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European Commission  
Directorate-General for Economic and Financial Affairs

# Vade Mecum on the Stability and Growth Pact

## 2019 Edition

This Vade Mecum was prepared in the European Commission's Directorate-General of Economic and Financial Affairs under the direction of Marco Buti, Director-General, Carlos Martinez Mongay, Deputy Director-General, Lucio Pench, Director for Fiscal Policy and Policy Mix, and Gilles Mourre, Head of Unit for Fiscal Policy and Surveillance.

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Beyond specific inputs, the Vade Mecum draws heavily on a series of methodological notes and policy briefs developed over the past years to cover the various aspects of the Stability and Growth Pact and its implementation. Due to the large number of colleagues who have contributed to this body of work over the years it has not been possible to name them all. Nevertheless their contribution has been central.

Secretarial support and layout was provided by Maria Stampouli.

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

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# 0. INTRODUCTION

Enhancing the clarity of the strengthened fiscal (and economic) governance toolbox is among the actions set out in the 21 October 2015 Communication by the Commission *On steps towards Completing Economic and Monetary Union*. <sup>(1)</sup> This is the fifth edition of the Vade Mecum. It was published for the first time in May 2013 with the aim of improving transparency about the way that the Commission applies the rules of the Stability and Growth Pact (SGP, or the Pact). An annual update was called for by the Communication *On steps towards Completing Economic and Monetary Union*, with a view to further increasing transparency and explaining the rules in a structured and pedagogical way. It is a manual prepared by, and under the responsibility of, the Directorate-General for Economic and Financial Affairs of the European Commission. It presents the relevant procedures and methodologies designed for implementing the SGP. These are either enshrined in European Union (EU) legislation (Treaty, SGP regulations, delegated acts) or arise from the interpretation of the general provisions of the legislation by the Commission and Member States, in the context of the work of the Economic and Financial Committee of the Council, or specific interpretative Communications by the Commission.

The Vade Mecum is a compiled-style document that brings together all elements relevant to the implementation of the SGP. In this edition, we are changing the style of the document with a view to streamlining the information presented and facilitating readability of the explanations of EU rules and of the institutional processes of budgetary surveillance. <sup>(2)</sup> The streamlining of the document does not mean that the Commission is changing the rules. The document focuses on describing current EU fiscal rules. Technical details for hands-on experts, such as numerical examples and reporting tables, are provided on the Commission's website. Selected relevant economic concepts are recapped in boxes. The purpose of these changes is to make the document accessible, not only for experts and organisations working on public finance issues in Member States but also for non-specialists.

With respect to the 2018 issue, there have been limited substantive changes related to surveillance practices. Specifically, the minimum benchmark methodology was modified. In addition, fiscal semi-elasticities, annual minimum benchmark figures and the minimum medium-term budgetary objectives were updated.

The Vade Mecum describes the working of the SGP step-by-step at the time of writing (with February 2019 as a cut-off date). It should not be considered as definitive: it presents current practices in the implementation of the SGP, which might evolve as the need arises. The Vade Mecum will continue to be updated annually to reflect, in a timely manner, any significant changes to the rules and/or surveillance practices.

This Vade Mecum covers the preventive and the corrective arms of the Pact, in Parts I and II respectively. Part III presents the institutional processes –both European and national– relevant for EU budgetary surveillance.

Part I focuses on the preventive arm of the Pact and contains four Sections. Section 1.1 provides the background. Section 1.2 elaborates on the role and assessment of medium-term budgetary objectives. Section 1.3 sets out how the assessment of compliance with the preventive arm is undertaken and Section 1.4 describes the conditions and procedures linked to the observation of a significant deviation from the requirements of the preventive arm and the introduction of sanctions for euro-area Member States.

Part II presents the corrective arm of the Pact and is structured on the basis of the successive steps under the Excessive Deficit Procedure. Section 2.1 provides the background. Section 2.2 explains how an

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<sup>(1)</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0600&from=EN>

<sup>(2)</sup> The history of the SGP and the past monitoring framework is reported in the previous editions of Vade Mecum on the Stability and Growth Pact, e.g. in 2018 edition: [https://ec.europa.eu/info/publications/economy-finance/vade-mecum-stability-and-growth-pact-2018-edition\\_en](https://ec.europa.eu/info/publications/economy-finance/vade-mecum-stability-and-growth-pact-2018-edition_en)

Excessive Deficit Procedure is launched. Section 2.3 focuses on the assessment of the actions to be taken in response to a Council recommendation to put an end to an excessive deficit. Section 2.4 explains the steps to be taken following non-effective action in response to a Council recommendation or a decision to give notice. Section 2.5 explains how an Excessive Deficit Procedure is abrogated.

Part III, on institutional processes, is divided into two Sections. Section 3.1 considers the institutional dimension of the Union side of budgetary surveillance, placing the Stability and Convergence Programmes and the Draft Budgetary Plans in the context of not just budgetary but also wider economic surveillance. Section 3.1 also discusses the submission and reporting requirements related to both the Stability and Convergence Programmes and the Draft Budgetary Plans. Section 3.2 discusses Member States' obligations in terms of their own budgetary processes, stemming from the Six-Pack, the Two-Pack, and the Fiscal Compact established by the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.

# 1. THE PREVENTIVE ARM OF THE STABILITY AND GROWTH PACT

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

## 1.1. LEGAL BASIS AND RATIONALE OF THE PREVENTIVE ARM

### 1.1.1. Legal basis of the preventive arm

Article 121 of the Treaty on the Functioning of the European Union (TFEU) is the primary legal basis of the preventive arm of the SGP (see Box 1.1). It establishes a multilateral surveillance procedure based on the Broad Economic Policy Guidelines, <sup>(3)</sup> which set out the overall context in which Member States' policies are assessed. Economic policies that are assessed as inconsistent with those guidelines, or which risk jeopardising the proper functioning of Economic and Monetary Union, can lead to procedural steps set out under Article 121(4) TFEU (among others the Significant Deviation Procedure).

#### BOX 1.1: ARTICLE 121 TFEU

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

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

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

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

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

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

4. Where it is established, under the procedure referred to in paragraph 3, that the economic policies of a Member

<sup>(3)</sup> Those guidelines take the form of policy priorities endorsed by the spring European Council in its conclusions.

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

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

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

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

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

The implementation of the preventive arm of the Pact is governed by secondary legislation in the form of Council Regulation (EC) 1466/97, of 7 July 1997, *on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies*, as amended by Council Regulation (EC) 1055/2005, of 27 June 2005, and Regulation (EU) 1175/2011 of the European Parliament and of the Council of 16 November 2011. <sup>(4)</sup> <sup>(5)</sup>

It is further specified in the Opinion of the Economic and Financial Committee of the Council (EFC) on *Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence programmes* endorsed by the Council on 16 June 2017 (Code of Conduct on the SGP). <sup>(6)</sup> In addition, Regulation (EU) 1173/2011 of the European Parliament and of the Council, of 16 November 2011, *on the effective enforcement of budgetary surveillance in the euro area* added a system of sanctions for enhancing the enforcement of the preventive arm on the basis of Article 136 TFEU (see Box 1.2) for euro-area Member States only.

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<sup>(4)</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1466:20111213:EN:PDF>

<sup>(5)</sup> European Council Resolution on *the SGP* of 17 June 1997 ([http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997Y0802\(01\):EN:HTML](http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997Y0802(01):EN:HTML)) and the Report of the ECOFIN Council on *Improving the implementation of the SGP*, endorsed by the European Council of 22 March 2005 ([http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/coc/2005-03-23\\_council\\_presidency\\_conclusions\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2005-03-23_council_presidency_conclusions_en.pdf)), also form part of the preventive arm of the Pact, but do not contain additional operational requirements.

<sup>(6)</sup> <http://data.consilium.europa.eu/doc/document/ST-9344-2017-INIT/en/pdf>.  
The Code of Conduct on the SGP includes the Commonly agreed position on Flexibility in the Stability and Growth Pact, of 12 February 2016, Opinion of the Economic and Financial Committee on “*Improving the predictability and transparency of the SGP: A stronger focus on the expenditure benchmark in the preventive arm*”, of 6 December 2016, and Opinion of the Economic and Financial Committee on “*Improving the assessment of effective action in the context of the excessive deficit procedure – A specification of the methodology*”, of 6 December 2016.

**Box 1.2: ARTICLE 136 TFEU**

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

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

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

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

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

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

Moreover, Regulation (EU) 473/2013, of 21 May 2013, *on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit for the Member States of the euro area* complements the surveillance for euro-area Member States and increases the reporting and monitoring requirements under the Excessive Deficit Procedure (EDP).<sup>(7)</sup> It is further specified in the Opinion of the EFC on *Specifications on the implementation of the Two Pack and guidelines on the format and content of draft budgetary plans, economic partnership programmes and debt issuance reports* endorsed by the Council on 8 November 2016 (Code of Conduct on the Two-Pack), which in particular includes the harmonised framework for the content of the draft budgetary plans.<sup>(8)</sup> Regulation (EU) 473/2013 also gives independent fiscal institutions a key role in preparing and monitoring macroeconomic forecasts and budgetary decisions and in supervising the operation of national fiscal rules.

Finally, Regulation (EU) 472/2013, of 21 May 2013, *on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability*<sup>(9)</sup> in particular suspends, for Member States under a macroeconomic adjustment programme, the reporting requirements under the SGP and integrates the budgetary targets of the programme into the applicable recommendations and decisions under the SGP.

Section 3.2 discusses obligations on Member States in terms of their own budgetary processes, stemming from the Six-Pack, the Two-Pack and the Fiscal Compact established by the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG).

<sup>(7)</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0011:0023:EN:PDF>

<sup>(8)</sup> [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/coc/2014-11-07\\_two\\_pack\\_coc\\_amended\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf)

<sup>(9)</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0001:0010:EN:PDF>

### 1.1.2. Rationale behind the preventive arm

The fundamental idea behind Article 121 TFEU is that in an increasingly integrated EU, and particularly in the euro area, the interdependence between Member States means that their interests are best served through the co-ordination of their economic policies.

The preventive arm of the SGP endeavours to ensure that fiscal policy is conducted in a way that leads to healthy public finances over the short, medium and longer terms. It requires that Member States attain a country-specific MTO for their budgetary position. This is set in structural terms, i.e. cyclically adjusted and net of one-off and other temporary measures (see Box 1.3). For Member States that are not at their MTO, an appropriate adjustment path towards it should be defined and adhered to. By setting a budgetary target in structural terms, the preventive arm of the Pact aims to ensure that the underlying fiscal position of Member States is conducive to medium-term sustainability, while allowing for the free operation of automatic stabilisers. Section 1.2 presents a detailed overview of the MTO.

Compliance with the requirements of the preventive arm is assessed using a two-pillar approach. The assessment of the structural balance, which constitutes one pillar, is complemented by an analysis of the growth rate of an expenditure aggregate net of discretionary revenue measures (i.e. an assessment of compliance with the expenditure benchmark), which constitutes the other pillar (see Section 1.3.6). Compliance with the preventive arm is assessed through an overall assessment which takes both those elements into account.

The expenditure aggregate is comprised of overall government expenditure net of interest payments, spending on EU programmes paid for by EU funds, and cyclical elements of unemployment benefits. Nationally-financed government investment is smoothed over four years. The underlying rationale is to focus on government spending that: (i) is independent of cyclical conditions (by netting out the cyclical elements of unemployment spending); (ii) is within the government's control (by netting out interest expenditure); and (iii) has to be paid for out of tax revenues (by netting out spending on programmes directly funded by the EU); all the while (iv) without penalising peaks in investment (by averaging investment over a number of years). In addition, when assessing compliance with the expenditure benchmark, the impact of one-off measures is systematically corrected for as part of the overall assessment.

Member States at their MTO must ensure that government expenditure grows at most in line with a medium-term rate of potential GDP growth – which is the rate that ensures adherence to the MTO over time – unless any excess growth is matched by discretionary revenue measures that yield additional revenues. Member States on the adjustment path to the MTO must ensure that their expenditure grows at a rate set below that medium-term rate of potential GDP growth unless the excess growth is matched by discretionary revenue measures that yield additional revenues. This does not limit or in any way determine the size of government spending. All that is required is that any excess expenditure growth over the benchmark rate is funded by equivalent discretionary revenue-increasing measures.

Over the economic cycle, Member States that are at their MTOs and whose net government expenditure grows in line with potential GDP will remain at their MTO. Member States on the adjustment path will keep their net expenditure growing at a rate below potential GDP and maintain the required adjustment pace towards the MTO. This rate is set according to a methodology agreed with the Member States and defined in the Code of Conduct on the SGP, such that the difference (i.e. the convergence margin) brings a correction that is equivalent to that required by the appropriate adjustment path to the MTO. Graph 1.1 summarises the average dynamics over the cycle in terms of compliance with the MTO.

Graph 1.1: The expenditure benchmark as an instrument to reach or stay at the MTO

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

## 1.2. THE MEDIUM-TERM BUDGETARY OBJECTIVE: CONCEPT AND ROLE

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

### 1.2.1. Defining the Medium-Term Budgetary Objective

The MTOs are defined in structural terms, meaning that they represent the cyclically-adjusted general government budget position, net of one-off and other temporary measures (see Box 1.3 on the calculation of the structural balance).

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

- (i) *provide a safety margin with respect to the 3% of GDP deficit limit.* For each Member State, that safety margin is estimated in the form of a minimum benchmark which takes past output volatility and budgetary sensitivity to output fluctuations into account.
- (ii) *ensure sustainability or rapid progress towards sustainability.* That criterion is assessed against the need to ensure the convergence of debt ratios towards prudent levels, with due consideration to the economic and budgetary impact of ageing populations.
- (iii) *in compliance with (i) and (ii), allow room for budgetary manoeuvre, in particular taking into account the needs for public investment.*

The Regulation further specifies that euro-area and ERM2 Member States must have an MTO that corresponds to at least -1% of GDP. Contracting Parties of the TSCG have further committed themselves to MTOs of at least -0.5% of GDP, <sup>(10)</sup> unless their debt ratio is significantly below 60% of GDP and the risks in terms of the long-term sustainability of their public finances are low. In those cases, the lower limit for the balance remains at -1% of GDP.

<sup>(10)</sup> This applies also to those non-euro-area Contracting Parties that have declared themselves bound by the provisions of the Fiscal Compact (Denmark, Bulgaria and Romania).

### BOX 1.3: CALCULATING THE STRUCTURAL BALANCE

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

In algebraic terms  $CAB = (BAL/Y) - \varepsilon * OG$  where BAL stands for general government balance, Y for GDP, and the cyclical component,  $\varepsilon * OG$ , for the product of the semi-elasticity of the budget balance to the cycle,  $\varepsilon$ , and the output gap, OG. The output gap, which measures the cyclical position of an economy, is defined as the difference between actual and potential output. The latter is estimated by the Commission using a production function method, endorsed by the ECOFIN Council on 12 July 2002, which allows the identification of the different components of potential output. <sup>(11)</sup> All methodological improvements are agreed by the Member States and discussed in a dedicated forum, the Output Gap Working Group, within the EU's Economic Policy Committee. <sup>(12)</sup>

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

The budgetary semi-elasticity is equal to the difference between the semi-elasticity of revenue and the semi-elasticity of expenditure. On the revenue side, the elasticities of individual revenue items are estimated by the OECD (personal income taxes, corporate income taxes, indirect taxes, social security contributions, non-tax revenue). They correspond to the percentage change in a particular type of revenue associated with a percentage change in output. They are then aggregated using the share of each in total revenue as weights, so as to derive the elasticity of the level of total revenues (in monetary terms) with respect to output. Subtracting one from the value of the revenue elasticity gives the value of the elasticity of the revenue-to-GDP ratio with respect to the output gap. Multiplying the latter with the size of total revenue as a share of GDP yields the value of the semi-elasticity of revenue. On the expenditure side, the OECD elasticity of unemployment-related expenditures is used and weighted with the share of unemployment-related expenditure in total expenditure (based on Eurostat data). Subtracting one from that value and then multiplying it by the size of total public spending as a share of GDP gives the semi-elasticity of expenditure.

The individual elasticities underlying the semi-elasticities are revised every nine years using the individual elasticities updated by the OECD in the context of the Output Gap Working Group. <sup>(13)</sup> The weights (tax and spending structure, revenue/expenditure-to-GDP ratio) are updated every six years to reflect changes in the government receipts and spending. The Commission updated in 2018 the value of the budgetary semi-elasticities to be used in fiscal surveillance as of spring 2019. Part II, Chapter 2 of the 2018 Report on Public Finances in EMU shows the semi-elasticities and weights currently in use.

The average budgetary semi-elasticity used for the EU is 0.5 and ranges from 0.30 to 0.63 across Member States, suggesting significant differences in the cyclical position of the budget balance. The semi-elasticity for revenue is close to zero, since revenue is almost as cyclical as GDP, except for non-tax revenue. Therefore, the revenue-to-GDP

<sup>(11)</sup> For more details, see K. Havik, K. McMorrow, F. Orlandi, C. Planas, R. Raciborski, W. Röger, A. Rossi, A. Thum-Thysen and V. Vandermeulen, "The production function methodology for calculating potential growth rates and output gaps", *European Economy, Economic Papers* No. 535, November 2014.

<sup>(12)</sup> Since the autumn 2016 fiscal surveillance exercise, the standard production function methodology is complemented with the use of a "constrained judgement" approach including a "plausibility tool" developed in the Output Gap Working Group to identify countries where there were strong concerns that the commonly agreed methodology could produce output gaps subject to a large degree of uncertainty. See Box 1.4.

<sup>(13)</sup> For more details, see G. Mourre, C. Astarita and S. Princen, "Adjusting the budget balance for the business cycle: the EU methodology", *European Economy, Economic Papers*, November 2014, and Price, R. W., Dang T. and Guillemette Y., "New tax and expenditure elasticity estimates for EU budget surveillance", *OECD Economics Department Working Paper* No. 1174, 2014.



ratio moves only slowly with the business cycle, especially in Member States where non-tax revenue is relatively low. In contrast, the semi-elasticity for expenditure ranges from -0.38 to -0.64, which accounts for the larger part of the disparity in the budgetary semi-elasticity across Member States. Its value broadly corresponds to the share of total expenditures in GDP. That broad correspondence mirrors the fact that the elasticity of the expenditure-to-GDP ratio to the output gap is close to minus one. Indeed, the cyclical effect of the denominator (GDP) largely dominates the low cyclical effect of expenditure in level, given the small share of unemployment-related expenditure in total expenditure.

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

The ability to correctly identify one-off measures is crucial for carrying out fiscal surveillance. The Commission has developed a set of guiding principles for classifying transactions as one-offs in order to make the criteria used in fiscal surveillance more transparent. Those guiding principles are summarised below and are extensively explained in Chapter II.3 of the 2015 Report on Public Finances in EMU, <sup>(14)</sup> which also provides examples of frequently occurring one-offs and discusses a number of measures that have “borderline” characteristics, but which ultimately have not been considered to be one-off measures.

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

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

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

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

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

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<sup>(14)</sup> [http://ec.europa.eu/economy\\_finance/publications/ceip/pdf/ip014\\_en.pdf](http://ec.europa.eu/economy_finance/publications/ceip/pdf/ip014_en.pdf)

### 1.2.2. Calculating the appropriate Medium-Term Objective

The MTOs presented by the Member States in their Stability and Convergence Programmes (SCPs) must comply with the requirements set out in Section 1.2.1. The Commission assesses compliance with those requirements according to the methodology set out in the Code of Conduct on the SGP.

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

(a) **The safety margin with respect to the 3% of GDP deficit limit:** For each Member State, the minimum value of the MTO that ensures that safety margin is assessed by taking into account past output volatility and the budgetary sensitivity to output fluctuations (i.e. the budgetary semi-elasticities as discussed in Box 1.3). The resulting value gives the minimum benchmark (MTO<sup>MB</sup>). A Member State with a high degree of past output volatility and an above-average budgetary sensitivity will need a more demanding MTO in order to ensure that the 3% of GDP limit is not breached during a normal economic cycle. By allowing sufficient margin with respect to the 3% of GDP limit, the operation of automatic stabilisers is ensured. Box 1.4 considers the calculation of the minimum benchmark in more detail and Annex 2 shows the most recent update of the minimum benchmarks based on the Commission 2018 autumn forecast.

#### BOX 1.4: ANNUAL UPDATE OF THE MINIMUM BENCHMARKS

The minimum benchmark (MB) is the operationalisation of the concept of “safety margin” mentioned in Council Regulation (EC) 1466/97 (the preventive arm of the Stability and Growth Pact). It indicates the budgetary position in structural terms that provides a safety margin against breaching the 3% of GDP deficit criterion in normal economic cyclical fluctuations.

In recent years, the MB has become more stringent and volatile for most Member States. This is due to the gradual incorporation of the significant negative output gaps recorded during the economic crisis in the 25-year rolling time window used in the current methodology. Furthermore, there is no correlation between the MB results and the country-specific volatility of the economic cycle mainly because output gap outliers are trimmed at EU level. To address the flaws of the current methodology, the Commission presented several alternative options that were discussed with Member States. The new methodology represents a compromise solution that was agreed at the EFC of 1st February 2019.

From 2020, the country-specific MB<sub>*i*</sub> will be set as follows:

$$MB_i = -3 + 1.2 \frac{[\text{stdev}_i(\varepsilon_i * OG_i) + \text{stdev}_{EU}(\varepsilon * OG)]}{2}$$

$$\text{subject to } -0.7 \geq MB_i \geq -1.5$$

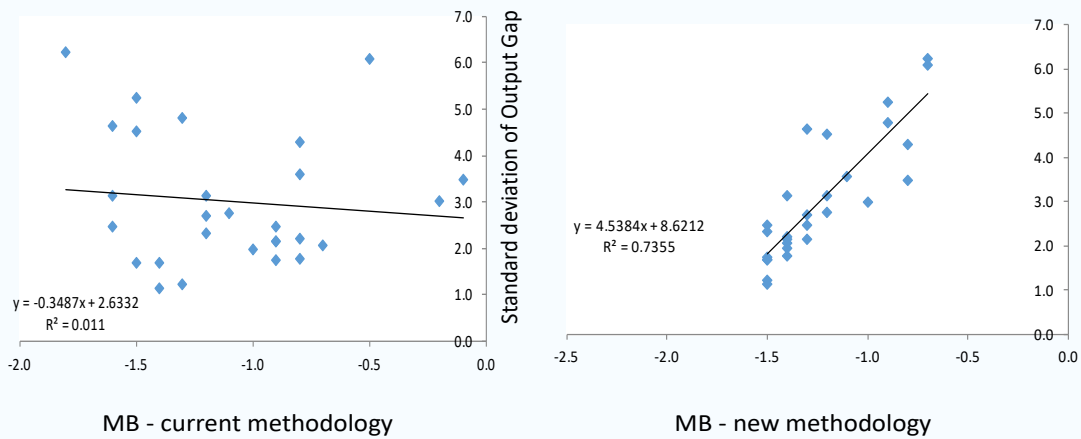
This implies that the safety margin with respect to the 3% of GDP deficit criterion will be computed as the simple average between the country-specific standard deviation of the cyclical component of the budget balance,  $\text{stdev}_i(\varepsilon_i * OG_i)$ , and the one based on all Member States' available historical observations since 1985,  $\text{stdev}_{EU}(\varepsilon * OG)$ , multiplied by a coefficient of 1.2. The new methodology also includes a MB floor of -1.5% of GDP and a MB ceiling

of -0.7%, which are included to avoid excessively lenient or stringent MBs.

