from the formulae and at bringing together both indicators of fiscal effort.

When both the corrected change in the structural balance and the "bottom-up" measure of fiscal effort point in the same direction, the careful analysis would look into other considerations mainly to address possible measurement errors, especially in case the estimated effort only marginally exceeds (falls short of) the recommended one.

Conversely, in the other two cases – where the indicators send conflicting messages – the careful analysis aims at disentangling the possible sources of the difference, in order to conclude which of the two is providing the most accurate picture of the fiscal consolidation actions implemented by the concerned Member State.

In this sense, differences may stem from, among other reasons:

(i) Unexpected dynamics in certain expenditure items. Generally, fiscal authorities can reasonably not be held accountable for the dynamics of certain expenditure categories: while any expenditure trend that is predictable should be considered and internalized by governments when deciding their fiscal policy mix, unexpected dynamics can be potentially excluded from the general framework. This would be the case, for instance, of increases in health expenditure related to unexpected health events affecting a large size of the population. This kind of unexpected events is already captured in the "top-down" approach via the γ correction. However, in the "bottom-up" general framework this will be considered as an expenditure slippage, given that the formula systematically corrects for some exogenous expenditure items[44] but not for other more specific ones. Thus, the careful analysis will allow the reconciliation of the two indicators where the difference stems from some specific non-discretionary expenditure developments that are asymmetrically accounted for in both indicators.

(ii) Inflation developments. The careful analysis will also allow the identification of whether inflation developments may be driving the "bottom-up" and "top-down" estimates apart. In fact, the "bottom-up" estimate of fiscal effort on the expenditure side considers expenditures in nominal terms, whereas the "top-down" estimate is computed in real terms. For a given real expenditure level, unexpected inflation developments will be corrected for in the "top-down" approach through the cyclical adjustment, whereas they will be considered as an expenditure slippage in the "bottom-up" estimate. This should be reconciled in the qualitative assessment of the results.

(iii) Adjustments to the "bottom-up" measure of the fiscal effort on the expenditure side. The "bottom-up" estimate of fiscal effort on expenditure side explicitly excludes the changes in

[44] Namely the share of interest expenditure and unemployment benefits that can be considered outside the control of the government. The share of public investment matched by EU funds should not be considered as a negative fiscal effort given that this expenditure is being compensated on by dedicated funds.

interest expenditure and public investment matched by EU funds,[45] which are not excluded from the computation of the structural balance and should therefore be considered in the careful analysis.

All in all, the careful analysis will determine whether the Member State concerned has delivered or not on its policy commitments.

The report on action taken by the Member State concerned will be an important piece of information for conducting the careful analysis. In particular, Member States are requested to include the targets for government revenue and expenditure as well as for the discretionary measures consistent with those targets. These measures should be described in detail so as to facilitate the assessment. For non-euro area EU Member States the report on action taken is only produced once in the EDP lifetime – usually within six months of the recommendation being issued. Euro area Member States in EDP since the entry into for the 'Two-Pack' additionally shall report every six or three months the in-year budgetary execution, the budgetary impact of discretionary measures, targets for the government expenditure and revenues, and information in the measures adopted and the nature of those envisaged to achieve the targets.

6. THE CUMULATIVE FISCAL EFFORT FOR MULTI-ANNUAL EDPS

A Member State is found compliant with the EDP recommendation if the annual nominal target is met.[46] As a result the EDP procedure would be held in abeyance even if the required annual fiscal effort is not delivered. This can generate an asymmetry in the way compliance with the EDP recommendation is assessed, as explained below.

This poses a particular challenge for multi-annual EDPs. For example, one could consider a 2-year EDP in which a Member State complies with the nominal target without delivering the recommended annual fiscal effort in the first year, while it does not meet the nominal target but delivers the annual fiscal effort recommended for the second year. An assessment of effective action that would take place in the second year would conclude that the Member State concerned has taken effective action if it focuses only on the (second) year under consideration. Therefore, it would pave the way for an extension of the deadline for correction without imposing any sanction, in spite of the fact that the overall structural effort for both years as recommended in the EDP would not have been met, jeopardizing a durable correction of the excessive deficit. By the same token, a Member State that decides to frontload the necessary fiscal consolidation by delivering a fiscal effort above the recommended one in the first year and somewhat below in the following year, would be penalised in the assessment of effective action.

In forthcoming assessments of effective action, the Commission will examine whether the overall fiscal effort over the EDP correction period is delivered in order to balance – at least partially – the asymmetry in the assessment. This ensures that a Member State that meets its nominal target in the first year without delivering the recommended annual effort would only be found

[45] Unemployment benefit payments related to the evolution of the number of unemployed are cyclical, therefore they do not contribute to the difference between the "top-down" and the "bottom-up" estimate of fiscal effort.

[46] This is consistent with the Code of Conduct, which specifies that the EDP procedure shall be abrogated when the deficit is forecast to remain below 3% of GDP in a durable manner (irrespective of whether the fiscal effort has been delivered) and the forward looking element of the debt benchmark is respected. Recursively, if the intermediary nominal targets are fulfilled, the procedure should be held in abeyance.

compliant with the recommendation in the second year if it delivers the cumulated fiscal effort of the first two years even if the nominal target is not met. Analogously, by looking at the cumulated fiscal effort, Member States wishing to frontload the required adjustment would not be discouraged to do so.

All in all, Member States will be better equipped to correct their excessive deficit in a lasting manner i.e. having a deficit forecast not exceeding the 3% of GDP threshold over the Commission forecast horizon. If the deficit reaches 3% of GDP at maximum in the final year of the EDP, but the durability of the correction is still not ensured, effective action will be assessed against the overall (cumulated) effort as benchmark. The α, β and γ corrections to the change in the structural balance will also be considered in cumulative terms.

Similarly, the "bottom-up" assessment will also be conducted in cumulative terms for those Member States whose EDP recommendations specifically indicate the amount of additional fiscal consolidation measures to be implemented every year (i.e. after spring 2013). For Member States that do not meet the annual nominal target nor the cumulated (uncorrected) change in the structural balance, the joint assessment of both the corrected change in the structural balance and the "bottom-up" will be considered in the careful analysis together with other considerations where relevant as described in Section 2 and 5.

As a corollary to the proposed improvements in the assessment of effective action the Commission suggests that the annual recommended fiscal effort should be expressed in cumulative terms in the forthcoming EDP recommendations, as described in the example below. This change would obviously be reflected both in the required improvement of the structural balance and the necessary additional fiscal consolidation measures to achieve these targets. As mandated by the legislation, the annual targets to be expressed in terms of the cumulated change in the structural balance will be directly specified in the Article 126(7) recommendation.

Example: Fiscal consolidation targets in a multiannual EDP recommendation (% of GDP)

EDP recommendations up to December 2013

	20xx	20yy	20zz
Headline deficit	X%	Y%	Z%
Improvement in the structural balance	A%	B%	C%

Additional consolidation measures up to December 2013

	20xx	20yy	20zz
Additional consolidation measures	E%	F%	G%

EDP recommendations from December 2013

	20xx	20yy	20zz

Headline deficit	X%	Y%	Z%
Improvement in the structural balance	A%	B"%=(A+B)%	C"=(A+B+C)%

Additional consolidation measures from December 2013

	20xx	20yy	20zz
Additional consolidation measures	E%	F"%=(E+F)%	G"%=(E+F+G)%

Annex 1: Analytical derivation of the refined β parameter

1) Simplifying the notation

The formula originally used for the beta parameter can be written as follows:

$$\beta_t^{current} = \frac{(\Delta R_t - DM_t - \eta^R\, y_t.R_{t-1}) - (\Delta R_t - DM_t - \eta^R\, y_t.R_{t-1})^{rec}}{Y_t^*}$$

For the sake of simplicity and clarity the above formula introduces some minor difference in notation compared to the body of the note. In particular, η^R stands for the elasticity of revenues to the output gap (and replaces ε^* previously used, as it is customary to refer to semi-elasticities, e.g. in the computation of the cyclically adjusted balance). All quantities are expressed in nominal terms, unless otherwise noted. Therefore, y_t represents growth of nominal GDP (and replaces y_t^{nom} previously used), and Y_t^* potential output at current prices.[47] The other symbols and conventions remain unchanged: R_t, - the level of government revenues; DM_t - the level of discretionary revenue measures; capital letters denote levels and lower case letters growth rates.