As Table 1 illustrates, the MB average for the 28 Member States computed with the new methodology for 2020 is -1.2% of GDP, i.e. in line with the EU average under the current methodology. Four Member States are impacted by the floor of -1.5 (Belgium, Germany, Malta and Austria) while two Member States are affected by the ceiling of -0.7 (Estonia and Greece).

The new methodology is more stable, less sensitive to outliers and ensures a positive correlation between the minimum benchmark and the country-specific volatility of the economic cycle (see Chart 1).

**Chart 1: correlation between the volatility of the output gap and the MBs**



Given the importance of the minimum benchmarks for the assessment of eligibility for use of the flexibility clauses in the preventive arm of the SGP, they will continue to be updated on a yearly basis for the time being. However, as the new methodology to compute the minimum benchmark will provide much more stable results than the current one the Committee may consider in the future an update of the minimum benchmark every three years, together with the minimum MTO.

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

$$MTO^{ILD} = \underbrace{Balance_{debt\ stabilising\ (60\%\ of\ GDP)}}_{(i)} + a * \underbrace{Ageing\ Cost}_{(ii)} + \underbrace{Effort_{debt-reduction}}_{(iii)}$$

Component (i) represents the budgetary balance that would stabilise the debt ratio at 60% of GDP. It corresponds to the product of 60% and the forecast average nominal growth until 2060 (for MTOs over

the period 2017-2019) and until 2070 (for MTOs over the period 2020-2022), as calculated by the Ageing Working Group in its 2015 and 2018 reports, respectively. <sup>(15)</sup>

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

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

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

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

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

As the MTO is designed to ensure sustainability adherence to the MTO, or the adjustment path towards it, is also considered a relevant factor in assessing compliance with the debt criterion, see Section 2.2.2.2.

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

The three bounds on the MTO are then combined to yield the country-specific greatest lower bound for the MTO, which corresponds to the lowest MTO that fulfils all the criteria defined above. It is known as the minimum MTO: <sup>(16)</sup>

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

The values of the minimum MTOs that will be applicable for the period 2020 to 2022 are presented in Annex 2. It is important to note that these values represent a lower bound for the MTOs that are to be nominated by Member States in their SCPs. With a view to promoting ownership of the MTOs, it is up to each Member State to choose an MTO that reflects its individual needs. For a small number of Member States, there is a risk that the minimum MTO does not fulfil the forward-looking debt-reduction benchmark by the end of the next MTO three year cycle, i.e. by 2022. These Member States may wish to consider a more demanding MTO.

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<sup>(15)</sup> The calculation is based on the real GDP forecast and an average inflation rate of 2%. Data sources are the latest available  $t+10$  forecast and the Ageing Working Group estimates beyond  $t+10$ . The Ageing Working Group in cooperation with the Directorate-General for Economic and Financial Affairs of the European Commission revises their projections of GDP growth every three years. For the most recent projections see 2018 Ageing Report: Underlying Assumptions and Projection Methodologies, [https://ec.europa.eu/info/sites/info/files/economy-finance/ip065\\_en.pdf](https://ec.europa.eu/info/sites/info/files/economy-finance/ip065_en.pdf)

<sup>(16)</sup> If the MTO yielded by those formulae corresponds to an unrealistically tight primary balance, a Member State can ask to benefit from an exception clause. Indeed, as there is no precedent of a country maintaining a primary surplus significantly above 5.5% of GDP for a sustained period of time, Member States would not be required to comply with a minimum value for their MTO implying a primary surplus significantly over that limit in the period to which the specific MTO applies. Instead, an exception can be made, which allows the Member State concerned to present a MTO corresponding to a primary surplus of 5.5% of GDP, as long as the -1% of GDP lower bound for euro-area and ERM2 Member States is adhered to.

### 1.2.3. Revising the Medium-Term Budgetary Objective

Regulation (EC) 1466/97 requires that the minimum MTOs are revised every three years. This follows the publication of the Ageing Report, which provides up-to-date data on the ageing challenge facing the Member States. In addition to the three-yearly revisions of the minimum MTOs, Member States that undertake structural reforms with a major impact on the sustainability of the public finances can also have their minimum MTOs revised on a case-by-case basis, in agreement with the Commission. In particular, the introduction of major pension reforms that have an impact on long-term fiscal sustainability could result in a revision of the minimum MTO. <sup>(17)</sup> Even if the minimum benchmarks are updated yearly, the minimum MTOs remain frozen for three years.

## 1.3. ASSESSMENTS OF COMPLIANCE

The assessment of compliance under the preventive arm is based on an analysis of the data presented in both the SCPs and the Draft Budgetary Plans (DBPs) and on a risk assessment based on the Commission forecasts.

In the case of the SCPs, the Commission assesses the content of the programmes in terms of compliance of the Member State's policies with the policy priorities endorsed by the European Council and with the requirement to attain or to be on the adjustment path towards the MTO. The assessment of compliance is based on Articles 5 and 9 of Regulation (EC) 1466/97 and comprises the following:

- an *ex post assessment* of budgetary execution for the outcomes of year  $t-1$ , on the basis of outturn data validated by Eurostat;
- an *in-year assessment* of the budgetary plans for year  $t$ , on the basis of in-year estimates, complemented by a risk assessment based on the Commission forecasts;
- an *ex ante evaluation* of the budgetary plans for  $t+1$ , complemented by a risk assessment based on the Commission forecasts, and
- a *qualitative assessment* covering years  $t+2$  and  $t+3$ , which go beyond the horizon of available Commission forecasts at the time of the submission of the SCP.

In the case of the DBPs, the assessment of compliance is based on Article 7 of Regulation (EU) 473/2013 and comprises the following:

- an *in-year assessment* of the budgetary plans for year  $t$ , on the basis of in-year estimates, complemented by a risk assessment based on the Commission forecasts; and
- an *ex ante evaluation* of the budgetary plans for  $t+1$ , complemented by a risk assessment based on the Commission forecasts.

The analysis of budgetary policy in the SCPs and DBPs aim to deliver, for each Member State, an overall assessment of compliance with the requirements of the preventive arm, in terms of being at the MTO or on the adjustment path towards it.

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<sup>(17)</sup> In the case of major pension reforms, updated long-term budgetary projections must be peer reviewed and endorsed by the Economic Policy Committee (Ageing Working Group) before updating the Ageing Report figures for MTO calculations.

The assessment of compliance contains three key elements:

- Is the MTO set at an appropriate level? That question is discussed in Section 1.3.1 and relevant only for SCPs.
- Is the Member State at the MTO or on the adjustment path towards the MTO, by considering the position of the structural balance? That question is discussed in Sections 1.3.2 to 1.3.5.
- Are expenditure outcomes/plans in line with the expenditure benchmark? That question is discussed in Section 1.3.6.

Section 1.3.7 describes how those three elements should be put together, to arrive at an overall assessment of compliance with the preventive arm of the SGP.

At the outset, it is important to realise that the assessment is done in two stages: (i) by taking the SCP/DBP targets, after recalculating the structural balance based on the commonly agreed methodology<sup>(18)</sup>; and (ii) taking into account the risks associated with the SCP/DBP scenario, as embodied in the most recent Commission forecasts. It is the latter that is then used to set each Member State's requirements in terms of structural adjustment under the preventive arm.

If the ex post analysis concludes that a significant deviation from the adjustment path to the MTO (or the MTO itself) has occurred, a Significant Deviation Procedure will be launched. Section 1.4 provides more details.

**BOX 1.5: THE "NO-POLICY-CHANGE" ASSUMPTION USED IN THE COMMISSION FORECASTS**

The European Commission presents its fully fledged European Economic Forecasts twice a year (spring and autumn). Those forecasts are produced independently by Commission staff under the assumption of "no policy change". A forecast under the no-policy-change (NPC) assumption extrapolates past revenue and expenditure trends and relationships in a way that is consistent with past policy orientations, and includes all fiscal policy measures as defined here. A fiscal policy measure is defined as an intervention by the government to change past policy orientations that is specified in sufficient detail, as well as adopted or at least credibly announced, and has a direct incremental budgetary impact compared to the baseline. An NPC forecast may also include the adoption of a limited number of working assumptions, to deal in particular with possible structural breaks or specific multi-year patterns observed in the past that are deemed likely to recur.

The Commission outlined a set of ten methodological principles to clarify what is, and what is not, compatible with the NPC assumption as implemented by the Commission. Those principles aim to make the general definition of an NPC forecast mentioned above operational and to help decide how to treat specific cases or transactions in an NPC forecast setting. These were published in Part II, Chapter 1.2 of the 2016 Report on Public Finances in EMU<sup>(19)</sup> which also includes examples and a discussion on cases which may require some interpretation.

The need for interpretation arises in all stages of the forecasting process, such as the choice of extrapolation method or the proxy chosen for the underlying tax base, the working assumptions to deal with e.g. structural breaks, the decision on whether the available information about a government action can be regarded as sufficient to treat it as a "fiscal policy measure" in the forecast, the judgement about the assumptions underlying the official quantification of a measure, etc. The definition of the NPC assumption also implies that the Commission's fiscal

<sup>(18)</sup> It is implemented by the Commission services through the CONV simplified routine to recalculate the potential GDP/output gap submitted by the Member States in their plans. For more details, see "The production function methodology for calculating potential growth rates and output gaps", *European Economy, Economic Papers* No. 535, November 2014.

<sup>(19)</sup> [http://ec.europa.eu/economy\\_finance/publications/eip/pdf/ip045\\_en.pdf](http://ec.europa.eu/economy_finance/publications/eip/pdf/ip045_en.pdf)

forecasts are not the same as the “most likely” forecasts. Indeed, the objective of the Commission’s NPC forecasts is to show the size of the policy action that is still necessary to be specified and credibly announced in order to reach the budgetary targets. The NPC forecasts do not say anything about the likelihood of actually reaching those targets.

### 1.3.1. Is the MTO set at an appropriate level?

Member States are setting out their MTOs in their SCPs. MTOs should be at least as demanding as the minimum MTOs (Section 1.2.1). The Commission assesses whether the MTO is in line with the minimum MTOs emerging from the formula (Section 1.2.2). In accordance with Article 121(3) TFEU and Articles 5(2) and 9(2) of Regulation (EC) 1466/97, if the Council considers that the MTO presented in an SCP should be strengthened, it will indicate in its country-specific recommendation (CSR) that the Member State is invited to adjust its programme.

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

The achievement of the MTO is assessed by verifying whether the Member State’s structural balance is planned and forecast to be at least at the level of the MTO. As a matter of convention, from an ex post perspective, the Commission considers the structural balance to be in line with the MTO, if it is within  $\frac{1}{4}$  pp of GDP of its value. <sup>(20)</sup> That convention has been applied over time, and aims to account for the inevitable uncertainty in estimating the structural balance. If the Member State is not at its MTO <sup>(21)</sup> in one of the years under consideration, it must nonetheless be on an appropriate adjustment path towards it. The adjustment delivered or set out for future years should be defined by an annual improvement in the structural balance, respecting the rules of the preventive arm of the SGP.

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

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

For all Member States with debt in excess of 60% of GDP or with pronounced risks of overall debt sustainability, <sup>(22)</sup> a faster adjustment path, i.e. above 0.5% of GDP, is expected. All Member States should undertake a greater adjustment in good economic times, while the effort may be more limited in bad economic times (see Box 1.6, for detailed modulation).

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

In addition, the Regulation also provides for a “waiver” from any adjustment in case of an “*unusual event outside the control of the Member State [...]*” (see Section 1.3.5).

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<sup>(20)</sup> A deviation from the MTO of less than  $\frac{1}{4}$ % of GDP enters in the (corrected) required adjustment in the following year.

<sup>(21)</sup> Even if the Member State plans to be at its MTO on the basis of the face value or/and recalculated structural balance, it is expected to make a structural effort if the Commission forecast shows that it is not at the MTO.

<sup>(22)</sup> In that context, risks to overall debt sustainability are measured, among other information, by the medium-term sustainability indicator S1. That indicator shows the additional adjustment required, in terms of improvement in the government structural primary balance over 5 years to reach a 60% public debt-to-GDP ratio by 2033, including financing for future additional expenditure arising from population ageing. For more information, see the 2018 Fiscal Sustainability Report: [https://ec.europa.eu/info/sites/info/files/economy-finance/ip094\\_en\\_vol\\_1.pdf](https://ec.europa.eu/info/sites/info/files/economy-finance/ip094_en_vol_1.pdf)

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

The Code of Conduct on the SGP <sup>(23)</sup> gives a detailed breakdown of the required annual adjustment – the so-called matrix of requirements (see Box 1.7) – that was originally proposed by the Commission in its Communication on *Making the best use of the flexibility within the existing rules of the Stability and Growth Pact* of 13 January 2015, <sup>(24)</sup> to take the economic cycle as well as the debt level and sustainability needs of each Member State more adequately into consideration. That interpretation is fully in line with Articles 5 and 9 of Regulation (EC) 1466/97, which allow for modulation of the efforts and for no adjustment in case of an “unusual event outside the control of the Member State [...] which has a major impact on the financial position of the general government”. In the latter case, the requirements on the adjustment path to the MTO do not apply for the relevant years and no adjustment to the structural balance is required (see also Section 1.3.5).

Predictability of the assessment is key in a context where a significant deviation from the requirements will lead to procedural consequences, which may include financial sanctions for euro-area Member States. In order to provide ex ante guidance and to ensure predictability of the assessment’s outcome and certainty on what is expected from a Member State, the required adjustment for year  $t$  is frozen in the spring of year  $t-1$ . However, where the freezing of the requirements could lead to unwarranted consequences, the conditions ex post prevail over the frozen requirements (see Box 1.7 for a detailed explanation). Member States subject to a Significant Deviation Procedure which have not yet corrected the significant deviation with respect to their MTO, or the adjustment path towards it, should have an adjustment path that reflects their Council recommendation under Article 121(4) TFEU.

**BOX 1.6:     DEFINING THE APPROPRIATE ADJUSTMENT PATH**

The required annual fiscal adjustment is varied so that Member States can adapt their fiscal efforts over the economic cycle while taking into account their fiscal consolidation needs.

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

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

<sup>(23)</sup> <http://data.consilium.europa.eu/doc/document/ST-9344-2017-INIT/en/pdf>

<sup>(24)</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0012&from=en>



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

\* Regulation (EC) 1466/97 does not specify an appropriate annual adjustment for Member States outside the euro area and ERM2 with debt below 60% of GDP and at most moderate risks of debt sustainability. While those Member States should pursue greater improvements in good times and more limited in bad times, the Regulation does not quantify the adjustment.

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

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

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

The resulting adjustment requirement for year  $t$ , in terms of the change in the structural balance, is set out in spring  $t-1$ . It will then be used as the benchmark for assessing the appropriateness of the change in the structural balance for year  $t$  in the in-year assessment that occurs during year  $t$ , and in the ex post assessment that occurs in year  $t+1$ . In order to avoid unwarranted consequences arising from fluctuations in the output gap and the structural balance beyond the control of the governments, if the output gap turns out to be larger than -3% of potential GDP (i.e. the Member State is found to be in very bad times or exceptionally bad times) or if the Member States' initial position is closer to the MTO (such that the requirement would result in an overachievement of the MTO), the initial requirements are 'unfrozen'. Such "unfreezing" may take place on two occasions: in autumn  $t-1$ , which in principle allows the change to be taken into account in the Member State's budget for year  $t$  before it is finally adopted, and in spring  $t+1$ , at the time of the ex post assessment of compliance with the preventive arm.

### BOX 1.7: IMPLEMENTATION OF CONSTRAINED JUDGEMENT

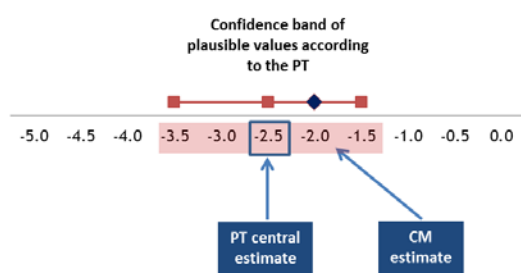
The constrained judgement approach allows the Commission –under limited and specific circumstances– to depart from the output gap estimates of the commonly agreed methodology in its assessment of the cyclical position of the Member State concerned. <sup>(25)</sup> In other words, the Commission can apply a constrained degree of judgement within its fiscal surveillance framework. Constrained judgement is implemented in two steps.

In the first step, “the plausibility tool” is applied to signal cases when the outcome of the commonly agreed methodology could be interpreted as being subject to a large degree of uncertainty and, therefore, deserving of further investigation on the part of the Commission. In particular, further investigation is needed when the output gap estimates calculated using the common methodology fall outside a given statistical confidence interval, which has been agreed within the Output Gap Working Group. <sup>(26)</sup> The results of the plausibility tool are used asymmetrically. This implies that only cases where the tool indicates that the common methodology’s estimate of the output gap may be either excessively positive or insufficiently negative are considered as part of the constrained judgement process.

Graph 1 provides a simplified illustrative situation where the estimate of the output gap based upon the common method is not flagged. Let us assume that the interval of reasonable output gap values built around the plausibility tool’s central estimate is between -3.5% and -1.5% for a given year. At the same time, let us assume that the common methodology estimate for that same year is -2.0%. Given that -2.0% falls inside the interval of [-3.5, -1.5], there is no reason to flag the common methodology estimate as potentially problematic and so activate the constrained judgment process.

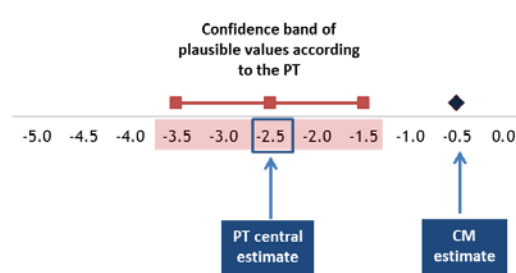
Constrained judgement is applied in a situation where the common methodology estimate falls outside the interval of reasonable values defined by the “plausibility tool”. In contrast to the example provided in Graph 1, such a situation is depicted in Graph 2. In that latter case the fictional common methodology estimate (-0.5%) is not reasonably near to the plausible estimate.

Graph 1: The common methodology estimate falls inside the range of plausible values defined by the plausibility tool



Note: PT = plausibility tool, CM = common methodology.  
Source: Commission services.

Graph 2: The common methodology estimate falls outside the range of plausible values defined by the plausibility tool



Note: PT = plausibility tool, CM = common methodology.  
Source: Commission services.

<sup>(25)</sup> In 2018 the EFC extended the application of the constrained judgement approach for one year following the expiry of a trial period of two years.

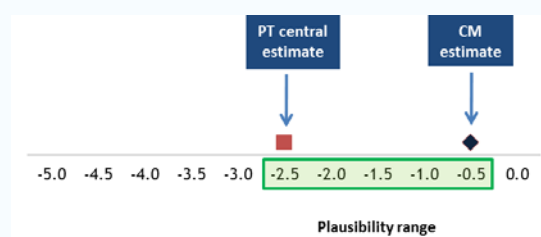
<sup>(26)</sup> The statistical confidence interval is based on two different threshold criteria, depending on the targeted degree of certainty. Those threshold criteria correspond respectively to RMSE68 and RMSE90, the latter being stricter than the former. For more details, please see Box II.3.1 in the 2017 Report on Public Finances in EMU.  
[https://ec.europa.eu/info/sites/info/files/economy-finance/ip069\\_en.pdf](https://ec.europa.eu/info/sites/info/files/economy-finance/ip069_en.pdf)

The second step involves the application of constrained judgement. Once the common methodology estimate of the output gap has been flagged by the plausibility tool, the Commission has discretion for identifying the plausible level of the output gap. The latter has to be within “the plausibility range” defined, on the one hand, by the common methodology estimate and, on the other hand, the plausibility tool’s central estimate – i.e. [-2.5, -0.5] in the example depicted in Graph 3.

The tool, however, does not specify where precisely within the plausibility range the most accurate estimation of the output gap lies. It is neither possible nor desirable to specify ex ante criteria that mechanically determine an exact position within that range. In fact, the constrained judgement approach is intended to allow the Commission to depart from the commonly agreed methodology estimate, but not to routinely substitute it with an alternative estimate. Essentially, based on sound economic judgement, the Commission could consider a value of the output gap other than that estimated by the commonly agreed methodology, provided that it remains within that range. See 2017 Report on Public Finances in EMU, Part II, Chapter 3 for more information on how the qualitative assessment is done by the Commission.

Depending on the level of the output gap that is found to be more plausible within the plausibility range, there may be implications for the fiscal assessment if an alternative fiscal adjustment requirement is implied. The level change in the output gap implied by the Commission’s analysis may also have an impact on some Member States’ eligibility for use of the structural reform and investment clauses. The output gap change may bring them into compliance with i) the safety margin criterion (i.e. the minimum benchmark) used for assessing eligibility for both clauses or ii) the -1.5% output gap eligibility threshold for use of the investment clause.

Graph 3: Plausibility range for the scenario of Graph 2



Note: PT = plausibility tool, CM = common methodology.  
Source: Commission services.

The plausibility tool entails two main limitations for constrained judgement:

First, constrained judgement on future years can only be based on the extrapolation of the plausibility range. The reason for that limitation is that a plausibility analysis can be performed only on the current or last observed year, i.e. on the basis of outturn data or, at least, on the basis of released data for the first three quarters of the year (i.e. at the time of the autumn forecast), and cannot be produced for future years. In that way the probability of significant revisions is considerably reduced. See 2017 Report on Public Finances in EMU, Part II, Chapter 3 for details on the approach the Commission uses for extrapolating the plausibility range for  $t+1$  and  $t+2$ . As the approach is crude, it underlines the fragility of the exercise. Therefore, departing from the commonly agreed methodology estimate should be done with caution, based on sound evidence.

Second, constrained judgement does not –by any means– affect the calculation of the change in the output gap used by the Commission for the calculation of the fiscal effort. Indeed, the plausibility tool underlying the constrained judgement approach only provides information on the uncertainty surrounding the level of the output gap in a particular year. In other words, it cannot produce a consistent time series. Therefore, the measurement of the fiscal effort used in the surveillance process is unaffected by the constrained judgement approach and continues to be calculated on the basis of the estimates delivered by the commonly agreed methodology.

### 1.3.3. Taking into account the implementation of structural reforms

The SGP provides the necessary flexibility within the rules to support structural reforms without compromising fiscal responsibility. Regulation (EC) 1466/97 allows Member States that implement major structural reforms to deviate temporarily from the MTO or the adjustment path towards it, if those reforms have a positive budgetary impact in the long term, including higher potential growth. The deviation is allowed so long as the Member State: (i) remains in the preventive arm, (ii) preserves an appropriate safety margin with respect to the 3% of GDP deficit reference value <sup>(27)</sup> and (iii) its budgetary position is expected to return to the MTO within the programme horizon (i.e. by the year  $t+4$  at the latest, with  $t$  being the year of submission of the SCP). The Code of Conduct on the SGP <sup>(28)</sup> provides additional guidance on the use of the flexibility embedded in the existing fiscal rules to strengthen the link between structural reforms and fiscal responsibility.

The so-called “structural reform clause” (see Box 1.9) allows for a temporary deviation from the MTO or the adjustment path towards it under well-defined conditions. More specifically, structural reforms must (i) have a verifiable positive impact on the long-term sustainability of public finances, (ii) be major and (iii) be fully implemented.

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

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

According to the Code of Conduct on the SGP, the effects of the reforms over time “are to be assessed by the Commission and the Council in a prudent way, making due allowance of the margin of uncertainties associated to such an exercise”. <sup>(29)</sup>

In operational terms, that assessment by the Commission should build on the input provided by the Member State concerned regarding both the costs and savings that are direct consequences of the reform, and the indirect budgetary impact linked to potential output effects. Annex 1 to the Code of Conduct on the SGP – which details the structure of the SCPs – establishes that the growth and budgetary implications of “major” structural reforms should be detailed by Member States when submitting their economic and budgetary projections. Based on the information provided <sup>(30)</sup> by the Member State, the

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<sup>(27)</sup> The Code of Conduct on the SGP sets out that that safety margin should take account of past output volatility and budgetary sensitivity to output fluctuations, which indicates that the structural balance should be equal or above the minimum benchmark, defined in Section 1.2.1.1.

<sup>(28)</sup> <http://data.consilium.europa.eu/doc/document/ST-9344-2017-INIT/en/pdf>

<sup>(29)</sup> <http://data.consilium.europa.eu/doc/document/ST-9344-2017-INIT/en/pdf>

<sup>(30)</sup> According to the Code of Conduct on the SGP, sufficient, detailed information is to be provided in the SCPs. Therefore Member States applying for the use of the structural reform clause are requested to include in both the SCP and the National Reform Programmes (NRPs) a table with detailed description (including the budgetary impact) of each structural reform. That table is presented on the Commission website: [https://ec.europa.eu/info/files/numerical-examples-and-technical-aspects-hands-experts-2019-edition\\_en](https://ec.europa.eu/info/files/numerical-examples-and-technical-aspects-hands-experts-2019-edition_en)

Commission will pass an informed judgement, which may include a plausibility assessment, on whether the reform meets the sustainability-enhancing condition to qualify for application of the clause. That plausibility analysis could draw upon the agreed methodology, <sup>(31)</sup> while having in mind uncertainties and risks associated with quantitative estimations of impacts of structural reforms.

The reforms must be major. While there are some individual reforms with a major positive impact on growth and the long-term sustainability of public finances, such as pension reforms (see Box 1.8), well-designed and comprehensive packages of reforms addressing structural weaknesses may also have a major positive impact. This is notably the case when the reforms are mutually reinforcing through an appropriate policy mix and sequencing of implementation.

All the reforms must be fully implemented before being considered as eligible for the clause. The reforms must be adopted by the national authorities through provisions of binding force, whether legislative or not, in accordance with the applicable domestic laws and procedures. However, the effective implementation of an adopted reform may take time and may be subject to delays and setbacks. That possibility raises the question of introducing strong safeguards against the risk of implementation failures. While the SGP does not provide the tools for monitoring the enforcement of structural reforms, the European Semester process, notably the Macroeconomic Imbalances Procedure, and the Excessive Imbalances Procedure <sup>(32)</sup> allow the Commission and the Council to assess the challenges and imbalances requiring structural reforms, and to monitor action taken by the Member States.

If the structural reform is not yet fully implemented, in order to assess ex ante whether those eligibility criteria are met, the Member State should also submit a dedicated structural reform plan – incorporated, if relevant, in the National Reform Programmes (NRPs) or Corrective Action Plan. <sup>(33)</sup> The plan must include well-specified measures and set credible timelines for their adoption and delivery. The implementation of the reforms will be closely monitored in the context of the European Semester. If the Member State is under the Excessive Imbalances Procedure and has submitted a Corrective Action Plan with the necessary information, the implementation of the reforms will be monitored through the Excessive Imbalances Procedure. In both cases, Member States will be expected to provide in-depth and transparent documentation quantifying the short-term costs –if any– of the reforms and both the medium-term budgetary and potential growth impact of the reforms, as well as providing details on the timetable of their implementation. Concurrently, Member States will provide an independent evaluation of the information provided to support their application for the reform clause, including on the estimated short and medium-term impact on the budgetary position or comprehensive and independent information to support the estimated impact.

#### **BOX 1.8: THE PENSION REFORM CLAUSE**

Sustainability-enhancing pension reforms have received specific consideration in the legislation (Articles 5(1) and 9(1) of Regulation 1466/97) and in the Code of Conduct on the SGP.

Pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar, constitute a specific case of structural reforms which also justify a temporary deviation from the MTO or the adjustment path

<sup>(31)</sup> Plausibility analysis for estimating impact of structural reforms is presented on the Commission website: [https://ec.europa.eu/info/files/numerical-examples-and-technical-aspects-hands-experts-2019-edition\\_en](https://ec.europa.eu/info/files/numerical-examples-and-technical-aspects-hands-experts-2019-edition_en)

<sup>(32)</sup> Regulation (EU) 1176/2011, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0025:0032:EN:PDF>

<sup>(33)</sup> 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 (EC) 1466/97.

towards it by the amount of the direct incremental impact of the reform on the general government balance, provided that an appropriate safety margin with respect to the 3% of GDP deficit reference value is preserved. <sup>(34)</sup> Such pension reforms have a direct deficit-increasing impact in the short term. The direct impact of a pension reform involves a transfer of pension obligations to or from the general government that is made up of two elements: i) the social contributions or other revenue collected by the pension scheme taking over the pension obligations and which is meant to cover those obligations and ii) the pension and other social benefits paid by that 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 foregone social contributions or other revenues.

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

The structural reform clause is requested *ex ante* by a Member State in their SCPs one year ahead of the application of the clause. The clause is granted in the context of the assessment of the SCPs, specifically in the relevant CSR. The Council grants the temporary deviation from the MTO, or the adjustment path towards it, following a proposal from the Commission, based on an overall assessment of the situation of the Member State concerned. When a Member State is granted a deviation under the structural reform clause, the expenditure benchmark is automatically recalibrated so that it also incorporates the allowed deviation. If a Member State invokes the clause in autumn, the structural reform clause may be granted provided it is endorsed by the Council in the autumn of the same year as an updated CSR. <sup>(35)</sup>

If a Member State fails to implement or reverses the agreed reforms, the temporary deviation from the MTO, or from the adjustment path towards it, will no longer be considered as warranted. If such failure results in an observed significant deviation (Section 1.3.7) from the MTO or the path towards it, the Commission will launch a Significant Deviation Procedure (see Section 1.4).

#### BOX 1.9: THE OPERATIONALISATION OF THE "STRUCTURAL REFORM CLAUSE" AND THE "INVESTMENT CLAUSE"

The structural reform and investment clauses allow Member States to temporarily deviate from their MTOs or the appropriate adjustment path towards them. The deviation should not lead, however, to a breach of the 3% of GDP deficit threshold and, at the time of the assessment of the application for use of the clause, <sup>(36)</sup> a safety margin in relation to that threshold should be continuously preserved. As indicated in Box 1.7, the requirements in terms of the change in the structural balance (and the expenditure benchmark) for each year are set and kept unchanged on the basis of the spring forecast of the year before. Therefore, the temporary deviation linked to structural reforms and/or investments submitted in the SCPs in year  $t$  will be allowed from year  $t+1$  onwards.

Regarding the amount of the allowed deviation linked to structural reforms <sup>(37)</sup> and/or investments, the Code of Conduct on the SGP <sup>(38)</sup> –based on Regulation (EC) 1466/97– establishes the following:

- The allowed deviation –or, in the case of the investment clause, the full allowed deviation (i.e. the initial

<sup>(34)</sup> The Code of Conduct on the SGP sets out that that safety margin should take account of past output volatility and budgetary sensitivity to output fluctuations, which indicates that the structural balance should be equal or above the minimum benchmark, defined in Section 1.2.1.1.

<sup>(35)</sup> A numerical example of the flexibility clauses in the preventive arm is presented on the Commission website: [https://ec.europa.eu/info/files/numerical-examples-and-technical-aspects-hands-experts-2019-edition\\_en](https://ec.europa.eu/info/files/numerical-examples-and-technical-aspects-hands-experts-2019-edition_en)

<sup>(36)</sup> For the sake of predictability, clauses are not retracted once granted, if compliance with the Minimum Benchmark is altered due to subsequent Minimum Benchmark revisions.

<sup>(37)</sup> Certain pension reforms are treated separately from the structural reform clause - see Box 1.8.

<sup>(38)</sup> <http://data.consilium.europa.eu/doc/document/ST-9344-2017-INIT/en/pdf>

deviation and the following incremental deviations, if any)– from the MTO, or the adjustment path towards it, will not exceed 0.5% of GDP, thereby establishing a cap to the maximum allowed deviation;

- Moreover, if a Member State is given the benefit of both clauses, the cumulative temporary deviation allowed under the two clauses will not exceed 0.75% of GDP.

The need to cap the deviation is explained by the significant uncertainty associated with estimating the costs and benefits of structural reforms in particular.

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

- The application of the structural reform clause and of the investment clause (including the following incremental deviations, if any) is restricted to one single time per period of adjustment towards the MTO;
- The maximum initial distance of the structural balance from the MTO is 1.5% of GDP in year  $t$ . That condition is meant to ensure that –in the benchmark case of an annual adjustment of 0.5% of GDP– the Member State can achieve its MTO within the four-year horizon of the SCP.

For both clauses, the allowed deviation is adjusted according to the Member State’s distance to its MTO in order to equalise the impact on the debt level.

A Member State at its MTO is allowed to depart from it for three years. Effectively, this means that a Member State benefiting from the clauses would be able to remain at the distance of temporary deviation –or, in the case of the investment clause, at the distance of the initial temporary deviation complemented with following incremental temporary deviations, if any– to the MTO, until year  $t+3$ . From year  $t+4$  onwards, the Member State will lose the benefit of the temporary deviation granted in the first year and the Member State is then required to adjust according to the matrix. In the benchmark case, to do so will return the Member State to its MTO. For the incremental temporary deviation in the case of the investment clause, the logic is kept unchanged: if a Member State asks for an incremental temporary deviation in year  $t$  for year  $t+1$ , it will lose the benefit of the temporary deviation from year  $t+4$  and onwards.

For Member States not yet at the MTO but likely to reach it before the end of the period, an adjustment parallel to the original trajectory is required until they find themselves at the distance of the temporary deviation allowed to the MTO. At that point, the Member State would halt the adjustment until year  $t+3$ .

Algebraically, with  $t$  being the year of submission of the SCPs and assuming  $t+1$  is the year for which the temporary deviation is granted, the new adjustment path towards the MTO for a Member State benefiting from the structural reform clause and the investment clause respectively will be: <sup>(39)</sup>

#### **Structural reform clause**

$$SB_{t+1} = SB_t + \min[\text{adj\_matrix}_{t+1} - \text{deviation}, \{(MTO - \text{deviation}) - SB_t\}]$$

$$SB_{t+2} = SB_{t+1} + \min[\text{adj\_matrix}_{t+2}, \{(MTO - \text{deviation}) - SB_{t+1}\}]$$

$$SB_{t+3} = SB_{t+2} + \min[\text{adj\_matrix}_{t+3}, \{(MTO - \text{deviation}) - SB_{t+2}\}]$$

$$SB_{t+4} = SB_{t+3} + \min[\text{adj\_matrix}_{t+4}, \{MTO - SB_{t+3}\}]$$

#### **Investment clause**

$$SB_{t+1} = SB_t + \min[\text{adj\_matrix}_{t+1} - \text{deviation}, \{(MTO - \text{deviation}) - SB_t\}]$$

$$SB_{t+2} = SB_{t+1} + \min[\text{adj\_matrix}_{t+2} - \text{Incr. dev.}_{t+2}, \{(MTO - (\text{deviation} + \text{Incr. dev.}_{t+2}) - SB_{t+1}\}]$$

$$SB_{t+3} = SB_{t+2} + \min[\text{adj\_matrix}_{t+3} - \text{Incr. dev.}_{t+3}, \{(MTO - (\text{deviation} + \text{Incr. dev.}_{t+2} + \text{Incr. dev.}_{t+3}) - SB_{t+2}\}]$$

$$SB_{t+4} = SB_{t+3} + \min[\text{adj\_matrix}_{t+4} - \text{Incr. dev.}_{t+4}, \{MTO - (\text{Incr. dev.}_{t+2} + \text{Incr. dev.}_{t+3}) - SB_{t+3}\}]$$

<sup>(39)</sup> It has to be noted that for Member States benefiting from the clause while they are above the MTO, that formula results in a ceiling and not a compulsory adjustment path.

Where:

- $SB_{t+1}$  denotes the structural balance in % of GDP in year  $t+1$
- $adj\_matrix_{t+1}$  denotes the appropriate adjustment towards the MTO in year  $t+1$  resulting from the matrix in Box 1.7
- deviation denotes the temporary allowed deviation
- $\{(MTO - deviation) - SB_{t+i}\}$  denotes the distance between the MTO minus the allowed temporary deviation and the structural balance prevailing the previous year
- $Incr. dev. t+i$  denotes the positive incremental change with respect to the temporary deviation allowed in the previous year (for the investment clause only).

Expressing the above in terms of the adjustment required in year  $t+1$ , gives:  
 $reform\_adj_{t+1} = \min\{adj\_matrix_{t+1} - deviation, [(MTO - deviation) - SB_t]\}$

#### 1.3.4. Taking into account investment

Under the preventive arm of the SGP, some investments aiming at, ancillary to, and economically equivalent to major structural reforms may, under certain conditions, justify a temporary deviation from the MTO or from the adjustment path towards it. The Code of Conduct on the SGP <sup>(40)</sup> provides guidance on the application of those provisions (Articles 5(1) and 9(1) of Regulation (EC) 1466/97). The application of the investment clause is described in Box 1.9.

A temporary deviation from the MTO, or the adjustment path towards it, may be granted for the financing of certain specific investments with positive, direct and verifiable long-term effects on growth and on the sustainability of public finances under certain conditions. Those conditions are, in particular, that the Member State's GDP growth is forecast to be negative or to remain well below its potential (resulting in negative output gap greater than 1.5% of potential GDP), the Member State remains in the preventive arm and at the time of the assessment of the application for use of the clause, an appropriate safety margin with respect to the 3% of GDP deficit reference value is preserved (see Section 1.2.2).

The deviation allowed must be linked to national expenditure on projects co-funded by the EU under the Structural and Investment Funds, <sup>(41)</sup> Trans-European-Network or Connecting Europe Facility. National co-financing of investment projects also co-financed by the European Fund for Strategic Investments (EFSI) is also allowed. These projects must have positive, direct and verifiable long-term budgetary effects. Moreover, co-financed expenditure should not substitute for nationally-financed investments, so that total public investments do not decrease.

The investment clause is activated *ex ante* upon request from Member States in their SCPs one year ahead of the application of the clause. The process for Member States to request the flexibility and for the Council to grant it is the same as for the "structural reform clause" (Section 1.3.3). When requesting the application of the investment clause, Member States should include the following information in their SCPs: i) the forecast path of national co-financing expenditure (as a % of GDP); ii) detailed information on the positive, direct and verifiable long-term budgetary effect of the expenditure covered by the clause; iii) the corrected path of the structural balance resulting from the application of the clause; and iv) an independent evaluation of the information provided to support the application for the investment clause, including the estimated long-term impact on the budgetary position, or independent information to support the estimated impact. The Member State should present information by main category of projects co-financed by the EU (including the EFSI). Information must also be included on the size of the

<sup>(40)</sup> <http://data.consilium.europa.eu/doc/document/ST-9344-2017-INIT/en/pdf>

<sup>(41)</sup> See Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32013R1303>



expenditure involved, the key features and objectives of the investment project, and the projected contribution to boosting potential growth and the long-term sustainability of public finances.

The Council grants the temporary deviation from the MTO, or the adjustment path towards it, following a proposal from the Commission, based on an overall assessment of the situation of the Member State concerned. The temporary deviation for investment expenditure will be subject to a plausibility assessment by the Commission and the Council, where consideration is given to whether the project in question aims at, is ancillary to, and is economically equivalent to the implementation of structural reforms. In its assessment, the Commission considers whether the eligible investment occurs against the background of structural actions aimed at improving the productive capacity of the economy. However, the granting of the temporary deviation under the investment clause will not be conditional on a specific assessment of structural reforms, comparable to the assessment undertaken for the application of the structural reform clause.

The investment clause is granted in the context of the assessment of the SCPs, specifically in the relevant CSR. If a Member State invokes the clause in autumn, the investment clause may be granted provided it is endorsed by the Council in the autumn of the same year as an updated CSR. 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 corresponding effective co-financing. The allowance will be reviewed reflecting the actual co-financing of the Member States. The (downward) revision of that temporary deviation does not imply that a Member State implements an effort superior to the one necessary to reach its MTO. When a Member State is granted a deviation under the investment clause, the expenditure benchmark is automatically recalibrated so that it also incorporates the allowed deviation. <sup>(42)</sup>

#### 1.3.5. Considering the impact of adverse economic events

In cases of a severe economic downturn in the euro area or in the EU as a whole, the pace of fiscal consolidation may be adapted for all Member States so long as this does not endanger fiscal sustainability in the medium run. Parallel provisions apply to Member States in the preventive arm and in the corrective arm (see Section 2.3.3.1).

Article 5(1) and Article 9(1) of Regulation (EC) 1466/97 provide that: “In the case of an unusual event outside the control of the Member State concerned which has a major impact on the financial position of the general government or in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the MTO referred to in the third subparagraph, provided that this does not endanger fiscal sustainability in the medium term.”

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

Apart from a severe economic downturn for the euro area or the EU as a whole, Article 5(1) and Article 9(1) refer to *an unusual event outside the control of the Member State*. Together with Article 6(3) and Article 10(3), those provisions envisage that temporary deviations with respect to the required fiscal

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<sup>(42)</sup> A numerical example of the flexibility clauses in the preventive arm is presented on the Commission website: [https://ec.europa.eu/info/files/numerical-examples-and-technical-aspects-hands-experts-2019-edition\\_en](https://ec.europa.eu/info/files/numerical-examples-and-technical-aspects-hands-experts-2019-edition_en)

adjustment towards the MTO can either be allowed *ex ante* or can be left out of consideration *ex post*, provided that they result from: i) an unusual event; ii) that is outside the control of the Member State; iii) with a major impact on the financial position of the general government; and iv) not endangering fiscal sustainability in the medium term. By its very nature, the clause will only be applied in extraordinary situations and granted on the basis of individual case-by-case assessments, in line with the rules and their overall aim of promoting sound and sustainable public finances. Typically, that clause had been considered as being intended to allow for events such as natural disasters.

As the adjustment requirements under the preventive arm are set in terms of the change in the structural balance, temporary deviations under the “unusual event” provisions should (only) reflect the extent to which such events affect the annual change in the structural balance, compared to that which would have been otherwise observed in the absence of the event.

That exceptional treatment is therefore linked to several principles: <sup>(43)</sup>

- the additional spending should be directly linked to the unusual event;
- deviations in that regard can be allowed on a temporary basis only;
- the allowed deviations should only reflect the additional costs compared with the previous year (“incremental costs”), to the extent that the additional expenditures required to tackle the unusual event affect the structural effort and be net of any targeted contribution from relevant EU-funds;
- the burden of proof rests on the Member State requesting the deviation, which should substantiate its request with detailed information, while the Commission retains the right to make its own assessment about the exact figures to be taken into account.

In terms of implementation, for the purpose of assessing the *ex-post* occurrence of a significant deviation from the preventive arm requirements, the Commission:

- allows for a deviation from the required adjustment for year  $t$  equal to the additional costs related to tackling the unusual event in year  $t$  (with respect to baseline represented by the expenditure in  $t-1$ );
- allows for a deviation from the cumulated adjustment required over years  $t$  and  $t+1$  equal to the additional costs related to tackling the unusual event in years  $t$  and  $t+1$  (with respect to the same  $t-1$  baseline).

At the same time, and in line with the provisions of the SGP, the granting of the clause should not endanger fiscal sustainability in the medium term. When conducting its assessment of the *ex-ante* risk of a significant deviation from the preventive arm requirements, the Commission makes a preliminary assessment of the Member State’s eligibility for a deviation in relation to the additional expenditure linked to unusual events, although this can only be confirmed in the *ex-post* assessment. The Commission makes a final assessment on a case-by-case basis, including on the eligible amounts, on the basis of observed data as provided by the authorities of the Member States concerned.

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<sup>(43)</sup> The principles applied to assess costs arising from unusual events are set out in Section 2 of The Commission Communication 2016 *Draft Budgetary Plans: an Overall Assessment*, November 16, 2015, <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=COM:2015:0800:FIN>

This boils down to taking into consideration the amount of the extra costs (compared to the baseline) when assessing compliance for the budgetary figures of year  $t$  (the first year where the extra costs kick in), and the incremental costs (i.e. the extra costs in  $t+1$  compared to  $t$ ) would be considered when assessing year  $t+1$ .<sup>(44)</sup> In general, any activation of the clause should be of a temporary nature, i.e., as a rule, not going beyond  $t+1$ , although exceptions may be possible in cases where it is concluded that a multi-annual event should still be considered unusual for the purposes of the Pact. For Member States already at their MTO (or very close to it), the operationalisation of the clause should ensure that they do not have to return to their MTO in the year after applying the deviation, as to do so would imply carrying out an adjustment that would not have occurred in the absence of the additional costs.

More specifically, Member States at their MTOs and those still on the adjustment path toward it should be granted the same type/quality of deviation. In order to do so, it is necessary to require Member States to adjust onto a trajectory that is parallel to the original path. While the deviation is expressed in terms of the change in the structural balance for Member States on the adjustment path to their MTO, for Member States already at the MTO the allowed deviation is expressed as a deviation from the MTO itself. In order to establish equal treatment, a Member State at the MTO would be allowed to depart from it for up to three years, thereby not penalising it compared with the deviation allowed to other Member States. In terms of the trajectory of the temporary deviation, this is consistent with the approach on the commonly agreed position on flexibility within the SGP endorsed by the Council on 12 February 2016 under the structural reform and investment clauses (see Box 1.9). Similarly, when a Member State is granted a deviation under the unusual events clause, the expenditure benchmark is automatically recalibrated so that it also incorporates the allowed deviation.

Whereas the *severe economic downturn* provision of the SGP has never been activated, the *unusual event* provision has been exercised in recent years to cater for the incremental budgetary costs, among others related to i) the exceptional refugee inflows towards the Member States and ii) security costs to tackle the heightened terrorist threat in specific Member States.