With the new notation the formula of the agreed refined version of the β parameter becomes:

$$\beta_t^{new} = \frac{(\Delta R_t - DM_t - [y_t + (\eta^R - 1)\Delta OG_t].R_{t-1}) - (\Delta R_t - DM_t - [y_t + (\eta^R - 1)\Delta OG_t].R_{t-1})^{rec}}{Y_t}$$

2) Analytical derivation

<u>*a) Definition of cyclically-adjusted revenues*</u>

The cyclically adjusted revenue (*CAR*) of the commonly agreed methodology is equal to:

---

[47] It replaces the equivalent expression $GDP_t^{potential}.\left(GDP_t^{nom}/GDP_t^{real}\right)$ previously used in the denominator.

$$CAR_t = \frac{R_t}{Y_t} - \varepsilon_R . OG_t$$

where $\frac{R_t}{Y_t}$, OG_t and ε_R respectively are revenues-to-GDP current ratio, current output gap and the revenue semi-elasticity. The output gap and the revenue semi-elasticity are respectively equal to:

$$OG_t = \frac{Y_t - Y_t^*}{Y_t^*} \qquad \varepsilon_R = \left(\frac{R_0}{Y_0}\right) . (\eta^R - 1)$$

where Y_t, Y_t^* and η^R respectively are the actual output level, the potential output level and the elasticity of revenues to the output gap. The revenues-to-GDP ratio that is used in the computation of ε_R is a 10-year average and is therefore time invariant: its marked by a subscript "0". [48]

b) Decomposition of the change in cyclically-adjusted revenues

The change in cyclically adjusted revenues is equal to:[49]

$$\Delta CAR_t = \Delta\left(\frac{R_t}{Y_t}\right) - \varepsilon_R . \Delta OG_t = \frac{\Delta R_t - y_t . R_{t-1}}{Y_t} - \left(\frac{R_0}{Y_0}\right) . (\eta^R - 1) . \Delta OG_t$$

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 $\frac{DM_t}{Y_t}$ 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 further rearrangements[50]:

$$\Delta CAR_t = \underbrace{\frac{DM_t}{Y_t}} + \underbrace{\frac{\Delta R_t - DM_t - y_t . \eta^R . R_{t-1}}{Y_t}} + \underbrace{(\eta^R - 1) . \left[\frac{R_{t-1}}{Y_t} y_t - \left(\frac{R_0}{Y_0}\right) . \Delta OG_t\right]}$$

---

[48] Further details on the methodology for cyclically-adjusted balances can be found in *The cyclically adjusted budget balance used in the EU fiscal framework: an update* (DG ECFIN Economic Papers 478, March 2013).

[49] It is recalled that all the displayed quantities are nominal, except the output gap which is expressed in real terms.

[50] $\Delta CAR_t = \frac{DM_t}{Y_t} + \frac{\Delta R_t - DM_t - y_t . R_{t-1}}{Y_t} - \left(\frac{R_0}{Y_0}\right) . (\eta^R - 1) . \Delta OG_t$

$$\Delta CAR_t = \frac{DM_t}{Y_t} + \frac{\Delta R_t - DM_t - y_t . R_{t-1}}{Y_t} - (\eta^R - 1) . \frac{R_{t-1}}{Y_t} y_t + (\eta^R - 1) . \frac{R_{t-1}}{Y_t} y_t - \left(\frac{R_0}{Y_0}\right) . (\eta^R - 1) . \Delta OG_t$$

$$\Delta CAR_t = \frac{DM_t}{Y_t} + \frac{\Delta R_t - DM_t - y_t . \eta^R . R_{t-1}}{Y_t} + (\eta^R - 1) . \left[\frac{R_{t-1}}{Y_t} y_t - \left(\frac{R_0}{Y_0}\right) . \Delta OG_t\right]$$

(i) *(ii)* *(iii)*

where DM_t are the discretionary revenue measures in year *t*.

Therefore the change in the structural revenues can be decomposed in three terms which can be interpreted in the following way:

- The first term is equal to the effect of discretionary revenue measures, expressed as a percentage of actual output.