#### 1.3.6. Is the Member State compliant with the requirements of the expenditure benchmark?

The assessment of the appropriateness of the path towards the MTO includes an assessment of the respect of the expenditure benchmark. The expenditure benchmark aims to ensure that Member States' policies are consistent with either remaining at the MTO or being on an appropriate adjustment path towards it.

##### *Applying the expenditure benchmark*

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

- Annual expenditure growth should not exceed a reference medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures, thus, allowing the Member State to remain at its MTO. The deviation of expenditure developments shall not be considered significant if the Member State concerned has overachieved the MTO, taking into account the possibility of significant revenue windfalls and the budgetary plans laid out in the SCP do not jeopardise that objective over the programme period.

For Member States that have not attained their MTO:

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<sup>(44)</sup> Normally, the Commission does not take into account a negative incremental, unless the Member State explicitly reports such a reduction of the costs in its SCP/DBP.

- Annual expenditure growth should not exceed a specific lower rate, which is set below the reference medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures. The difference between the appropriate growth rate for net expenditure and the reference medium-term rate of potential GDP growth is referred to as the convergence margin and is set so as to ensure the appropriate adjustment towards the MTO (i.e. in line with the required change in the structural balance). The convergence margin is calculated to be consistent with the required tightening of the structural balance.
- Any discretionary reductions of government revenue items must be matched by either expenditure reductions or by discretionary increases in other revenue items or both.

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

The expenditure benchmark applies to an expenditure aggregate that excludes interest expenditure, expenditure on EU programmes fully matched by EU funds revenue, and cyclical elements of unemployment benefit expenditure. In addition, nationally-financed government investment is averaged over a four-year period to smooth the impact of any large investment projects. In that respect, the Code of Conduct on the SGP requires the smoothing of investments with the purpose of reducing “*the potentially very high variability of investment expenditure, especially in the case of small Member States*”. In addition, when assessing compliance with the expenditure benchmark, the impact of one-off measures is systematically corrected for as part of the overall assessment. <sup>(45)</sup>

In order to avoid a (partial) double-counting of investment expenditure matched by EU funds that are excluded from the expenditure aggregate and in line with the purpose outlined in the Code of Conduct on the SGP, only investments that are *not* matched by EU funds are smoothed (see Box 1.11). Given that EU-funded investments are deducted from the expenditure aggregate, there is no need for smoothing them. Furthermore, they are budget-neutral and therefore do not introduce volatility in the budget balance of the Member States concerned.

#### *Computing the expenditure benchmark*

For Member States that have not yet attained their MTO, the adjustment requirements set out in the CSRs under the European Semester are also formulated in terms of the expenditure benchmark. For Member States that are at their MTO, the expenditure benchmark does not reflect any required improvement in the

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<sup>(45)</sup> <http://data.consilium.europa.eu/doc/document/ST-14814-2016-INIT/en/pdf>

structural balance but indicates the maximum growth rate of expenditure compatible with the Member State remaining at the MTO. <sup>(46)</sup>

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

- the medium-term rate of potential GDP growth;
- the convergence margin, which is subtracted from the medium-term rate of potential GDP growth to obtain the reference rate for countries not at their MTO;
- a measure of inflation (GDP deflator) to convert the benchmark growth rate, which is derived from a real variable (potential real GDP growth), into nominal terms so that it can be compared to the change in the expenditure aggregate.

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

The medium-term rate of potential GDP growth is calculated on the basis of a ten-year average, comprising five years of backward-looking data, the year underway and four years of forward-looking data. Those figures build on the Commission forecasts, which follow the commonly agreed methodology set out by the Output Gap Working Group for the years beyond the scope of the Commission forecast. The medium-term rate of potential GDP growth applied to set the requirements for year  $t$  is calculated on the basis of the Commission spring forecast in  $t-1$ .

The convergence margin is Member State-specific and is applied to the medium-term rate of potential GDP growth. For Member States not at their MTOs, the convergence margin serves to support the annual improvement of the structural balance towards the MTO, as required under the preventive arm of the SGP (see Box 1.7). That requirement is then used to calculate the applicable convergence margin and the corresponding reference rate, as explained in Box 1.10. All things being equal, the higher the required improvement in the structural balance, the greater the applicable convergence margin and the tighter the reference rate that constrains net expenditure growth. The convergence margin is calculated based on the assumption that any decrease in the share of public expenditure that is not financed by additional revenue measures (which would occur if net expenditure grows more slowly than GDP) would lead to an exactly proportional improvement of the structural balance (the coefficient being equal to the share of public expenditure in GDP times the shortfall of expenditure growth). The size of the convergence margin therefore depends on the size of the general government sector, with larger public sectors requiring less expenditure restraint in percentage terms to yield a particular tightening of the structural budget. As with the medium-term rate of potential GDP growth, the convergence margin for year  $t$  is set in spring  $t-1$ , according to the methodology set out in Box 1.10.

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<sup>(46)</sup> <http://data.consilium.europa.eu/doc/document/ST-14814-2016-INIT/en/pdf>

**BOX 1.10: THE CONVERGENCE MARGIN**

The size of the convergence margin depends on the share of government primary expenditure in GDP (P, in % of GDP). The higher P, the larger the improvement of the structural balance when the growth rate of net public spending (numerator) is lower than GDP (denominator) growth. <sup>(47)</sup>

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

$$C = (\text{adj}/P) * 100$$

where the “adj” term corresponds to the required tightening expressed in percentage points of GDP and the value of P comes from the same Commission forecast vintage on which the medium-term rate (ten-year average) of potential GDP growth is centred. For example, the 2015 share of government primary expenditure in GDP (as per the spring forecast 2015) is used to calculate the convergence margin for 2016.

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

$$L = R - C.$$

For Member States at their MTO, the convergence margin is by construction set to zero.

For the purposes of surveillance, the reference rate L is then converted into nominal terms by using the GDP deflator from the Commission’s spring forecast of the preceding year. The convergence margin thus allows the required improvement in the structural balance to be translated into a maximum allowable growth rate of expenditure.

Regulation (EC) 1466/97 does not envisage any specific adjustment requirements for Member States that are above their MTO. For analytical purposes, however, it is possible to calculate the reference rate L that is compatible with the Member State returning to the MTO, on the basis of the initial distance from the MTO.

In that case, the convergence margin is given by the first formula, but will have a negative sign. The convergence margin thus obtained does not reflect any specific requirement, under the SGP, whether in terms of the level or pace of adjustment towards the MTO. <sup>(48)</sup>

In order to ensure that the ex post assessment’s outcome is predictable and that Member States are able to take the appropriate measures in the forthcoming budget plan, the applicable convergence margin and the resulting reference rate is communicated in the spring of year *t-1* for year *t* and is kept fixed – unless the required adjustment is reset (for application of the ‘freezing principle’ see Box 1.7).

While potential GDP is measured in real terms, expenditure plans are typically set in nominal terms. Therefore, to convert the expenditure benchmark into nominal terms to allow for the comparison, the

<sup>(47)</sup> For example, for a Member State with primary expenditure of 40% of GDP and a recommended adjustment in the structural balance of 0.6%, the convergence margin is 1.5 percentage points of GDP. If the primary expenditure-to-GDP ratio increases to 41%, it reduces the convergence margin to 1.46 pp., i.e. the lower rate will be 0.04 pp. higher. Assuming real GDP growth of 2%, the 1 pp. increase in primary expenditure in fact corresponds to a lower rate that is 8% higher (0.54 compared to 0.50).

<sup>(48)</sup> That convergence margin does not represent in any way an encouragement to the Member State to return to its MTO but rather provides an indication of the maximum growth rate of net expenditure compatible with the Member State reaching the MTO.

GDP deflator is used as a measure of inflation. <sup>(49)</sup> The GDP deflator from the Commission’s spring forecast of the preceding year is used. Thus, the same forecast vintage is used for defining the initial requirements both in terms of the improvement in the structural balance and in terms of the expenditure benchmark expressed in nominal terms (see Table 1.1).

Table 1.1: Use of deflators for setting the expenditure benchmark

| Budget and year of in year assessment | Year of ex post assessment (during European Semester) | Deflators to use   |
|---------------------------------------|---|--|
| 2019                                  | 2020  | Deflator for 2019 from the 2018 spring Commission forecast |
| t                                     | t+1   | Deflator for t from the t-1 spring Commission forecast     |

Compliance with the expenditure benchmark requires that planned expenditure growth be compared with the appropriate benchmark growth rate (see Box 1.11). <sup>(50)</sup>

**BOX 1.11: HOW IS THE NET EXPENDITURE GROWTH RATE FOR YEAR *t* COMPUTED?**

Step 1 – The first step in the calculation requires the computation of *modified* expenditure aggregates for years *t* <sup>(51)</sup> and *t-1*, referred to as  $G_t$  and  $G_{t-1}$ , respectively.

<sup>(49)</sup> The GDP deflator fulfils two criteria: First, it is conceptually sound and coherent with the aim of the preventive arm. Since the expenditure benchmark is based on a potential rate of GDP growth, aligning growth rates of both net expenditure and revenues (where growth rate is proxied by GDP growth) and using a common deflator ensures a constant differential and allows a Member State that respects the expenditure benchmark to remain at its MTO. Second, on a practical level, the GDP deflator typically displays less volatility than other measures of inflation and is therefore more conducive to supporting transparent and stable policy-making.

<sup>(50)</sup> A numerical example of the expenditure benchmark, in line with the methodology outlined in Section 1.3.6 and Box 1.11, is presented on the Commission website: [https://ec.europa.eu/info/files/numerical-examples-and-technical-aspects-hands-experts-2019-edition\\_en](https://ec.europa.eu/info/files/numerical-examples-and-technical-aspects-hands-experts-2019-edition_en)

<sup>(51)</sup> Year *t* is the year of budgetary execution being assessed (either *ex ante*, *in-year* or *ex post*).

|   | <b>Variable<br/>(for <math>t</math> unless otherwise mentioned, in nominal terms)</b>   | <b>Source</b>   |
|---|---|---|
| + | Government expenditure aggregate  | SCPs (table 2a, ESA code TE )   |
| - | Interest expenditure  | SCPs (table 2a, ESA code D.41)  |
| - | Government expenditure on EU programmes which is fully matched by EU funds revenue  | SCPs (table 2c, row 1)  |
| - | Gross fixed capital formation not matched by EU funds (for year $t$ ) = Gross fixed capital formation (for year $t$ ) – Investment expenditures matched by EU funds (for year $t$ ) | SCPs (table 2a, ESA code P.51g) –<br>SCPs (table 2c, row 1a) <i>if available</i>                                  |
| + | Gross fixed capital formation not matched by EU funds averaged over $t-3$ to $t$  | SCPs (table 2a, ESA code P.51g) –<br>SCPs (table 2c, row 1a) <i>if available</i><br>ESTAT (and ECB) for past data |
| - | Cyclical unemployment benefit expenditure   | SCPs (table 2c, row 2)  |
| = | <i>modified</i> expenditure aggregate $G_t$   |   |

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

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

### Concluding the assessment on the expenditure benchmark

For Member States that have exceeded their MTO and whose budgetary plans, as laid out in the SCP, do not jeopardise the MTO over the programme period, the deviation of expenditure developments shall not be considered significant, taking into account the possibility of significant revenue windfalls. In all other cases, the conclusion of the assessment should focus on whether the growth rate of government expenditure, net of discretionary revenue measures, contributes to the appropriate adjustment towards the MTO or whether it is in line with the medium-term rate of potential GDP growth for countries at their MTO. In addition, when assessing compliance with the expenditure benchmark, the impact of one-off measures (on both the expenditure and revenue sides) is systematically corrected for as part of the overall assessment. For cases of a Member State being granted a deviation under the structural reform or investment clauses, see Sections 1.3.3 and 1.3.4 respectively.

Compliance with the expenditure benchmark in Member States’ SCPs (or DBPs) is assessed against the information provided therein and the Commission forecasts, with the latter being the basis for the risk assessment of the programmes/plans. The *ex post* assessment of compliance is based on outturn data.



### 1.3.7. The assessment of compliance with the preventive arm

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

The assessment evaluates the overall compliance of the Member State with the requirements of the preventive arm and can reach a conclusion of compliance, (some) deviation <sup>(52)</sup> or significant deviation. For the ex ante assessment, the latter refers to a risk of a significant deviation based on the Member State’s plans and the Commission forecast; for the ex post assessment (which is based on observed data as available in spring of year  $t+1$ ), it triggers the Significant Deviation Procedure, as outlined in Section 1.4. The assessment should also include a discussion of the figures underlying the two indicators, i.e. structural balance and expenditure benchmark, to enable a clear understanding of the basis of the overall conclusion.

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

- (a) for a Member State that has not reached the MTO, <sup>(53)</sup> when assessing the change in the structural balance, whether the deviation is at least 0.5% of GDP in a single year or at least 0.25% of GDP on average per year in two consecutive years;
- (b) when assessing expenditure developments net of discretionary revenue measures, whether the deviation has a total impact on the government balance of at least 0.5% of GDP in a single year or cumulatively in two consecutive years.

The deviation may not be taken into consideration when it results from an unusual event outside the control of the Member State concerned and which has a major impact on the financial position of the general government or in the case of a severe economic downturn for the euro area or the Union as a whole, provided that this does not endanger the fiscal sustainability in the medium term, (see Section 1.3.5).

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

- (i) The Member State exceeded its MTO in  $t$ .
- (ii) The Member State achieved its MTO in  $t$ .
- (iii) The Member State did not achieve its MTO in  $t$ .

In considering compliance with the preventive arm, the analysis of Member States exceeding their MTO will be different depending on the following elements. If the Member State’s structural balance has exceeded the MTO in year  $t$  and its budgetary plans, as laid out in the SCP, do not jeopardise the MTO over the programme period, the deviation of expenditure developments for year  $t$  shall not be considered

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<sup>(52)</sup> “Some” deviation refers to any deviation which is not significant – within the meaning of Articles 6(3) and 10(3) of Regulation (EC) 1466/97.

<sup>(53)</sup> In case a Member State has reached its MTO, a deviation from it of at least 0.5% of GDP still results in a significant deviation.

significant (also for the assessment of the two-year deviations comprising year  $t$ ).<sup>(54)</sup> However, if the overachievement of the MTO is explained by significant revenue windfalls,<sup>(55)</sup> the deviation in the expenditure benchmark may be considered significant (also for the assessment of the two-year deviations comprising year  $t$ ).

As a convention, from an ex post perspective, the Commission considers a Member State to be at its MTO if it is within  $\frac{1}{4}$  pp of GDP from its MTO (see Section 1.3.2).

A Member State that did not achieve its MTO in  $t$  will need to have been or plan to be on an appropriate adjustment path to the MTO in that year. This will require comparing the actual change in the structural balance with the appropriate adjustment path and to assess compliance with the expenditure benchmark, with respect to the requirements frozen in spring of year  $t-1$  (for application of the ‘freezing principle’ see Box 1.6).<sup>(56)</sup>

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

As part of the incorporation of the MTO objective into the national legal order, those countries that are Contracting Parties to the TSCG and bound by the Fiscal Compact must implement automatic correction mechanisms at the national level, which will operate in the event of significant observed deviations (see Section 3.2 for more detail).

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

- If the Member State is compliant with both indicators, the overall conclusion will be one of compliance with the preventive arm. On an ex ante basis, it means that if the plans turn out as forecast, the Member State will be compliant with the preventive arm, while on an ex post basis it indicates compliance in the previous year.
- In all other cases, in line with Article 6(3) or Article 10(3) of Regulation (EC) 1466/97, the conclusion will depend on the “overall assessment”, which should include an in-depth analysis based on the two indicators. Within the overall assessment, the conclusion of a (risk of or observed) significant deviation requires at least one indicator to be in significant deviation, in line with the specification in the Code of Conduct on the SGP. If the Member State is in significant deviation on both indicators, it gives a strong presumption of a (risk of or observed) significant deviation, but an overall assessment is still needed before reaching the conclusion, as there is no element of automaticity in the Regulation in reaching the conclusion of a significant deviation.<sup>(57)</sup> On an ex ante basis, a conclusion of a risk of significant deviation means that if the plans turn out as forecast,

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<sup>(54)</sup> That is, the two-year deviation for year  $t$ , computed over years  $t-1$  and  $t$ , as well as the two-year deviation for year  $t+1$ , computed over years  $t$  and  $t+1$ .

<sup>(55)</sup> The issue surrounding the identification of revenue windfalls is discussed in Part II, Chapter 3 of the 2018 Report on Public Finances in EMU: [https://ec.europa.eu/info/sites/info/files/economy-finance/ip095\\_en.pdf](https://ec.europa.eu/info/sites/info/files/economy-finance/ip095_en.pdf)

<sup>(56)</sup> For a Member State under a Significant Deviation Procedure that has not corrected its significant deviation, the adjustment path should reflect the requirements of the Council recommendation requesting the correction of the significant deviation.

<sup>(57)</sup> Articles 6(3) and 10(3) of Regulation (EC) 1466/97: “A deviation from the medium-term budgetary objective or from the appropriate adjustment path towards it shall be evaluated *on the basis of an overall assessment* [...]. The assessment of whether the deviation is significant shall, in particular, *include* the following criteria [...]”.

the Member State will be in significant deviation with respect to the preventive arm and would have a Significant Deviation Procedure launched once the outturn figures are confirmed. On an ex post basis, a conclusion of an observed significant deviation acts as the trigger for a Significant Deviation Procedure.

In the overall assessment, particularly when only one indicator points to a significant deviation, the Commission analyses the factors that lead to the discrepancy between the two indicators. It informs the Council about that analysis, explaining the discrepancy between both indicators and the reasons behind the conclusion of the overall assessment. The conclusion of the assessment of Member States' plans should consider whether the resulting change in the structural balance, including the analysis of expenditure net of discretionary revenue measures and of one-off (revenue and expenditure) measures, appears to be appropriate or whether a significant deviation from the adjustment path can be expected – either on a one-year or on a two-year basis.

Both the structural balance and the expenditure benchmark have their respective strengths. They could be described as follows:

- The structural balance might dispense with the need to distinguish between discretionary and non-discretionary changes in revenues and quantifying individual measures. In addition, in some cases, the use of a single-year estimate of potential GDP growth, which underpins the calculation of the structural balance, could lead to a measure that appears more meaningful than the one provided by an estimate of medium-term potential GDP growth that includes some exceptionally high or low yearly estimates of potential GDP growth, as conventionally foreseen by the methodology. <sup>(58)</sup> Finally, a possible advantage of the structural balance is that it might provide an incentive for effective revenue administration.
- The expenditure benchmark as a rule is more predictable in the sense that expenditure rules, in setting an upper limit for the growth rate of government expenditure, can serve as an operational target for the preparation of annual budgets and help monitor their in-year execution. Compliance with the expenditure benchmark is measurable ex post and, in general, is less affected by factors that lie outside government control, including abnormal responses of revenues to economic activity. In order to ensure transparency, the Commission and the Member States will provide a quantification of discretionary revenue measures incorporated in the estimation of the expenditure benchmark. A work stream in the Alternates of the EFC was initiated to that effect in May 2017.

To ensure equal treatment of Member States and consistency of assessments over time, the Commission goes one step further in streamlining the use of surveillance indicators than the Code of Conduct on the SGP. <sup>(59)</sup> As indicated to Member States and reflected in the recitals of the 2017 CSRs, since the adoption of that Opinion the Commission has given a stronger role to the expenditure benchmark when assessing compliance with the preventive arm of the SGP, adjusting the indicator for possible shortcomings highlighted by a systematic comparison with the information provided by the structural balance.

Where a conclusion of overall significant deviation is reached on an ex post basis on outturn data, it triggers a Significant Deviation Procedure. Section 1.4 presents it in more detail.

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<sup>(58)</sup> For example, the large negative impact that the economic and financial crisis had on the estimates for potential GDP growth implies that, for a number of Member States, the averaging formula can lead to an estimated ten-year potential growth rate that is much lower than estimates made for more recent and future years.

<sup>(59)</sup> <http://data.consilium.europa.eu/doc/document/ST-9344-2017-INIT/en/pdf>

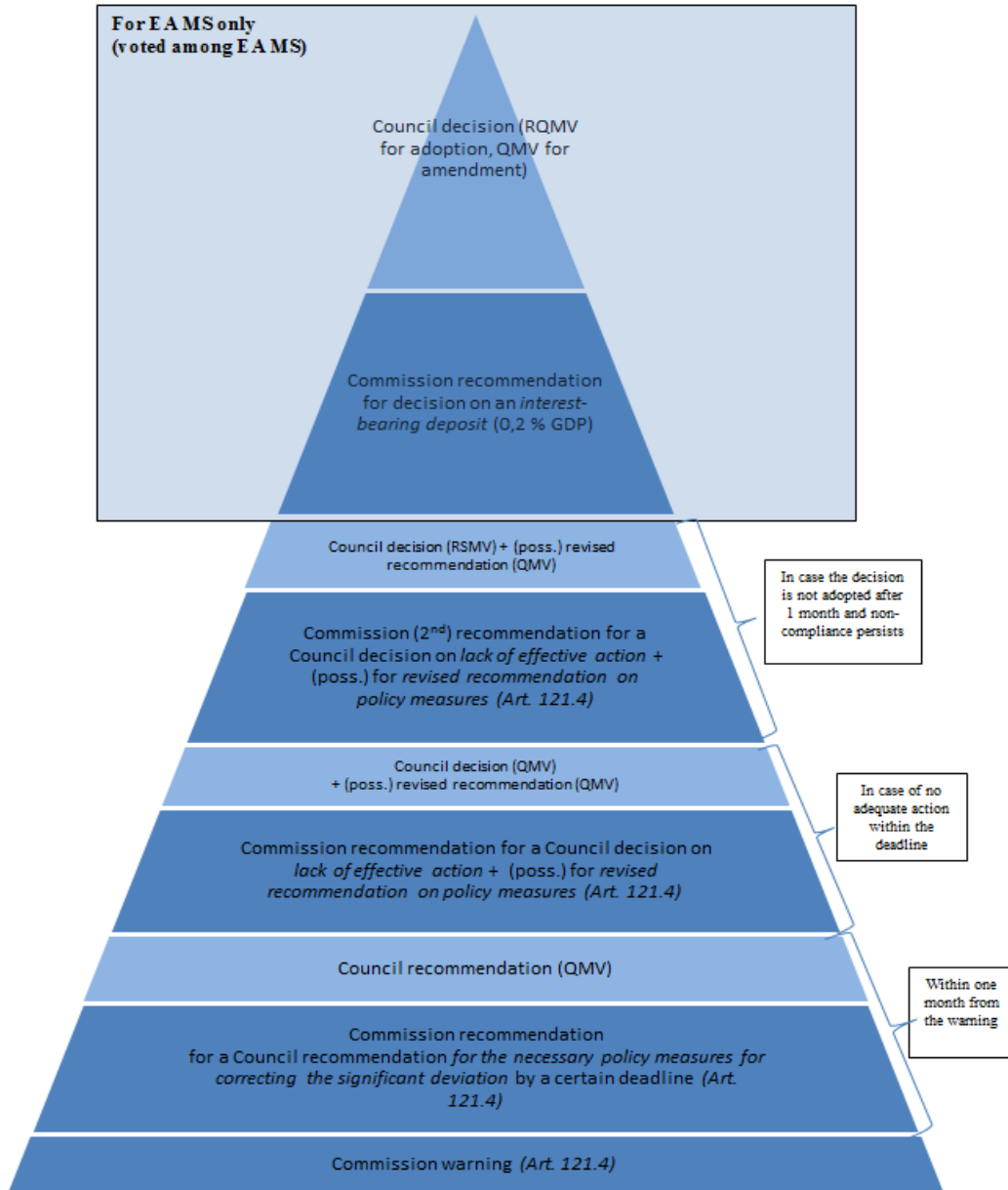
Table 1.2: The overall assessment under the preventive arm

| $\Delta$ SBal                                  | Adjustment delivered   | Deviation   | Breach of the threshold of significance  |
|--|--|---|--|
| <b>Dev. from the EB</b>                        |  |   |  |
| <b>Benchmark Respected</b>                     | Compliance   | <i>Need an overall assessment</i><br>(cannot lead to a Significant Deviation Procedure) | <i>Need an overall assessment</i><br>(can lead to a Significant Deviation Procedure)   |
| <b>Deviation</b>                               | <i>Need an overall assessment</i><br>( cannot lead to a Significant Deviation Procedure) | <i>Need an overall assessment</i><br>(cannot lead to a Significant Deviation Procedure) | <i>Need an overall assessment</i><br>(can lead to a Significant Deviation Procedure)   |
| <b>Breach of the threshold of significance</b> | <i>Need an overall assessment</i><br>(can lead to a Significant Deviation Procedure)     | <i>Need an overall assessment</i><br>(can lead to a Significant Deviation Procedure)    | <i>Need an overall assessment, but strong presumption of significant deviation</i> (can lead to a Significant Deviation Procedure) |

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

The ex post assessment of the compliance with the preventive arm of the Pact is of particular importance as, where a significant deviation from adjustment path to the MTO is observed, the Commission will launch a Significant Deviation Procedure (SDP). This is based on outturn data. Graph 1.3 sets out the various steps to be followed, while Annex 3 provides details on the voting arrangements. The procedural steps of the SDP are set out under Article 121(4) TFEU and Articles 6(2) and 10(2) of Regulation (EC) 1466/97.

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



The purpose of the SDP is to ensure that the Member State concerned returns to an appropriate adjustment path towards its MTO, ultimately correcting for the occurred significant deviation. It is also a useful early warning to prevent the Member State from slipping into an excessive deficit. In the recommendations under the SDP, the Commission proposes to the Council the required fiscal adjustment and quantifies the corresponding measures. When determining the proposed fiscal adjustment, the Commission takes into account the size of the significant deviation, amongst other factors, e.g. the economic and fiscal situation of the Member State. The SDP should be understood as an enhanced surveillance regime, where failure to comply with the recommendation is considered a lack of effective action.

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

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

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

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

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

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

## 2. THE CORRECTIVE ARM OF THE STABILITY AND GROWTH PACT

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

### 2.1. LEGAL BASIS, RATIONALE AND PROCEDURAL STEPS

A peculiarity of the EDP is that the word “deficit” is used to refer both to a situation of excessive general government borrowing and to government debt that is greater than 60% of GDP and is not diminishing at a satisfactory pace. Where it is important to distinguish between the two concepts, the distinction is made explicitly in this manual. Where the procedure is the same whatever the cause of the breach, the word “deficit” is used to refer to both excesses of deficit and debt.

#### 2.1.1. Legal basis of the corrective arm

The primary legal basis of the corrective arm of the SGP is Article 126 TFEU and Protocol N° 12 to the Treaty. Article 126 TFEU lays down that Member States shall avoid excessive deficits and defines budgetary discipline in terms of compliance with specific bounds for government deficit and debt levels (see Box 2.1).<sup>(60)</sup> It also sets out the steps to be taken when one or both of those conditions are not complied with. The reference values against which the deficit and debt criteria are based are defined in Protocol N° 12 (see Box 2.2). Article 136 TFEU forms the basis of a number of elements that were introduced as part of the Six-Pack and the Two-Pack (see Box 1.2). The intergovernmental TSCG also includes some elements relevant to the corrective arms of the SGP. In particular, the Contracting Parties commit themselves to voting through a procedure equivalent to reverse qualified majority voting on all votes concerning euro-area Member States for deficit-based EDPs, and to presenting an economic partnership programme (EPP) when subject to an EDP.<sup>(61)</sup>

The implementation of the corrective arm is governed by secondary legislation, based on Article 126(14) TFEU, in the form of Regulation (EC) 1467/97 *on speeding up and clarifying the implementation of the excessive deficit procedure*, as amended by Council Regulation (EC) 1056/2005, of 27 June 2005, and Regulation (EU) 1177/2011 of the European Parliament and of the Council of 8 November 2011.<sup>(62)</sup> It is further specified in the Code of Conduct on the SGP.<sup>(63)</sup> The Opinion of the EFC on *Improving the assessment of effective action in the context of the excessive deficit procedure – A specification of the methodology* of 29 November 2016 specifies the methodology for assessing compliance with EDP recommendations.<sup>(64)</sup> In addition, Regulation (EU) 1173/2011 *on the effective enforcement of budgetary surveillance in the euro area* added a system of preventive and graduated enforcement mechanisms to the

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<sup>(60)</sup> Protocol N° 15 on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland annexed to the TFEU states that the United Kingdom “shall endeavour to avoid an excessive deficit”. As a result, the avoidance of excessive deficit and debt is not directly binding for the United Kingdom.

<sup>(61)</sup> The commitment to RQMV applies only to Contracting Parties whose currency is the euro. The commitment to present an economic and budgetary partnership programme applies also to Denmark, Romania and Bulgaria.

<sup>(62)</sup> As amended by Regulation (EC) 1056/2005 and Council Regulation (EU) 1177/2011. The consolidated text is available under: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1467:20111213:EN:PDF>. Annex 1 contains links to all relevant legislation.

<sup>(63)</sup> <http://data.consilium.europa.eu/doc/document/ST-9344-2017-INIT/en/pdf>  
The current version of the Code of Conduct on the SGP was endorsed by the Council on 16 June 2017.

<sup>(64)</sup> <http://data.consilium.europa.eu/doc/document/ST-14813-2016-INIT/en/pdf>  
This Opinion of the EFC was endorsed by the Council on 6 December 2016.

Pact. <sup>(65)</sup> It complements the sanctions for euro-area Member States envisaged under Article 126(11) TFEU and the Regulation (EU) 1174/2011 with the aim of ensuring that sanctions are applied at a time when Member States are able to react. <sup>(66)</sup> Those two Regulations set out the roles and procedures to be followed by Member States, the Commission, the Council, the European Council and the European Parliament. <sup>(67)</sup>

In relation to reporting requirements, Council Regulation (EC) 479/2009 *on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community* defines the statistical and reporting obligations on Member States. <sup>(68)</sup> The Code of Conduct on the Two-Pack sets out the guidelines on the format and content of Draft Budgetary Plans (DBPs), EPPs and debt issuance reports. <sup>(69)</sup> Regulation (EU) 472/2013 *on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability* streamlines the requirements placed on financially fragile countries and embeds those provisions in the EU framework for policy co-ordination and surveillance, thus suspending the reporting requirements under the SGP for Member States under a macroeconomic adjustment programme. <sup>(70)</sup>

Regulation (EU) 473/2013 *on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit for the Member States of the euro area* complements the surveillance cycle for all euro-area Member States and increases monitoring and reporting requirements for countries under EDP. <sup>(71)</sup> As part of those requirements, the Commission can request that Member States under EDP be subject to closer monitoring, with the submission of regular reports all the way through their EDP. <sup>(72)</sup> The Regulation also allows the Commission to issue an autonomous recommendation to Member States at risk of missing their deadline for correction. Moreover, with the launch of an EDP, euro-area Member States must present an EPP, which sets out the fiscal structural reforms necessary to ensure an efficient and lasting correction of the excessive deficit.

**Box 2.1: ARTICLE 126 OF TFEU**

1. Member States shall avoid excessive government deficits.
2. The Commission shall monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors. In particular it shall examine compliance with budgetary discipline on the basis of the following two criteria:
  - (a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, unless:
    - either the ratio has declined substantially and continuously and reached a level that comes close to the reference value,
    - or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

<sup>(65)</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011R1173&from=EN>

<sup>(66)</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011R1174&from=EN>

<sup>(67)</sup> European Council Resolution on the SGP of 17 June 1997 (EUR-Lex - 31997Y0802(01) - EN - EUR-Lex) and the Report of the ECOFIN Council on Improving the implementation of the SGP, endorsed by the European Council of 22 March 2005 ([http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/coc/2005-03-23\\_council\\_presidency\\_conclusions\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2005-03-23_council_presidency_conclusions_en.pdf)), also form part of the corrective arm of the Pact but do not contain additional operational requirements.

<sup>(68)</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:145:0001:0009:EN:PDF>

<sup>(69)</sup> [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/coc/2014-11-07\\_two\\_pack\\_coc\\_amended\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf)

The current version of the Code of Conduct on the Two Pack was endorsed by the Council on 8 November 2016.

<sup>(70)</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0001:0010:EN:PDF>

<sup>(71)</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0011:0023:EN:PDF>

<sup>(72)</sup> The content and format of such reports is defined in Commission Delegated Regulation 877/2013.



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

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

3. If a Member State does not fulfil the requirements under one or both of these criteria, the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State.

The Commission may also prepare a report if, notwithstanding the fulfilment of the requirements under the criteria, it is of the opinion that there is a risk of an excessive deficit in a Member State.

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

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

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

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

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

9. If a Member State persists in failing to put into practice the recommendations of the Council, the Council may decide to give notice to the Member State to take, within a specified time limit, measures for the deficit reduction which is judged necessary by the Council in order to remedy the situation.

In such a case, the Council may request the Member State concerned to submit reports in accordance with a specific timetable in order to examine the adjustment efforts of that Member State.

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

11. As long as a Member State fails to comply with a decision taken in accordance with paragraph 9, the Council may decide to apply or, as the case may be, intensify one or more of the following measures:

- to require the Member State concerned to publish additional information, to be specified by the Council, before issuing bonds and securities,
- to invite the European Investment Bank to reconsider its lending policy towards the Member State concerned,
- to require the Member State concerned to make a non-interest-bearing deposit of an appropriate size with the Union until the excessive deficit has, in the view of the Council, been corrected,
- to impose fines of an appropriate size.

The President of the Council shall inform the European Parliament of the decisions taken.

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

13. When taking the decisions or recommendations referred to in paragraphs 8, 9, 11 and 12, the Council shall act on a recommendation from the Commission.

When the Council adopts the measures referred to in paragraphs 6 to 9, 11 and 12, it shall act without taking into

account the vote of the member of the Council representing the Member State concerned.  
A qualified majority of the other members of the Council shall be defined in accordance with Article 238(3)(a).

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

The Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the European Central Bank, adopt the appropriate provisions which shall then replace the said Protocol.

Subject to the other provisions of this paragraph, the Council shall, on a proposal from the Commission and after consulting the European Parliament, lay down detailed rules and definitions for the application of the provisions of the said Protocol.

#### **BOX 2.2:     PROTOCOL 12 ON THE EXCESSIVE DEFICIT PROCEDURE**

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

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

##### *Article 1*

The reference values referred to in Article 126(2) of the Treaty on the Functioning of the European Union are:

- 3 % for the ratio of the planned or actual government deficit to gross domestic product at market prices;
- 60 % for the ratio of government debt to gross domestic product at market prices.

##### *Article 2*

—‘government’ means general government, that is central government, regional or local government and social security funds, to the exclusion of commercial operations, as defined in the European System of Integrated Economic Accounts;

—‘deficit’ means net borrowing as defined in the European System of Integrated Economic Accounts;

—‘investment’ means gross fixed capital formation as defined in the European System of Integrated Economic Accounts;

—‘debt’ means total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government as defined in the first indent.

##### *Article 3*

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

##### *Article 4*

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

### 2.1.2. Rationale behind the corrective arm of the SGP

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

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

Compliance with the preventive arm of the Pact should ensure that Member States are kept out of the corrective arm under all except the most unusual of circumstances. Therefore, the EDP ought not to be thought of as being part of the normal budgetary procedure in the Member States, but as being the end of the line where previous budgetary policy errors are rectified. This is in line with the notion of “gross errors” referred to in Article 126(2) TFEU.

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

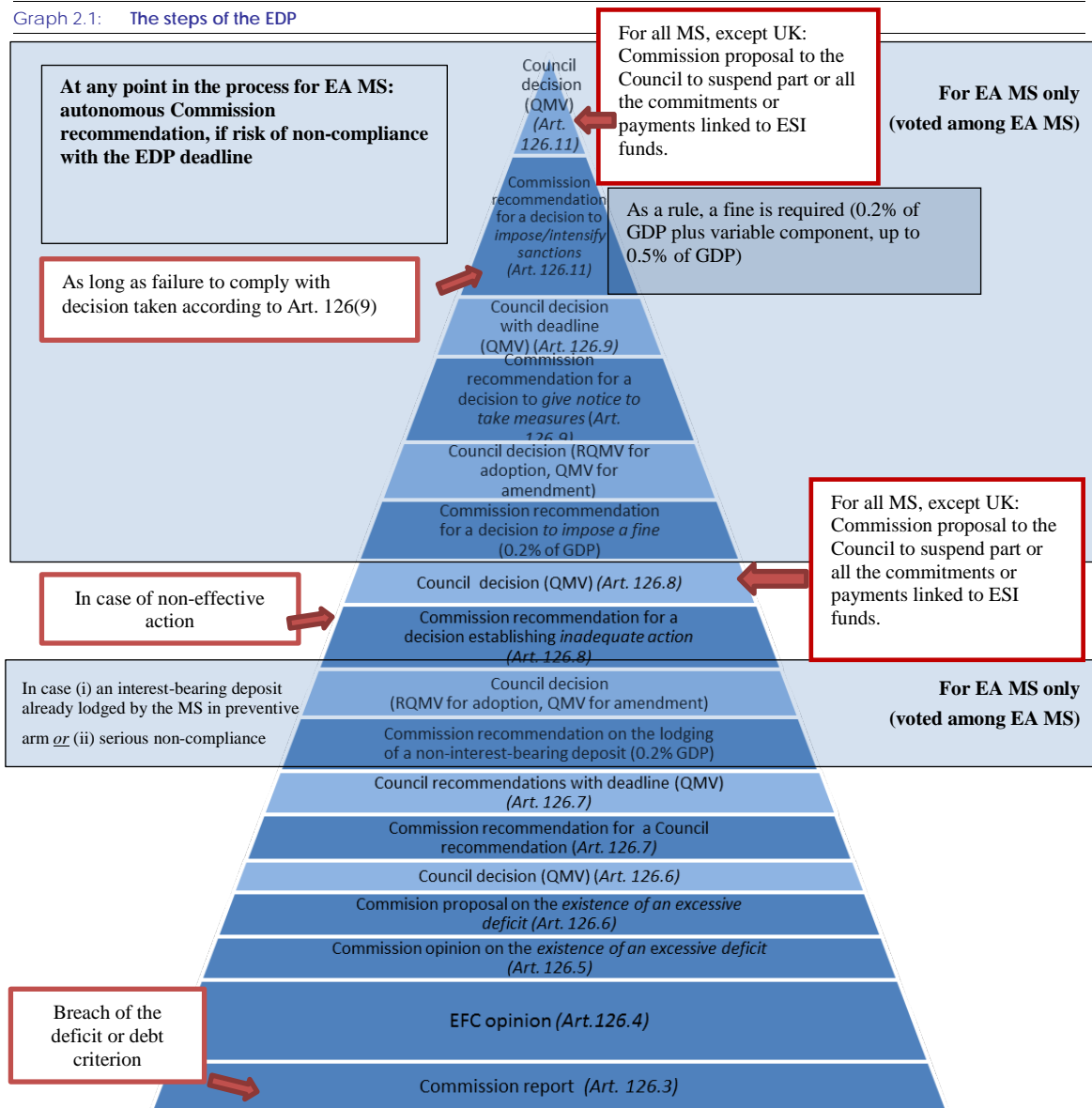
The operation of the corrective arm of the SGP is defined by a series of steps set out in Article 126 TFEU. These are summarised in Graph 2.1 and presented in more detail in the remainder of this Part. This subsection provides a brief overview of the main steps.

Following a breach of the deficit criterion (identified on the basis of outturns, plans or forecast data) or of the debt criterion (identified on the basis of outturn data), the Commission prepares a report pursuant to Article 126(3) TFEU. In that report, the Commission assesses the case for launching an EDP, based on a consideration of all factors pertinent to such a decision (Section 2.2). Article 126(4) TFEU requires that the EFC formulates an opinion on the Commission report. Following this, if the Commission considers that an excessive deficit exists or may occur, it issues an opinion to the Member State concerned under Article 126(5) TFEU. It then prepares a proposal for an Article 126(6) TFEU Council decision on the existence of an excessive deficit and, finally, a so-called Article 126(7) TFEU recommendation to be adopted by the Council, setting out adjustment requirements and a time limit to correct the Member State's public finance imbalances.

Following the Council decision under Article 126(6) TFEU and the adoption of the Article 126(7) TFEU recommendation, the Member State must show that it has taken action to address its excessive deficit within a deadline set out in the recommendation. For euro-area Member States, the Commission is also to recommend that a sanction be set in the form of a non-interest-bearing deposit if the Member State has already lodged an interest-bearing deposit under the preventive arm or in case of serious non-compliance with the budgetary policy obligations in the SGP (Section 2.3). The Commission then undertakes a first assessment, which looks at whether the Member State is on track to correct its excessive deficit. Depending on the outcome of that assessment, the procedure may be put/held in abeyance or stepped up. An EDP in abeyance is subject to continuous monitoring and may be activated again if that monitoring shows the Member State not to be on course to comply with the recommendation. The stepping up of the

EDP involves a Council decision following a Commission recommendation under Article 126(8) TFEU that effective action has not been taken (Section 2.4). For euro-area Member States, this is the next trigger for the imposition of sanctions. For all Member States except the UK, the Commission must propose to suspend part or all of the commitments under the European Structural and Investment Funds. For euro-area Member States whose EDP has been stepped up, the Council issues a notice under Article 126(9) TFEU.

Graph 2.1: The steps of the EDP



Note: EA: euro area, MS: Member States, QMV: qualified majority voting, RQMV: reverse qualified majority voting. Annex 3 sets out the voting modalities under the SGP in detail.

The notice mirrors the Article 126(7) recommendation, while also explicitly spelling out a series of measures conducive to achieving the budgetary targets. Following a notice under Article 126(9) TFEU or a revised Article 126(7) TFEU recommendation, an assessment of whether a Member State is on track to correct its excessive deficit can again lead to either maintaining/putting the procedure in abeyance or to a decision on a lack of effective action. In cases where the Commission concludes that effective action has

not been taken, the procedure is stepped up to Article 126(11) TFEU for euro-area Member States, with a Council decision to intensify sanctions.

The EDP is abrogated when the excessive deficit is corrected in a durable manner (according to the no-policy-change Commission forecast) and the correction is confirmed by outturn data (Section 2.5). In all cases, abrogation requires a correction of the deficit that is lasting and compliance with the debt rule on a forward-looking basis. The abrogation requires a Council decision under Article 126(12) TFEU adopted by a qualified majority vote in the Council, based on a Commission recommendation.

The Commission forecasts (and the no-policy-change assumption used therein – see Box 1.5) play an important role at the various stages of the EDP. At the opening of the EDP, the deficit is regarded as “temporary” if it is projected to move back below the Treaty reference value following the end of the unusual event or the severe economic downturn according to the Commission forecast (Regulation (EC) 1467/97). The forward-looking part of the debt benchmark (Section 2.2.1.2) also relies on the Commission forecast. The no-policy-change assumption also plays a role in the formulation of EDP recommendations (Section 2.2.3). In principle, it shows that further measures are needed to correct the excessive deficit situation. The fiscal targets contained in the recommendations are therefore such that by the EDP deadline, the headline deficit would be brought below 3% of GDP and the forward-looking part of the debt rule would be complied with. The no-policy-change assumption is also instrumental for the assessment of compliance with the EDP recommendation. In the assessment of effective action (Section 2.3.2.1), the “careful analysis” builds on an analysis of expenditure net of discretionary revenue measures to check compliance with the expenditure benchmark. Similar considerations apply to the EDP abrogation to the extent that the correction of the excessive deficit should be durable (Section 2.5). The relevant text here is the Code of Conduct on the SGP, where it is explicit that the assessment of sustainability of the correction has to be performed based on the Commission forecast. This holds for both the deficit and for the forward-looking part of the debt benchmark.

## 2.2. LAUNCHING AN EXCESSIVE DEFICIT PROCEDURE

This section sets out the steps involved in launching an EDP, from the breach of the numerical deficit and debt criteria in the Treaty to the adoption of a Council decision. Section 2.2.1 sets out the conditions for the deficit and debt triggering the production of an Article 126(3) report, the content of which is described in Section 2.2.2. Section 2.2.3 describes the content of Article 126(7) recommendations and Article 126(9) notices. Section 2.2.4 describes the preparation of a recommendation for a non-interest bearing deposit following a Council decision that an excessive deficit exists.

### 2.2.1. Establishing the existence of an excessive deficit or debt

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

The breach of the deficit criterion may be identified on the basis of outturns, plans or forecast data. The preparation of an Article 126(3) report on the basis of forecast data can be based on either the Member State’s plans –as outlined in their SCPs, DBPs, or in other announcements made by the government– or the Commission forecasts.

A planned breach of the debt criterion needs to be confirmed by outturn data in order to trigger the opening of an EDP. <sup>(73)</sup>

Although a breach of either the deficit or the debt criteria is sufficient to lead to the preparation of an Article 126(3) report, in some cases a Member State will be found to be in breach of both. In those cases, the Article 126(3) report will consider both criteria and an EDP may be launched on the basis of both criteria. <sup>(74)</sup>

#### 2.2.1.1. Establishing non-compliance with the deficit criterion

A Member State is non-compliant with the deficit requirement if its general government deficit is greater than 3% of GDP. No other considerations are taken into account before producing an Article 126(3) report on the basis of the deficit criterion. Indeed, the Commission must prepare a report whenever there is the risk of an excessive deficit or whenever the planned or actual government deficit exceeds the reference value of 3% of GDP. <sup>(75)</sup>

#### 2.2.1.2. Establishing non-compliance with the debt criterion

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

Compliance with the debt criterion should be examined when a Member State’s debt exceeds 60% of GDP. A breach of the reference value of 60% of GDP from below automatically triggers the production of an Article 126(3) report, unless the debt-to-GDP ratio goes below the reference value within the Commission forecast horizon. <sup>(76)</sup> In all other cases, a breach of the debt criterion is judged by considering compliance with the debt reduction benchmark in three configurations: the backward-looking version; by taking into account the impact of the cycle; and the forward-looking version. The backward- and forward-looking benchmarks are computed over a three-year horizon to avoid treating debt peaks as normal factors, hence, catering for the volatility that would result from a one-year rule. Moreover, the length and depth of economic cycles are asymmetric and unknown and cannot, of course, be guaranteed to fit into a six-year time period. This means that meeting the debt reference benchmark on either the backward- or forward-looking measures might at time require large fiscal efforts in bad times. As this is undesirable in itself, the debt reduction benchmark is also adjusted for the effect of the cycle. As per

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<sup>(73)</sup> Unlike the deficit criterion, there is no notion of planned breach of the debt criterion in the Treaty (Article 126(2) and Article 126(7) TFEU).