- The second term corresponds to the revenue windfall/shortfall, expressed as a percentage of actual output. Indeed, 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* (cf. Vademecum Annex 5, *Computing the adjusted fiscal effort*). Therefore, 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 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 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. Therefore, item (iii) can be further developed as:
$$(\eta^R - 1).\left[\frac{R_{t-1}}{Y_t} y_t - \left(\frac{R_0}{Y_0}\right).\Delta OG_t\right] = (\eta^R - 1)(y_t - \Delta OG_t).\frac{R_{t-1}}{Y_t} + (\eta^R - 1)\left(\frac{R_{t-1}}{Y_t} - \frac{R_0}{Y_0}\right).\Delta OG_t$$

<u>*c) Derivation of the β parameter*</u>

The revenue windfall/shortfall that is observed *ex-post* on the basis of actual data may differ from the value forecasted *ex-ante* by the Commission in its recommendation. The difference between both values, the so called “revenue gap”, is a forecast error and is outside of the direct control of the authorities. When assessing government's actions, this error can corrected by subtracting the following term from the *ex-post* value of ΔCAR_t (based on the above decomposition):

$$\frac{(\Delta R_t - DM_t - \eta^R \; y_t . R_{t-1}) - (\Delta R_t - DM_t - \eta^R \; y_t . R_{t-1})^{rec}}{Y_t}$$

where the superscript *rec* denotes the values underlying Council recommendation. The above term is very close to the β parameter that has been used so far. The numerator of the term is identical to the one used in β, while the denominator is actual output rather than potential output. This refinement makes the parameter more in line with the theoretical foundations.

However, the above term corrects only for the item (ii) of the decomposition presented above, the "elasticity effect" and it is useful to consider whether the other elements do not merit also being taken into account in the correction of revenue developments.

As to item (i), the ratio of discretionary revenue measures to GDP, is the reflection of policy action and does not require correction.

As to item (iii) and its decomposition presented above, the second element - that is to say $(\eta^R - 1)\left(\frac{R_{t-1}}{Y_t} - \frac{R_0}{Y_0}\right).\Delta OG_t$ - equals virtually 0, 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 should be taken into account in the correction. In economic terms, this item can be interpreted as the automatic response of the revenue level to inflation and to potential growth.[51] It has been ignored in the current computation of the revenue windfall/shortfall, but the simulations show that its value can be above an insignificant level and it is useful to integrate it in the calculations.

Integrating this exposition of item (iii) into the decomposition of *ΔCAR* presented above yields:

$$\Delta CAR_t = \frac{DM_t}{Y_t} + \frac{\Delta R_t - DM_t - [y_t + (\eta^R - 1).\Delta OG_t].R_{t-1}}{Y_t} + (\eta^R - 1)\left[\frac{R_{t-1}}{Y_t} - \left(\frac{R_0}{Y_0}\right)\right].\Delta OG_t$$

The first term remains unchanged. The second term is the refined version of revenue windfall/shortfall expressed as a ratio to actual output and the third one is a technical term that takes into account the difference between $\frac{R_{t-1}}{Y_t}$ and $\frac{R_0}{Y_0}$ and that is virtually equal to 0. A similar reasoning to the one developed in the previous section leads to a refined version of β:

$$\beta_t^{new} = \frac{\left(\Delta R_t - DM_t - [y_t + (\eta^R - 1).\Delta OG_t].R_{t-1}\right) - \left(\Delta R_t - DM_t - [y_t + (\eta^R - 1).\Delta OG_t].R_{t-1}\right)^{rec}}{Y_t}$$

[51] $y_t - \Delta OG_t \simeq y_t^{(real)} + \pi_t - \Delta OG_t \simeq \pi_t + y_t^*$ where π_t and y_t^* respectively are the inflation rate and the (real) potential growth.

ANNEX 5

A COMMONLY AGREED POSITION ON FLEXIBILITY WITHIN THE STABILITY AND GROWTH PACT: FLEXIBILITY FOR CYCLICAL CONDITIONS, STRUCTURAL REFORMS AND INVESTMENT

(adopted by the Economic and Financial Committee on 27 November 2015 and endorsed by the ECOFIN Council on 12 February 2016)

Preamble

On 13 January 2015 the Commission adopted its Communication on flexibility within the Stability and Growth Pact (SGP). This document presents a commonly agreed position on flexibility in the SGP, as agreed by the EFC on 27 November 2015 and endorsed by the ECOFIN Council on 12 February 2016. 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.

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*[52] (hereafter "the Code of Conduct").

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 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.

[52] http://ec.europa.eu/economy_finance/economIC_governance/sgp/pdf/coc/code_of_conduct_en.pdf

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[53].

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:

(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.

[53] 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.

(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[54]. 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;

[54] 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.

(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;

(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[55].

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

[55] Article 4 of Regulation (EU) No 1173/2011.

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."*

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[56], 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

[56] 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.

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.

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 [57], 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 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[58]. 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

[57] Including eligible projects co-financed through the Youth Employment Initiative.

[58] 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.

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).
- 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.