<sup>(74)</sup> See, for example, of the EDP launched in June 2013 for Malta: [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/30\\_edps/126-03\\_commission/2013-05-21\\_mt\\_126-3\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/2013-05-21_mt_126-3_en.pdf) ; and in January 2014 for Croatia: [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/30\\_edps/126-03\\_commission/2013-11-15\\_hr\\_126-3\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/2013-11-15_hr_126-3_en.pdf)

<sup>(75)</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A31997Y0802%2801%29>

<sup>(76)</sup> This is to ensure consistency of treatment with countries having debt-to-GDP ratio above 60% and meeting the forward-looking debt benchmark.

Regulation 1467/97, only if a Member State is in breach of all those conditions has the Commission the obligation to present an Article 126(3) report. <sup>(77)</sup> More specifically, a breach of the debt criterion is judged according to the steps set out in Graph 2.2, namely:

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

and

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

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

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

and

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

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

where  $bb_{t+2}$  stands for the forward-looking benchmark debt ratio;  $b_{t+1}$  and  $b_{t+2}$  stand for the debt forecast in year  $t+1$  and  $t+2$  as estimated by the Commission under the “no-policy-change” assumption (see Box 1.5) on the basis of the fiscal outcome of year  $t$ . If the Member State is being considered for an EDP on the basis of its outturn data, the year  $t$  in the formula applies to the year that has just ended.

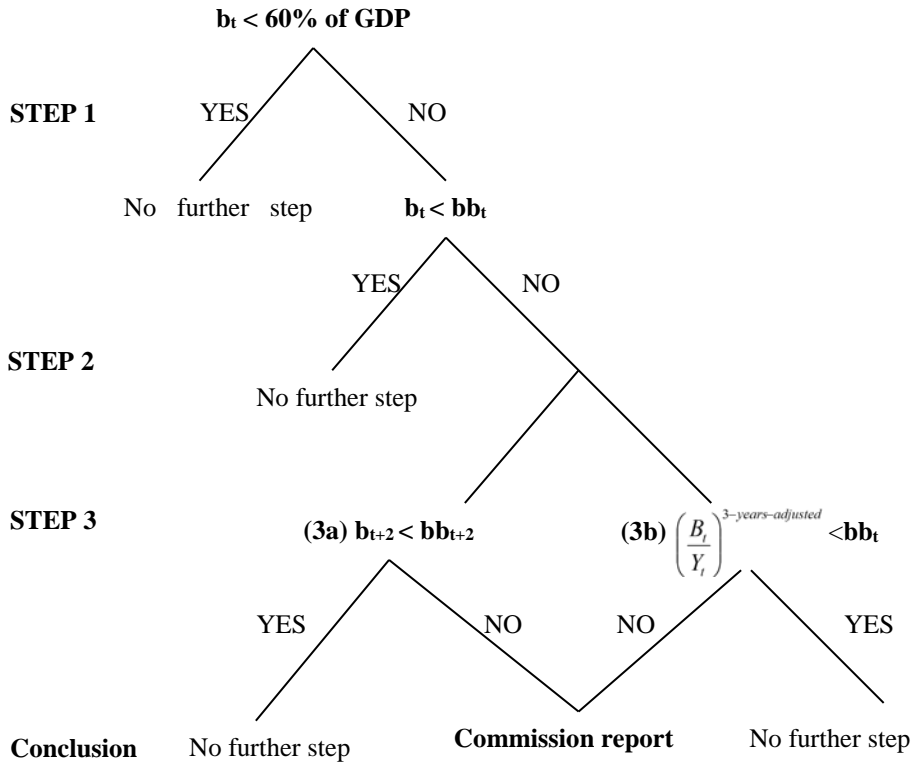
and

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

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<sup>(77)</sup> As explained in Section 2.2.2.3, as long as the Commission considers that the Member State’s situation has not changed since the last Article 126(3) report, it is not bound to produce another report.

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



The steps set out in Graph 2.2 do not apply when there is a breach of the reference value of 60% of GDP from below, as neither the backward- nor the forward-looking benchmark can be meaningfully computed in cases where a Member State goes above the reference value of 60% of GDP for the first time in year  $t$ . In such a case, the identified breach of the debt criterion automatically triggers the production of an Article 126(3) report, <sup>(78)</sup> in which due consideration is given to all the relevant factors (Section 2.2.2.2).

*The correction of the cycle*

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

Adjusting the debt-to-GDP ratio for the cycle consists of a correction of both the numerator and the denominator. The cyclical adjustment is undertaken as follows:

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

<sup>(78)</sup> Unless the debt-to-GDP ratio goes below the threshold reference value within the Commission forecast horizon.



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

That methodology therefore:

- corrects the debt level for the cyclical component of the deficit over the past three years. That adjustment implies that if the output gap is positive, the adjusted debt level will be larger than the observed debt and vice versa; and
- corrects the GDP level for the output gap over the past three years, so that the corrected level of GDP in time  $t$  represents the level that GDP would have reached if it had evolved according to its potential from year  $t-3$  on. The growth rate of the price deflator of GDP is used to convert real growth into nominal growth.

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

Member States that were in EDP when the Six-Pack amendments to the SGP were adopted (8 November 2011) are subject to transitional arrangements for the three years following the correction of their excessive deficit <sup>(79)</sup> in order to ensure that they have time to adapt their structural adjustments to the level needed to comply with the debt reduction benchmark. During those three years, compliance with the debt criterion is judged according to whether the Member State makes sufficient progress towards compliance. Thus, the debt requirement still applies during the transition period, as the Member States concerned must move towards compliance during that period.

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

1. The annual structural adjustment should not deviate by more than ¼ % of GDP from the linear structural adjustment ensuring that the least stringent condition consistent with the respect of the debt benchmark is met by the end of the transition period (minimum linear structural adjustment);
2. At any time during the transition period, the remaining annual structural adjustment should not exceed ¾ % of GDP. <sup>(80)</sup>

Those conditions should ensure that the path of deficit reduction chosen by the Member State is sustained over the three years of the transitional period (first condition) and is realistic (second condition), while providing some room for manoeuvre during the transition period. <sup>(81)</sup>

Whereas compliance is judged ex ante and ex post, only an observed breach of the MLSA can lead to the opening of a debt-based EDP. An ex ante assessment of compliance with the MLSA is undertaken both

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<sup>(79)</sup> The transition period does not begin on the date of the abrogation of the existing EDP, but with the correction of the deficit, which will typically take place in the year before the EDP is actually abrogated since abrogation can only take place based on actual data.

<sup>(80)</sup> That condition does not apply if the first condition implies an annual effort above ¾ % of GDP.

<sup>(81)</sup> Further details on the computation of the MLSA is presented on the Commission website:

[https://ec.europa.eu/info/files/numerical-examples-and-technical-aspects-hands-experts-2019-edition\\_en](https://ec.europa.eu/info/files/numerical-examples-and-technical-aspects-hands-experts-2019-edition_en)

on the basis of the plans submitted in the SCPs, which feeds the Country-Specific Recommendations concluding the European Semester, and every autumn for euro-area Member States on the basis of the DBPs in the associated Commission Opinion. The process is the following:

- Year 1: First year of the transition period

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

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

- Year 2: Second year of the transition period

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

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

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

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

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

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

## 2.2.2. Preparing an Article 126(3) report

The Article 126(3) report presents an assessment of the case for launching an EDP for a Member State on the basis of its deficit and/or debt position. The report is submitted to the EFC, which has two weeks following its adoption by the Commission to formulate an opinion under Article 126(4). The Council and the Commission shall make a balanced overall assessment of all the relevant factors, specifically, the extent to which they affect the assessment of compliance with deficit and/or the debt criteria as aggravating or mitigating factors.

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

The deficit criterion is considered in detail in the Article 126(3) report in the case of a reported or planned deficit of above 3% of GDP. The Treaty – and by extension the SGP – provides two exception clauses with regard to the opening of an excessive deficit procedure on the basis of the deficit criterion. Member

States are deemed to have complied with their deficit commitment if at least one of the two following conditions is met:

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

A deficit above 3% of GDP is considered exceptional when it results either (i) from an unusual event outside of the Member State's control and with a major impact on its public finances, or (ii) from a severe economic downturn. In relation to the treatment of unusual events such as natural disasters or, in recent years, the exceptional refugee inflows towards the Member States and security costs to tackle the heightened terrorist threat, the corrective arm envisages a similar provision to that contained in the preventive arm (see Section 1.3.5) with regard to opening an EDP. A severe economic downturn is defined<sup>(82)</sup> as a negative real growth of GDP or as an accumulated loss of output during a protracted period of very low real growth of GDP relative to its potential. The excess over a deficit of 3% of GDP is considered temporary if the Commission forecasts indicate that the deficit will fall below 3% of GDP following the end of the unusual event or the severe economic downturn, and if the deficit value is still close to 3% of GDP.

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

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

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

Regulation (EC) 1467/97 gives further details on the relevant factors to be taken into account, presenting a list that falls under three headings: developments in the medium-term economic position; developments in the medium-term budgetary position; and developments in the medium-term government debt position. However, the Regulation provides that that list is not exhaustive and that "*The Commission shall give due and express consideration to any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess compliance with deficit and debt criteria and which the Member State has put forward to the Council and the Commission. In that context, particular consideration shall be given to financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between Member States in the context of safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances*" (see Box 2.3). Regulation (EC) 1467/97 also includes as relevant factors "*the implementation of policies in the context of the prevention and correction of excessive macroeconomic imbalances, the implementation of policies in the context of the common growth strategy of the Union*". Therefore, the Commission Communication on flexibility of 13 January 2015 and the commonly agreed position on flexibility within the SGP endorsed by the Council on 12 February 2016 clarifies that Member States' contributions to the EFSI and the implementation of structural reforms (e.g. in the context of the European Semester, as well as within the Excessive Imbalances Procedure) fall under those categories and should be considered as relevant factors. Finally,

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<sup>(82)</sup> Article 2(2) of Regulation (EC) 1467/97.

Regulation (EU) 473/2013 requires that the extent to which the Member State has taken into account the Commission's Opinion on its DBP should also be considered as a relevant (mitigating or aggravating) factor.

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

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

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

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

When assessing “sufficient progress towards compliance” through the MLSA during the transition period, both the debt and the deficit figures are netted out from debt- and deficit-increasing operations, respectively. The same applies to the computation of the debt benchmarks (backward- and forward-looking), which are used to calculate the required annual MLSA.

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

Operations in the context of the Greek programme with an impact on the deficit of the supporting Member States (reduction of GLF margin and interest rates, distribution of SMP profits, etc.) are also subject to special consideration. Those operations do not lead to a Member State being placed in EDP on the basis of the deficit criterion because they are regarded as one-off and temporary measures, in line with the practice followed for other support operations in the context of the financial crisis, and as such netted out of the structural balance.

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

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

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

For a Member State that is already in EDP, a capital injection would not lead to a stepping-up of the procedure –

provided that the recommended fiscal effort had been delivered–, as one-off and temporary measures are netted out of the fiscal effort recommended to correct the excessive deficit by the deadline.

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

For Member States whose deficit does not significantly exceed a level that can be considered close to the 3% of GDP reference value and whose debt ratio does not exceed the 60% of GDP reference value, special consideration should be given to pension reforms, on the condition that overall fiscal sustainability is maintained. This acknowledges the fact that the budgetary implications of systemic pension reforms can be drawn out over a longer period while taking better account of the government’s capacity to absorb higher deficits over that protracted period.

Pension reforms that are eligible for consideration are those introducing a multi-pillar system that includes a mandatory, fully-funded pillar and publicly-managed pillar with an associated cost to the public finances. Special consideration should be given to the features of the overall pension system created by the reform, namely whether it promotes long-term sustainability while not increasing risks for the medium-term budgetary position.

In order to take the impact of any reforms into account, the net cost of the reform is measured as its direct impact on the general government deficit. Regulation (EC) 1467/97 is not explicit in what constitutes the net cost of such a reform, only referring to the “net costs of the publicly managed pillar”. The Code of Conduct on the SGP defines those costs as direct costs stemming from the fact that some of the government’s revenues has to be directed to the private pension pillar (adding to the costs of the reform), whereas some of the pension payments are, in fact, carried out by the private scheme instead of the public pillar (reducing the costs of the reform).

Consideration of the net cost should be part of a broader assessment of the overall features of the pension system created by the reform, namely whether it promotes long-term sustainability while not increasing risks for the medium-term budgetary position. In that way, Member States with a debt-to-GDP ratio below 60% that reform their pension system in a way that improves the long-term sustainability of their public finances but introduces short and medium-term costs, resulting in a slight excess over the deficit reference value of 3% of GDP, are not placed under the EDP on the basis of the excess related to the net costs of the reform.

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

The same relevant factors that may be taken into account for the opening of a deficit-based EDP are also borne in mind in the overall assessment for a Member State in breach of the debt requirements. In particular, adherence to the MTO, or the adjustment path towards it, is a relevant factor in assessing compliance with the debt criterion, as such adherence is supposed (under normal macroeconomic circumstances) to ensure sustainability or rapid progress to sustainability in the medium term. For a small number of Member States, there is a risk that the minimum MTO does not fulfil the forward-looking debt-reduction benchmark by the end of the next MTO three year cycle, i.e. by 2022. These Member States may wish to consider a more demanding MTO. In turn that factor needs to be evaluated in conjunction with an assessment of the overall economic environment (while considering that the debt reduction benchmark in itself already contains a correction for the impact of the cycle <sup>(83)</sup>), and other relevant factors, including implementation of structural reforms improving the sustainability of public

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<sup>(83)</sup> For a Member State breaching the 60% of GDP reference value from below, the current practice is to consider the cyclically-adjusted debt-to-GDP ratio in the context of the relevant factors, as in that case the sole identification of the breach of the debt criterion automatically triggers the production of an Article 126(3) report (Section 2.2.1.2) unless the debt-to-GDP ratio goes below the threshold reference value within the Commission forecast horizon.

finances, i.e. implying a downward shift in the path of the debt ratio at least in the medium term. In addition, the expected timeline for complying with the debt rule, under the assumption of a return to normal economic conditions, notably inflation, can provide a useful gauge when taking into account the relevant factors. The extent to which the Member State has taken into account the Commission’s Opinion on its DBP (see Section 3.1.3.3) is also a relevant factor to be considered. <sup>(84)</sup>

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

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

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

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

The contribution of SFAs to the evolution of gross government debt should be considered whenever an Article 126(3) report is prepared based on the debt criterion. That assessment of SFAs will not be quantitative in the sense that it will not yield a recalculated debt benchmark. Nevertheless, an adjustment to the change in gross government debt should be applied to reveal whether developments in SFAs justify the failure to meet the numerical debt benchmark. <sup>(85)</sup> In particular, gross debt should be “netted out” by the net acquisition of currency and deposits, to prevent the government’s cash management activity coming into conflict with its obligation to meet the debt criterion. This is further considered in Box 2.4.

**Box 2.4: CONSIDERING “STOCK-FLOW ADJUSTMENTS” FOR THE ASSESSMENT OF THE DEBT CRITERION**

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

*Currency holdings*

<sup>(84)</sup> Article 12(1) of Regulation (EU) 473/2013.

<sup>(85)</sup> Recital 14 to Council Regulation (EU) 1177/2011 foresees that the assessment of the composition of the stock-flow adjustment on debt developments may be sufficient to exclude the establishment of an EDP on the basis of the debt criterion.

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

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

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

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

#### *Intergovernmental loans*

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

#### *Other adjustments*

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

#### *2.2.2.3. Concluding the Article 126(3) report*

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

Following the Commission's report and taking fully into account the ensuing opinion from the EFC, if the Commission considers that an excessive deficit exists or may occur, it addresses an opinion to that effect to the Member State concerned and informs the Council accordingly, under Article 126(5) TFEU. The Commission also prepares a proposal for a Council decision on the existence of an excessive deficit under Article 126(6) TFEU and a recommendation for Council recommendations addressed to the Member State to correct the excessive deficit under Article 126(7) TFEU.

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

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

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

The Commission recommendation for a Council recommendation under Article 126(7) TFEU to correct the excessive deficit contains an analysis of the underlying macro-fiscal situation of the Member State, a timeframe within which the excessive deficit should be corrected, and annual targets for the nominal and structural deficit. Moreover, the recommendation specifies what those targets imply for the expenditure benchmark, i.e. the maximum allowable growth rate of expenditure net of discretionary revenue measures and of one-off (revenue and expenditure) measures.

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

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

Both EDP recommendations under Article 126(7) TFEU and decisions to give notice under Article 126(9) TFEU contain the following elements:

- A deadline for the correction of the excessive deficit. As a rule, when the EDP is launched in year  $t$ , following a Council decision on the existence of an excessive deficit, the latter should be corrected in year  $t+1$ . However, in case of special circumstances, a longer deadline could be set.
- A path towards the correction of the excessive deficit with intermediary annual targets for the general government balance. Even in the case of a deadline set for the year  $(t+1)$  following the identification of an excessive deficit (in  $t$ ), the EDP recommendation (or notice) would entail at least one intermediary nominal target (that of year  $t$ ).
- An annual fiscal effort of at least 0.5% of GDP as a benchmark, defined in terms of the improvement in the structural balance, consistent with the nominal path towards the correction of the excessive deficit.
- A deadline for the Member State concerned to adopt the necessary measures in order to comply with the recommendation.

In addition, the recommendations and notices should also specify what the annual targets imply for the expenditure benchmark. The Article 126(9) notice must also include a detailed specification of the measures and deadlines for their adoption.



### *Setting a path for the deficit and a deadline for correction*

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

The Code of Conduct on the SGP specifies:

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

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

Judging whether one year is sufficient to correct an excessive deficit requires a careful consideration of the magnitude of the necessary structural adjustment against both the urgency of the adjustment, in terms of the fiscal risk borne by the Member State in question, and the economic feasibility of such an effort. Article 2(6) of Regulation (EC) 1467/97 also indicates that relevant factors are taken into account when setting the deadline for the correction of the excessive deficit: “*If the Council, acting under Article 126(6) TFEU, decides that an excessive deficit exists in a Member State, the Council and the Commission shall, in the subsequent procedural steps of that Article of the TFEU, take into account the relevant factors referred to in paragraph 3 of this Article, as they affect the situation of the Member State concerned, including as specified in Article 3(5) and Article 5(2) of this Regulation, in particular in establishing a deadline for the correction of the excessive deficit and eventually extending that deadline.*” Thus, while the correction of an excessive deficit is expected to take place within the year following its identification, relevant factors including the implementation of major structural reforms are to be taken into account when considering instead a multiannual path for the correction of the excessive deficit, either in a new EDP or when extending the original deadline.<sup>(86)</sup> An additional year can also be considered, taking into account again both the economic feasibility and the urgency for the Member State to correct its excessive deficit in that additional year.

Irrespective of whether an EDP is opened due to a breach of the deficit or of the debt criterion, both Article 126(7) recommendations and Article 126(9) notices present a correction path with annual targets for the nominal and structural deficits. These are defined on the basis of an underlying macroeconomic scenario, as per the Commission forecasts. For Member States with the debt above 60% of GDP, the fiscal path has to take into account the need to comply with the debt benchmark so that the fiscal trajectory leads to a debt ratio that complies at least with the forward-looking element of the debt reduction benchmark at the end of the correction period, on a no-policy-change basis (see Box 1.5). As a

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<sup>(86)</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0012&from=en>

result, the level of the general government balance recommended for the final year may be above the Treaty reference value of a general government balance of -3% of GDP.

In line with Article 10 of Regulation (EU) 472/2013, the deficit targets for euro-area Member States under a macroeconomic adjustment programme should be integrated in the Article 126(7) recommendation or Article 126(9) notice. The measures needed to achieve those budgetary targets, as well as the deadlines for their implementation, are also to be specified in the Article 126(9) notice.

#### *Setting the expenditure benchmark*

The EDP recommendation is also formulated in terms of the expenditure benchmark, consistent with, and conducive to, the fulfilment of the targets for the headline deficit and the underlying improvement in the structural balance. If fully complied with, the expenditure benchmark effectively leads to a timely correction of the excessive deficit (including compliance with the forward-looking component of the debt reduction benchmark), as long as macroeconomic developments and events that are outside government control remain in line with the “EDP scenario”, i.e. the set of assumptions underpinning the EDP recommendation. Therefore, the benchmark rates are simply those that come out from the EDP scenario. Concretely, they are the limits to the annual changes in government expenditure consistent with meeting the targets for the headline deficit and the change in the structural balance. In the EDP recommendation, they are expressed in nominal terms for all the years covered by the recommendation.

The expenditure benchmark is net of the possible fiscal policy (discretionary) measures included on the revenue side in the EDP scenario. It excludes the projected amounts of interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. Nationally financed government gross fixed capital formation is smoothed over a four-year period. Any possible one-off measures, whether on the expenditure or on the revenue side, are also excluded. It is important to note that the calculation of the expenditure benchmark under the corrective arm is not the same as the calculation under the preventive arm (see Section 1.3.6).

The expenditure benchmark consistent with meeting the annual nominal and structural targets should be included in the Article 126(7) recommendations. As regards the Article 126(9) notices, they should in addition clearly specify both the necessary measures as well as the deadlines for their adoption, which define a timetable which will also bind the Member State to submit reports to show compliance with those requirements. The Article 126(7) recommendation also establishes a maximum deadline of six months for effective action to be taken and reported on in order to correct the excessive deficit in a timely manner. However, when justified by the seriousness of the situation, the deadline may be shortened to three months. It is four months in case of an Article 126(9) notice.

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

Along with the Article 126(7) recommendations (or notices), the Commission can request that euro-area Member States be subject to additional reporting requirements, as set out in Regulation (EU) 473/2013. <sup>(87)</sup> That request may occur at any point in the EDP for euro-area Member States that were not initially subject to it. In all cases, the Member States concerned will be required to submit the regular reports until the abrogation of their excessive deficit procedure. Those reporting requirements include a comprehensive assessment of budgetary execution at the time of the first report after the launch of the

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<sup>(87)</sup> Euro-area Member States under enhanced surveillance pursuant to Regulation (EU) 472/2013 are automatically made subject to that regular reporting, whether or not they are under EDP. Conversely, euro-area Member States under a macroeconomic adjustment programme are not made subject to that regular reporting as their obligations under their macroeconomic adjustment programme are sufficient to ensure the closer monitoring to which the regular reporting leads.

EDP and make it incumbent on the Member States to submit updates to the Commission every six months when under an Article 126(7) recommendation and every three months when under notice pursuant to Article 126(9) TFEU. The reports submitted should follow the specifications and templates of Commission Delegated Regulation (EU) 877/2013. <sup>(88)</sup>

#### 2.2.4. Sanctions: recommending a non-interest bearing deposit

For euro-area Member States, following the Council's adoption of a decision under Article 126(6) TFEU establishing the existence of an excessive deficit, the Commission shall issue a recommendation for a further Council decision requiring the Member State to lodge a non-interest bearing deposit if the Member State had lodged an interest-bearing deposit, following non-compliance with the recommendations in the preventive arm after a Commission warning, or on a case-by-case basis if the Commission identifies particularly serious non-compliance with the budgetary policy obligations laid down in the SGP. <sup>(89)</sup> When such a recommendation for a Council decision on sanctions is issued by the Commission, it will do so within 20 days of the Council's adoption of the Article 126(6) decision. The Council decision on the lodging of a non-interest bearing deposit is to be considered adopted unless the Council decides to reject the Commission's recommendation within ten days, using qualified majority voting. The amount of the non-interest bearing deposit is to equal 0.2% of the previous year's GDP, as a default and maximum value. However, the Commission may recommend that the Council reduce the amount or cancel the non-interest bearing deposit altogether. It may do so on the grounds of exceptional economic circumstances or following the reasoned request by the Member State concerned, addressed to the Commission within ten days of the Council's adoption of the Article 126(6) decision. The Council may also amend the Commission's recommendation for a deposit using qualified majority voting and adopt the amended text as a Council decision.

The deposit will be lodged with the Commission. If the Member State has already lodged an interest-bearing deposit, it will be turned into a non-interest bearing one and any difference in the applicable amount (taking into account the interest accrued) will be returned to the Member State or made up by it.

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

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

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

Article 126(7) recommendations and Article 126(9) notices contain a deadline for the Member State concerned to adopt the necessary measures to comply with the recommendation. Depending on whether the situation is deemed particularly serious or not, that deadline can be: three or six months in a recommendation; or four months in a Council decision to give notice. Within that deadline, the Member State must report to the Council and the Commission on action taken in response to the Council's recommendation or notice. The report, which is made public by the Member State, includes the targets for

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<sup>(88)</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0877&from=SV>

<sup>(89)</sup> Regulation (EU) 1173/2011, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A31997Y0802%2801%29>

government expenditure and revenue and for the discretionary measures on both the expenditure and the revenue side. Those elements should be consistent with the Council's requirements. The report should also contain information on the measures already taken and on the nature of those envisaged to achieve the targets. Those requirements do not apply to Member States under a macroeconomic adjustment programme.

In addition, in line with Regulation (EU) 473/2013, euro-area Member States subject to additional reporting requirements will provide, every six months when subject to a recommendation or every three months when subject to a notice, a comprehensive assessment of in-year budgetary execution for the general government and its subsectors including any financial risks stemming from contingent liabilities. That additional information should also be included in the first report on action taken. <sup>(90)</sup>

Regulation (EU) 473/2013 also requires euro-area Member States to submit EPP together with the report on the action taken following an Article 126(7) recommendation. <sup>(91)</sup> <sup>(92)</sup> The EPP is a one-off document where Member States describe the policy measures and structural reforms that they consider necessary to ensure an efficient and lasting correction of their excessive deficit. It should fully take into account the Council recommendations under the European Semester. The obligation for Member States to produce an EPP reflects the fact that excessive public deficits may be rooted –at least in part– in structural weaknesses. If those weaknesses are not directly addressed, budgetary measures may be insufficient to produce a lasting correction of the deficit. The EPP complements the budgetary measures taken over the course of an EDP with a wider strategy aimed at avoiding the occurrence of excessive deficits. It should identify specific priorities aiming to enhance competitiveness and long-term sustainable growth and addressing structural weaknesses in the Member State concerned. In particular, EPPs should detail the main fiscal structural reforms, such as those referring to taxation, pension, health systems and budgetary frameworks that will be instrumental to correct the excessive deficit in a lasting manner. Where appropriate, the EPPs should also identify the potential financial needs and resources.

In drawing up its EPP, the Member State should base its approach on the existing surveillance instruments, such as the CSRs issued to it by the Council at the end of the European Semester, in order to identify the set of structural reforms and priorities that will best underpin a lasting correction of its deficit. As a general guide, the relevant CSRs might be those referring to taxation, social security and health systems and budgetary frameworks. The EPP should, therefore, act as a continuation and intensification of the coordination between budgetary and structural policies which takes place under the European Semester.

Countries under the corrective arm of the MIP –known as the Excessive Imbalances Procedure– will already have drawn up a comprehensive roadmap of reforms when entering the Excessive Imbalances Procedure, known as the Corrective Action Plan. Those Member States are not asked to submit an EPP as their Corrective Action Plan can be amended to ensure that there is sufficient focus on measures that can underpin healthy public finances. Similarly, the link between the EPP and the Corrective Action Plan is recognised for Member States under the Excessive Imbalances Procedure once they are under EDP and have submitted an EPP. In those cases, the EPP should be incorporated in the new Corrective Action Plan, which then takes precedence in the monitoring.

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<sup>(90)</sup> The tables that should be used for the regular reporting for euro-area Member States under those additional reporting requirements can be found here:

<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0877&from=EN>

<sup>(91)</sup> Non-euro-area Contracting Parties of the TSCG that have chosen to be bound by the Fiscal Compact prior to adopting the euro (Bulgaria, Denmark and Romania) have also committed themselves to submitting an EPP. However, that commitment falls outside of the EU law framework.

<sup>(92)</sup> Member States subject to a macroeconomic adjustment programme do not have to submit EPPs, which is substituted by the programme conditionality.

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

The Commission is also allowed by Regulation (EU) 473/2013 to request a comprehensive independent audit of the public accounts and the provision of any available additional information for the purposes of monitoring progress towards the correction of the excessive deficit from euro-area Member States, on an ad hoc basis, independent of the activation of the additional reporting requirements. Box 2.5 provides more details.

**Box 2.5: ADDITIONAL AD HOC INFORMATION REQUESTS FROM EURO-AREA MEMBER STATES**

Pursuant to Regulation (EC) 473/2013 the Commission may require that euro-area Member States:

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

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

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

Following the submission by the Member State of the report on action taken, along with any other information requested by the Commission when relevant, the Commission undertakes a first assessment to evaluate compliance with the terms of the recommendation or notice according to an agreed methodology. This assessment considers whether the Member State concerned has publicly announced or taken measures that seem sufficient to ensure adequate progress towards the correction of the excessive deficit within the time limits set by the Council.

If the Commission considers that the Member State has acted in compliance with the recommendation (or notice) and that the EDP fiscal requirements are likely to be fulfilled, it informs the Council of its assessment and the procedure is put in abeyance (see Section 2.3.4). Otherwise, the procedure is either stepped up (if no effective action has been taken – see below) or, if the assessment of effective action is positive but “*unexpected adverse economic events with major unfavourable consequences for government finances occurred*” (Article 3(5) of Regulation (EC) 1467/97), a revised EDP recommendation or notice may be issued.

The notion of *adverse economic events* encompasses those developments outside of the government's control that may result in the deficit target not being met, in spite of the government putting in place measures that could have been expected to correct the deficit based on the scenario underlying the

recommendation. Those unexpected developments consist mainly of lower economic growth or a shortfall in revenues compared to what was expected at the time of the recommendation, as well as the impact of other unexpected and unusual events, such as natural disasters or, in recent years, the exceptional refugee inflows towards the Member States and security costs to tackle the heightened terrorist threat.

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

After the opening of an EDP and in tandem with the first assessment of effective action following an Article 126(7) recommendation, euro-area Member States' EPP is also assessed. To that end, the Commission prepares a proposal for a Council opinion on the EPP, following the guidance set out in Section 2.3.1.

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

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

Following the specifications provided in the Code of Conduct on the SGP, which are based on Regulation (EC) 1467/97, the logical and procedural steps for the assessment of effective action are summarised in a decision tree and summarised in Graph 2.3. <sup>(93)</sup> The Commission first examines whether the Member State concerned has met or is forecast to meet the recommended headline deficit target and the recommended underlying improvement in the structural balance. Compliance with both requirements leads to the EDP being held in abeyance.

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

To that end, the careful analysis first uses the expenditure benchmark to assess fiscal effort. If the expenditure benchmark is met, meaning that it shows an effort equal to or above what was recommended, there is a presumption that the Member State concerned has delivered on its policy commitments. If the

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<sup>(93)</sup> A numerical example of an assessment of effective action to an Article 126(7) recommendation or Article 126(9) notice is presented on the Commission website: [https://ec.europa.eu/info/files/numerical-examples-and-technical-aspects-hands-experts-2019-edition\\_en](https://ec.europa.eu/info/files/numerical-examples-and-technical-aspects-hands-experts-2019-edition_en)

expenditure benchmark is not met, there is a presumption the Member State has not delivered on its policy commitments.

In addition, the Commission uses qualitative economic judgement in making its final assessment to evaluate whether the Member State concerned has put in place enough actions to comply with the EDP recommendation. In sum, any conclusion needs to take into consideration the quantitative information from the expenditure benchmark together with other considerations –including of a qualitative nature– that do not emerge from the benchmark itself. Those considerations are typically related to the reasons that have caused the non-fulfilment of the expenditure benchmark and are directly linked to fiscal developments (see below).

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 (see Section 2.3.3). Conversely, if the careful analysis concludes that the Member State has not delivered on its policy commitments and that the headline deficit target is not met, the assessment will conclude on non-effective action and the procedure will be stepped up. However, an EDP cannot be stepped up if the Member State achieves its intermediate headline deficit targets, even if the policy commitments have not been delivered. At the same time, a careful analysis should be conducted to better understand the nature of the underlying budgetary developments. Where the absence of a stepping-up of the procedure is taken based on in-year data, the EDP can still be stepped up should the (notified) ex-post data show that the intermediate headline target was eventually not met.

It has to be borne in mind that the methodology for the assessment of effective action aims at assessing whether the action taken by the Member State is sufficient to meet the budgetary objectives of the recommendation or notice and is, as such, solely based on the analysis of indicators of budgetary effort. Therefore, a Member State's failure to deliver on effective action cannot be offset by structural reform efforts. By the same token, failure to deliver on structural reform commitments will not affect EDP abeyance decisions, if/when effective action has been delivered. The Commission Communication on flexibility of 13 January 2015 restated that the assessment of effective action remains as per the agreed methodology, which is focused on the delivery of the required budgetary effort. At the same time, the lack of implementation of the agreed <sup>(94)</sup> structural reforms can constitute an aggravating relevant factor: it could have a bearing at the margin of the careful analysis, in case of conflicting and inconclusive indications stemming from the top-down and bottom-up metrics. <sup>(95)</sup>

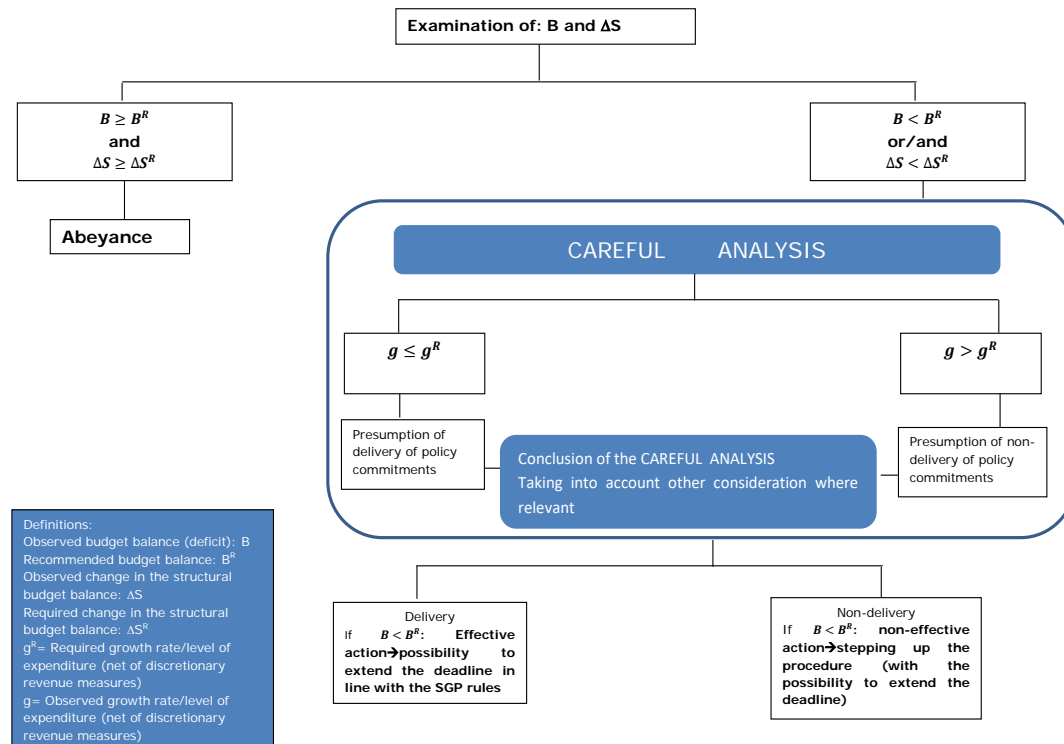
Focusing on the evolution of the fiscal variables in a given year can lead to an asymmetry in the assessment of compliance with the recommendations. The Commission, therefore, examines whether the fiscal effort over the correction period under scrutiny was delivered on a cumulative basis. In that way, a Member State cannot be unduly punished for a frontloaded effort. At the same time, it ensures that a Member State meeting its nominal target the first year without delivering the recommended annual fiscal effort would only be found compliant with the recommendation in the following years if it has delivered the cumulative fiscal effort over the correction period under scrutiny. Thus, for the purposes of the assessment of effective action, for Member States that do not meet the annual headline deficit target or the cumulative change in the structural balance, or neither of them, the assessment of the “cumulative” expenditure benchmark will be considered in the careful analysis together with other considerations where relevant.

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<sup>(94)</sup> E.g. the implementation of structural reforms in the context of the European Semester, such as within the Excessive imbalances procedure, as well as structural reforms detailed in the Economic Partnership Programme (see Section 2.3.2).

<sup>(95)</sup> The implementation of reforms cannot be expected to shift per se the conclusion in favour of a positive assessment of effective action given that it can be assumed that the reform effort would have already been taken into account in the formulation of the EDP recommendation or notice as a relevant factor that may warrant longer deadlines for correction of the excessive deficit.

Graph 2.3: The EDP decision tree for conducting effective action assessment



### The careful analysis: The expenditure benchmark

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, or both. In order to determine the reasons for the shortfall and ultimately whether the Member State has delivered on the policy commitments laid down in the recommendation, the careful analysis first and foremost builds on the outcome of the expenditure benchmark.

The expenditure benchmark approach takes into account “*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 on the SGP. Specifically, it focuses on aggregate expenditure developments and revenue-increasing (or decreasing) fiscal policy measures, i.e. on what is more directly under the control of the government.

When assessing compliance with the expenditure benchmark, expenditure is measured excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue, and non-discretionary changes in unemployment benefit expenditure. Nationally financed government gross fixed capital formation is smoothed over a four-year period. In addition, any possible fiscal policy measures on the revenue side are netted out from the expenditure aggregate. Any possible one-off measures, whether on the expenditure or on the revenue side, are excluded from the calculation, too. The net expenditure growth rate  $g_t$  for year  $t$  is computed as follows:

$$g_t = \frac{G_t - \Delta R_t - G_{t-1}}{G_{t-1}}$$



where  $G_t$  and  $\Delta R_t$  are the expenditure aggregate and the estimated impact of revenue measures having an incremental effect on revenues in year  $t$ , both net of one-off measures, as observed or forecast at the time of the assessment.

On the expenditure side, the change from the previous year ( $G_t - G_{t-1}$ ) is used as a proxy of the measures –both explicit and implicit ones– that determined the expenditure outcome in year  $t$ . Therefore, expenditure slippages (or underspending) are taken into account along with the effects of expenditure-increasing or decreasing measures clearly identified as such. On the revenue side, estimating the overall incremental effect of fiscal policy measures  $\Delta R_t$  requires that the measures are defined and their budgetary impacts are quantified.

Overall, if the net expenditure growth rate  $g_t$  is lower than, or equal to, the maximum allowable growth rate  $g_t^R$  contained in the EDP recommendation, the expenditure benchmark is met and there is a presumption that the Member State has delivered on its policy commitments. If not, the expenditure benchmark is not met and there is a presumption that the Member State has not delivered on its policy commitments.

#### *The careful analysis: Other considerations*

The Commission also uses qualitative economic judgement in making its final assessment. The careful analysis should, as indicated in the Code of Conduct on the SGP, provide a qualified economic judgement of the outcome of the expenditure benchmark that will allow the Commission to determine 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 factor, which is relevant to analyse fiscal effort beyond the expenditure benchmark indicator.

With the exclusion of the elements listed above (i.e. interest expenditure, expenditure on Union programmes fully matched by Union funds revenue, and non-discretionary changes in unemployment benefit expenditure), the smoothing of nationally financed gross fixed capital formation, and the exclusion of one-off measures, the expenditure benchmark leaves aside the effects of temporary factors or factors that lie to a large extent beyond government control. Similarly, temporary overreaction of (non-discretionary) revenues to economic fluctuations is not taken into account, as it does not affect the expenditure benchmark.

However, there might still be cases where the sole focus on the expenditure benchmark could lead to a biased conclusion. Other considerations may, therefore, be taken into account where relevant, including: possible statistical revisions in data; unexpected dynamics in certain expenditure items driven by unusual events out of government control; unforeseen inflation developments; or a high degree of uncertainty surrounding the quantitative assessment of the yields/costs of discretionary revenue measures.

All in all, the careful analysis determines 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 revenues and expenditures as well as for the discretionary measures consistent with those targets. Those measures should be described in detail so as to facilitate the assessment.

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

If a Member State is judged to have taken effective action and unexpected adverse economic events with major unfavourable consequences for government finances have occurred, the Commission may issue a recommendation for a revised Council recommendation to end the excessive deficit under Article 126(7)

TFEU. That new recommendation may extend the deadline for the correction of excessive deficit, usually by one year, although it could also issue new nominal and structural targets linked by a new underlying macroeconomic scenario, without extending the deadline. There is no obligation to extend the deadline. If the Commission does not choose to issue a revised recommendation, it may still do so in the future, provided that the Member State continues to be judged to have taken effective action.

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

- Either the Commission considers that the Member State has acted in compliance with the Article 126(7) recommendation (and when required informs the Council accordingly) and the procedure is placed in abeyance;
- Or the Commission considers that the Member State has taken effective action with regard to the Article 126(7) recommendation but that adverse unexpected events occurred. In this case, the Commission communicates its view that effective action has been taken, and presents the Council with a recommendation for a revised Article 126(7) recommendation. When this happens, the guidelines set out in Section 2.2.3 should be followed.
- Alternatively, the Commission may conclude that effective action has been taken, but that no revised recommendation should be issued. In that case, no further action is taken and the procedure is put in abeyance.

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

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

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

After the initial assessment of effective action, which is the only one specifically required by the SGP, Member States’ compliance with the recommendation (or notice) is subject to a continuous monitoring. That monitoring embeds specific milestones to take stock of the situation for euro-area Member States which have had the regular reporting requirements activated, as explained in Section 2.3.1. Those Member States will need to submit reports to the Commission and the EFC (every six months when subject to an Article 126(7) recommendation or every three months when subject to an Article 126(9) notice) after the initial report on action taken as outlined in Section 2.3.1. Those regular reports will cover the general government and its subsectors and present the in-year budgetary execution, the budgetary impact of discretionary measures taken on both the expenditure and revenue sides, targets for government expenditure and revenues and information on the measures adopted and the nature of those envisaged to achieve the fiscal targets. The specification of the content of the regular reports has been laid down in Commission Delegated Regulation 877/2013. <sup>(96)</sup>

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<sup>(96)</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:244:0023:0031:EN:PDF>

The regular Commission forecast exercises (Box 1.5) provide a natural occasion to check whether Member States (whether subject to the regular reporting or not) are still on track with the correction of their excessive deficit.

The Commission can issue an autonomous recommendation to formally warn Member States of a risk of non-compliance with the deadline for correction of their excessive deficit, before a lack of effective action has actually materialised. <sup>(97)</sup> The autonomous recommendation can call for the full implementation of the measures in the Council recommendation under Article 126(7) TFEU or in the notice under Article 126(9) TFEU, the adoption of other measures, or both, within a timeframe consistent with the deadline for correction of the excessive deficit. It is not meant to replace a stepping up of an EDP; instead its role is to warn Member States that can still meet the deadline for correcting their excessive deficits if the observed risks are catered for on time. It can assist in the case where there is a risk of the structural effort falling short of the one required, even if the nominal is on track as such a situation still entails risks. Where Member States are issued with a Commission autonomous recommendation, the assessment of whether they have complied with it should be taken into account in the assessment of compliance with the Council recommendation under Article 126(7) TFEU or notice under Article 126(9) TFEU as an aggravating or mitigating factor.

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

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

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

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

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<sup>(97)</sup> That possibility does not apply with regard to Member States under a macroeconomic adjustment programme.

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

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

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

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

As part of the follow-up to an Article 126(8) decision, the Commission may undertake surveillance missions (inviting representatives of the European Central Bank, if appropriate) to the Member State for the purpose of on-site monitoring. <sup>(98)</sup> In that case, the Commission will report the findings of its mission to the Council and may use them to inform its assessment of effective action.

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

Following the Council's adoption of a decision under Article 126(8) TFEU establishing a lack of effective action in response to the Article 126(7) recommendations, the Commission will issue a recommendation for a Council decision requiring the euro-area Member State to pay a fine equal to 0.2% of its previous year's GDP. The Commission is to issue its recommendation within 20 days of the Council's adoption of the Article 126(8) decision. The fine will be payable to the Commission and will be assigned to the European Stability Mechanism (pursuant to Article 10 of Regulation (EU) 1173/2011). If the Member State had already lodged a non-interest bearing deposit (see Section 2.2.4), the latter will be converted into a fine and any difference in the applicable amount will be returned to the Member State or made up by it.

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

While the default position is for the Commission to ask for a fine equal to 0.2% of the Member State's previous year's GDP, the Commission may recommend that the Council reduce the amount or cancel the

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<sup>(98)</sup> In accordance with Article 10a of amended Regulation (EC) 1467/97.

fine altogether. It may do so on the grounds of exceptional economic circumstances or following the reasoned request by the Member State concerned, addressed to the Commission within ten days of the Council's adoption of the Article 126(8) decision. Moreover, the Council may also amend the Commission's recommendation for a fine, using qualified majority voting, and adopt the amended text as a Council decision.

All Member States, except the United Kingdom, could also have a suspension of commitments –or payments– of the European Structural and Investment Funds, following an Article 126(8) decision. For (non-euro-area) Member States subject to a second or subsequent Article 126(8) decision, the application of macroeconomic conditionality should involve an increase in suspensions. Box 2.6 explains that macroeconomic conditionality.

#### **BOX 2.6: EUROPEAN FUNDS CONDITIONALITY IN 2014-2020**

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

Since 1 January 2014 the conditionality clause applies to the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund. The extension of the macroeconomic conditionality to all the ESI Funds means that it now applies to all Member States, <sup>(99)</sup> as all Member States are recipients of at least some of those funds. Non-compliance with specific elements of the SGP can therefore lead to a suspension of funding in addition to the provisions contained in Regulation (EC) 1467/97 on the corrective arm and in Regulation (EU) 1173/2011 for euro-area Member States. The idea underlying that macroeconomic conditionality is that the effectiveness of cohesion policy should not be undermined by unsound fiscal and macroeconomic policies.

There are two mechanisms for suspending financing under the ESI Funds. The first is after a lack of effective action by the Member State following a Commission request to review and propose amendments to its Partnership Agreement and relevant programmes (“first strand”). Such a request can be made in order to support reforms addressing Council recommendations under the European Semester or the Excessive Imbalances Procedure, or to maximise the impact of the funds for Member States receiving financial assistance. <sup>(100)</sup> That mechanism is therefore not directly linked to the quantitative assessments under the SGP, although it is linked to the Country-Specific Recommendations issued under the preventive arm of the SGP. In addition, following the commitment taken at the Statement of 20 December 2013, <sup>(101)</sup> the Commission adopted a Communication in July 2014 <sup>(102)</sup> that provides guidelines on how some of the provisions of that mechanism linking effectiveness of ESI Funds to sound economic governance will be implemented.

The second mechanism (“second strand”) is both automatic and directly linked to the corrective arm of the SGP. It provides for suspensions of ESI Funds in the event of non-compliance with specific elements of the EDP, the Excessive Imbalances Procedure and adjustment programmes linked to financial assistance. In terms of the EDP, a Council decision on a lack of effective action under Article 126(8) TFEU or Article 126(11) TFEU will automatically lead to a Commission proposal for the suspension of part or all of the commitments under the ESI Funds. In the case

<sup>(99)</sup> The only exception to this is the United Kingdom, which by virtue of Article 23(13) of Regulation (EU) 1303/2013 is exempt from any suspensions of commitments or payments of the Funds, based in particular on Protocol 15 of the TFEU on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland.

<sup>(100)</sup> A request to re-programme can only be made between 2015 and 2019.

<sup>(101)</sup> Statement by the European Commission on Article 23, OJ C 375, 20.12.2013, p. 2.

<https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2013:375:0002:0004:EN:PDF>

<sup>(102)</sup> Commission Communication on *Guidelines on the application of the measures linking effectiveness of the European Structural and Investment Funds to sound economic governance according to Article 23 of Regulation 1303/2013*, of 30 July 2014, <http://ec.europa.eu/transparency/regdoc/rep/1/2014/EN/1-2014-494-EN-F1-1.Pdf>

where immediate action is sought, or where there has been significant non-compliance – the Commission may instead propose a suspension of part or all of the payments rather than commitments.

A Commission proposal on the suspension of commitments is subject to Reverse Qualified Majority Voting (RQMV) in the Council. <sup>(103)</sup> It is deemed adopted unless a qualified majority of the Council decides to reject it within one month of its submission. Once adopted, it applies to commitments from 1 January of the forthcoming year. Conversely, a Commission proposal on the suspension of payments is subject to normal qualified majority voting in the Council. Once adopted, it applies to requests for payment submitted after the date of the decision to suspend.

Regulation (EU) 1303/2013 sets out specific conditions for both the scope and the level of suspensions that the Commission may propose: the principles of proportionality, equal treatment between Member States and the need to take the economic and social circumstances and the impact of the suspension on the economy of the Member State concerned will have to be taken into account. Annex III to the Regulation provides details on how those conditions should be applied. <sup>(104)</sup>

For a decision to suspend commitments following a first decision on a lack of effective action under Article 126(8) TFEU, the suspension can be at most equal to 50% of the commitments or 0.5% of GDP and applies to the year following the decision to suspend. Those limits can increase gradually to 100% of the next year's commitments, following subsequent decisions on a lack of effective action, in line with the seriousness of non-compliance, and to 1% of nominal GDP in the case of persistent non-compliance with the EDP.

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

#### 2.4.3. Procedures following a lack of effective action in response to a notice under Article 126(9) TFEU: Imposing sanctions on euro-area Member States <sup>(105)</sup>

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

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

- a requirement for the Member State concerned to make public additional information, to be specified by the Council, before issuing bonds and securities;
- an invitation to the European Investment Bank to reconsider its lending policy towards the Member State.

<sup>(103)</sup> Annex 3 provides more details on voting arrangements, including RQMV.

<sup>(104)</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2013:375:0002:0004:EN:PDF>

<sup>(105)</sup> Article 139(2) TFEU provides that the provisions of Articles 126(9) and 126(11) apply to those Member States whose currency is the euro.

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

In addition, the application of macroeconomic conditionality linked to the European Structural and Investment Funds should be widened, as set out in Box 2.8. With each decision on a lack of effective action, the Commission will recommend an increase in suspensions.

## 2.5. ABROGATION OF THE EDP

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

For the deficit criterion, compliance with the nominal requirement is absolute, apart from the possibility of taking into account the cost of pension reforms. Rules related to the treatment of pension reforms imply that an EDP may be abrogated even if the government deficit of the Member State concerned is above the 3% of GDP threshold, but only if its debt-to-GDP ratio is below 60% of GDP, the deficit remains close to the 3% of GDP threshold, and the net costs of a systemic pension reform explain the excess in the deficit. Decisions on EDP abrogation do not allow for any flexibility with respect to unusual events, however, and a Member State could see the abrogation of its EDP delayed if the costs associated with the unusual event keep the headline deficit above the 3% of GDP threshold.

Irrespective of the structural effort implemented, a “lasting correction” is deemed achieved if:

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

and

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

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

For the debt criterion, the requirement is as follows:

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

or,

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

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

Table 2.2 details possible cases in which an EDP abrogation can be considered, in relation to the fulfilment of the forward-looking element of the debt benchmark, for a deficit- or a debt-based EDP. One point deserves attention. When the forward-looking element of the debt benchmark is fulfilled, Member States are assessed according to the position of their general government deficit vis-à-vis the 3% of GDP Treaty reference value. However, when the forward-looking element of the debt benchmark is not fulfilled, Member States are assessed according to the position of their general government deficit vis-à-vis the target set in the recommendation for the final year: this can lead to a revised recommendation or to a stepping-up of the procedure (along with a revised recommendation).

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

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

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



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

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

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

This Part focuses on the institutional processes of budgetary surveillance and is divided into two Sections. Section 3.1 considers the institutional dimension of the EU's budgetary surveillance, placing the Stability and Convergence Programmes and the Draft Budgetary Plans in the context of not just budgetary but also wider economic surveillance. Section 3.1 also discusses the submission and reporting requirements related to both the Stability and Convergence Programmes and the Draft Budgetary Plans. Section 3.2 discusses obligations on Member States in terms of their own budgetary processes, stemming from the Six-Pack, the Two-Pack, and the Fiscal Compact established by the intergovernmental TSCG.

## 3.1. EU BUDGETARY PROCESSES

### 3.1.1. The annual cycle of integrated budgetary and economic surveillance

The surveillance of budgetary and economic policies takes place every year within the European Semester. The European Semester aims to ensure that the surveillance of budgetary and economic policies takes place in an integrated manner. That process of integrated surveillance allows for consistent policy guidance at European level to inform the timely setting of national policy.

The European Semester is launched each year by the presentation of the Annual Growth Survey <sup>(106)</sup> by the European Commission. In that document, the Commission presents its assessment of the economic situation in the EU and sets out the priorities for the coming year in terms of the economic and budgetary policies and reforms to boost growth and employment. At the same time, the Commission publishes recommendations on the economic policy of the euro area for adoption by the Council. That common timing reflects common challenges for the euro area ahead of country-specific discussions. In addition, an Alert Mechanism Report is published under the Macroeconomic Imbalances Procedure, to identify which Member States deserve closer attention through in-depth reviews, which are integrated in Country Reports. At the end of February, the Commission releases Country Reports for all Member States. Those reports, in the form of Staff Working Documents, analyse Member States' economic and social developments. They identify key macroeconomic and structural challenges and assess progress in advancing reforms. Importantly, they analyse the existence and the extent of possible macroeconomic imbalances for those Member States selected as requiring an in-depth review based on the reading of the Alert Mechanism Report. The March European Council reports in its conclusions on the discussion of the Annual Growth Survey and endorses policy priorities for Member States.

Following the adoption of the European Council conclusions, Member States submit their Stability and Convergence Programmes (SCPs) to the Commission and the Council in April, preferably by mid-April and not later than 30 April. These outline the public finance plans of Member States and are submitted alongside the National Reform Programmes (NRPs), which outline economic plans and report on progress made over the past year.

Based on the Country Reports and upon examining the NRPs and SCPs, the Commission proposes to the Council Country-Specific Recommendations in relevant policy areas. The Commission proposal includes its opinion for relevant Member States (all except Member States subject to a macroeconomic adjustment programme) on their SCP.

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<sup>(106)</sup> [http://ec.europa.eu/europe2020/making-it-happen/annual-growth-surveys/index\\_en.htm](http://ec.europa.eu/europe2020/making-it-happen/annual-growth-surveys/index_en.htm)

Based on the Commission's proposals, the Council adopts CSRs). This is a particularly important step of budgetary surveillance as it is the first time that the fiscal requirement for the year ahead is set. The Council opinions on each Member State's SCP are reflected in the recitals and the first recommendation of the CSRs. The recommendations for each Member State are discussed and endorsed by the European Council in June before being adopted by the Council. In line with Article 2-ab of Regulation (EC) 1466/97 the Council is "expected to, as a rule, follow the recommendations and proposals of the Commission or explain its position publicly". This is known as the "comply or explain" principle and is not just confined to the European Semester. It creates a strong presumption that the Council's opinion will follow the Commission's proposal, unless any divergence from it can be backed up by strong public explanations.

In addition to the documents submitted directly to the Commission and the Council, euro-area Member States are obliged to publish their national medium-term fiscal plans at the same time as their Stability Programmes. The national medium-term fiscal plans must contain at least all the information contained in the Stability Programmes and must be consistent with the framework for economic policy coordination in the context of the annual cycle surveillance, including the policy guidance issued at the beginning of the cycle and with recommendations issued under the SGP, the European Semester and the opinions on the Economic Partnership Programmes. In fact, national medium-term fiscal plans and Stability Programmes may be the same document. If a euro-area Member States chooses that option, it should clearly state in the Stability Programme that the latter is to be regarded as the national medium-term fiscal plan.

The surveillance cycle continues in the autumn with an assessment of euro-area Member States' Draft Budgetary Plans (DBPs) for the next year. There is a common budgetary timeline, according to which euro-area Member States must prepare and transmit their DBPs for the forthcoming year to the Commission and the Eurogroup by 15 October. The Code of Conduct on the Two-Pack <sup>(107)</sup> further stipulates that Member States' DBPs should be submitted to the Commission and the Eurogroup no earlier than 1 October.

The Commission adopts an Opinion on each DBP by 30 November at the latest. The opinion focuses on the (ex ante) assessment of compliance with obligations under the SGP. In that way, guidance is provided to euro-area Member States throughout the whole budgetary cycle. At the same time, the Commission also presents an overall assessment of the budgetary situation and prospects in the euro area as a whole, based on the plans submitted. <sup>(108)</sup>

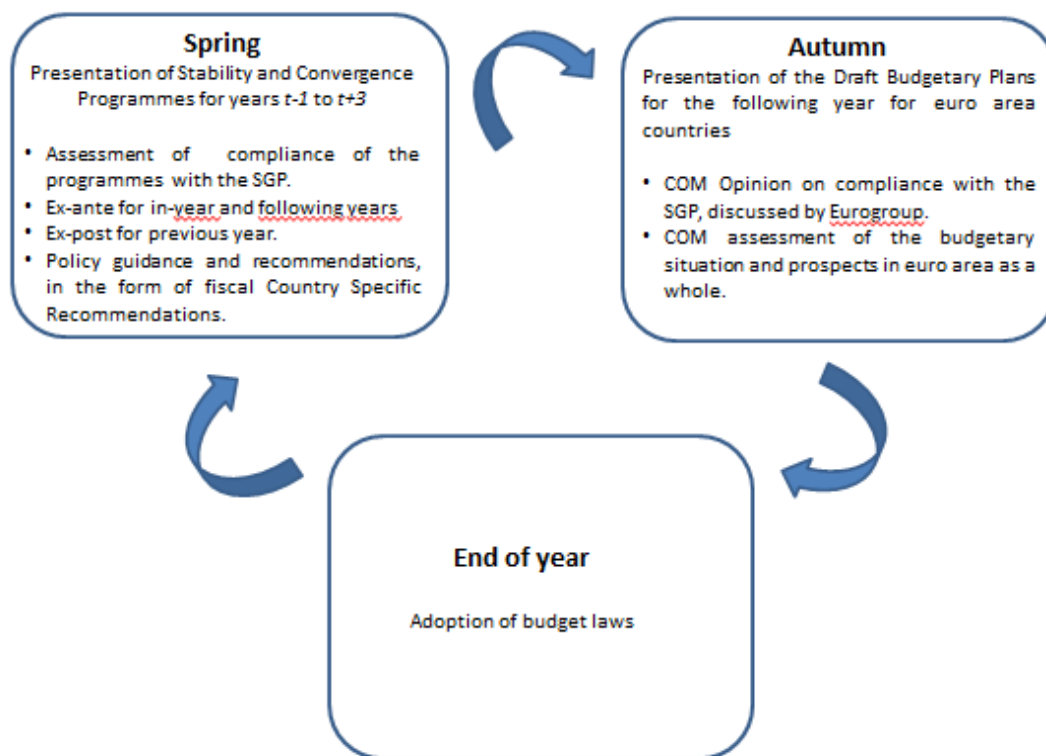
Graph 1.1 gives an overview of the annual cycle of budgetary surveillance. The assessment of the SCPs occurs alongside the publication of the Commission spring forecasts, while the Commission opinion on the DBPs is issued based on the publication of the Commission autumn forecasts. Furthermore, the Commission can issue an autonomous recommendation in relation to an open EDP when appropriate (see Section 2.3.4).

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<sup>(107)</sup> [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/coc/2014-11-07\\_two\\_pack\\_coc\\_amended\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf)

<sup>(108)</sup> See [https://ec.europa.eu/info/sites/info/files/economy-finance/comm\\_chapeau\\_211118.pdf](https://ec.europa.eu/info/sites/info/files/economy-finance/comm_chapeau_211118.pdf)

Graph 3.1: The annual cycle of budgetary surveillance



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

Regulation (EU) 472/2013 streamlines the requirements of the SGP for euro-area Member States under a macroeconomic adjustment programme. Specifically, those Member States are:

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

### 3.1.2. The Stability and Convergence Programmes

#### 3.1.2.1. Submission requirements

In accordance with Regulation (EC) 1466/97, Member States are required to submit annually SCPs to the Council and the Commission in April. Member States in the euro area submit Stability Programmes while Member States outside the euro area submit Convergence Programmes. <sup>(109)</sup> While the assessments of the SCPs cover both the preventive and the corrective arms of the Pact depending on the circumstances of each Member State, under Regulation (EC) 1466/97 the SCPs play a specific role under the preventive arm as they serve as the means for assessing ex ante compliance with the preventive arm.

Member States' programmes must be consistent with the policy priorities endorsed at European Council level and with the NRPs, which focus on structural and employment policies. A range of economic and budgetary data must be included. Section 3.1.2.2 discusses those requirements in more detail. The main economic and fiscal data presented should cover the year that just ended (year  $t-1$ ), the current year (year  $t$ ), and at least the following three years (year  $t+1$  to  $t+3$ ).

The Commission assesses the content of the SCPs in terms of the compliance of Member States' policies with the policy priorities endorsed by the European Council, and with the requirement to attain or to be on the adjustment path towards the MTO. An assessment of compliance with information requirements is also undertaken. Coherence with economic policy guidelines and compliance with the information requirements are based on a qualitative assessment, as discussed in Section 3.1.2.2.

Compliance with the MTO or the adjustment path towards it is the cornerstone of the budgetary analysis, including compliance with the expenditure benchmark. If the Council considers that the objectives and the content of the programme should be strengthened with particular reference to the adjustment path towards the MTO, it will invite the Member State concerned to adjust its programme on the basis of a Commission recommendation (Articles 5(2) and 9(2) of Regulation (EC) 1466/97).

#### 3.1.2.2. The reporting requirements

The content of the SCPs should comply with the requirements of Regulation (EC) 1466/97 and the Code of Conduct of the SGP. Member States are expected to follow those guidelines and to justify any departure from them. The standardisation of the format and content of the programmes is intended to ensure equal treatment. Overall, the SCPs should include data that enable a quantitative assessment of the Member State's fiscal outturns and plans, which conform to the requirements set out in the legislation, and which show that government policy is in line with the policy guidelines agreed on at Union level. <sup>(110)</sup> <sup>(111)</sup>

#### *Economic and budgetary forecasts and plans*

In order to enable the Council and the Commission to assess compliance with the MTO requirement, including an assessment of the expenditure benchmark, the SCPs must present a fully-fledged multi-annual macroeconomic scenario, projections for the main fiscal variables and their relevant components, and a description and quantification of the envisaged budgetary strategy. Given that the MTO is the

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<sup>(109)</sup> That requirement applies to all countries, except euro -area Member States under a macroeconomic adjustment programme in line with Regulation (EU) 472/2013. See Section 3.1.1.

<sup>(110)</sup> The tables to be supplied are available in the Code of Conduct on the SGP: <http://data.consilium.europa.eu/doc/document/ST-9344-2017-INIT/en/pdf>

<sup>(111)</sup> The same reporting requirements hold also for Member States in the corrective arm. Member States in the preventive arm interested in availing of the structural reform clause can apply for the clause using an additional table, which is presented on the Commission website: [https://ec.europa.eu/info/files/numerical-examples-and-technical-aspects-hands-experts-2019-edition\\_en](https://ec.europa.eu/info/files/numerical-examples-and-technical-aspects-hands-experts-2019-edition_en)

overarching goal of the preventive arm, Member States should report in their SCPs the MTO that they are aiming at as well as the planned adjustment path towards it.

In addition, Member States must provide the following information: budgetary targets for the general government balance in relation to the MTO and the projected path for the general government debt ratio; an update of the fiscal plans for the year of submission of the programme, based on the April notification of fiscal data, <sup>(112)</sup> including a description of the policies and quantification of measures, with information on expenditure and revenue ratios and on their main components (including one-off and other temporary measures); and the planned growth path of government expenditure and government revenue at unchanged policies (explaining the underlying assumptions, methodologies and relevant parameters), along with a quantification of the planned discretionary revenue measures. Budget balances should be broken down by subsector of general government and structural reforms should be specifically analysed when they are flagged as contributing to the achievement of the objectives of the programme.

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

#### *Macroeconomic forecasts*

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

Stability Programmes and national medium-term fiscal plans should be based on macroeconomic forecasts that have been produced or endorsed by an independent body (Section 3.2.2 provides more details). There is also a requirement for Member States to indicate whether their budgetary forecasts have been produced or endorsed by an independent body.

As part of the SCPs, the macroeconomic and budgetary forecasts should be compared to the most recent available Commission forecasts and, if appropriate, those of other independent bodies. Significant differences between the chosen macro-fiscal scenario and the Commission forecast should be explained in detail, especially if the level or growth of external assumptions departs significantly from the Commission forecasts.

#### *Quality of data*

In order to enhance cross-country comparability and to ensure high quality, the concepts used should be in line with the standards established at EU level, in particular in the context of the European System of Accounts (ESA). <sup>(113)</sup> Moreover, the forecasts presented should be prepared in a manner that is consistent with the requirements of Directive 2011/85/EU, which relate primarily to the credibility of the forecasts and the transparency with which they are prepared and presented.

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<sup>(112)</sup> The requirement to report public finance data to the Commission in the context of the EDP stems from Council Regulation (EC) 479/2009, <https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:145:0001:0009:EN:PDF>

<sup>(113)</sup> The revised European System of Accounts (ESA 2010), applied since September 2014, is set up by Regulation (EU) 549/2013 of the European Parliament and of the Council of 21 May 2013 *on the European system of national and regional accounts in the European Union*, <https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:174:0001:0727:EN:PDF>

### *Consistency of policy measures*

In addition to the data listed above, the SCPs should provide information on the consistency of the budgetary objectives and the measures to achieve them with the broad economic policy guidelines and the NRPs. <sup>(114)</sup> A description of the measures taken or envisaged to improve the quality of the public finances, as well as information on existing or envisaged national budgetary rules (expenditure rules, etc.) and any other institutional features, relative to the public finances should also be included in the SCPs. Given the inevitability of forecasting errors, the SCPs should include a comprehensive sensitivity analysis and/or develop alternative scenarios in order to enable the Commission and the Council to consider the complete range of possible fiscal outcomes.

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

### *3.1.3. The Draft Budgetary Plans for the euro area*

#### *3.1.3.1. Submission requirements*

There is a common budgetary timeline, according to which euro-area Member States must prepare and make public their draft budget for the forthcoming year by 15 October. <sup>(115)</sup> The Code of Conduct on the Two-Pack <sup>(116)</sup> further stipulates that Member States' DBPs should be submitted to the Commission and the Eurogroup no earlier than 1 October.

The Code of Conduct on the Two-Pack recognises that a Member State may be ruled by a government not enjoying full budgetary powers in terms of the national constitutional rules and/or conventions at the time when the draft budget law should be submitted to the national parliament (e.g. caretaker government or end-of mandate government by reason of upcoming national elections). In those cases, the deadline of 15 October, as it results from Article 6(1) of Regulation (EU) 473/2013 and the timeline set out in the Code of Conduct still apply and the Member State should submit a DBP prepared on a no-policy change basis. The incoming government should submit an updated DBP to the Commission and to the Eurogroup once it takes office.

The Code of Conduct provisions are intended to preserve the Two-Pack's spirit of enhanced budgetary cooperation, which aims at equipping the debate in the national parliament with an independent opinion from the Commission before the final approval of the budget, while allowing for the flexibility needed to cover different national processes and situations. The submission of an updated DBP should as a rule take place at least one month before the draft budget law is planned to be adopted by the national parliament, except where to do so would prove not feasible due to the country-specific parliamentary approval

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<sup>(114)</sup> Euro-area Member States under EDP that have submitted an Economic Partnership Programme (EPP) should provide in their Stability Programmes, information on the implementation of their EPP or any additional information requested in the Council opinion on their EPP. See Section 2.3.1.

<sup>(115)</sup> That requirement applies to all countries, except euro-area Member States under a macroeconomic adjustment programme in line with Regulation (EU) 472/2013. See Section 3.1.1.

<sup>(116)</sup> [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/coc/2014-11-07\\_two\\_pack\\_coc\\_amended\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf)

calendar. In the latter case, the submission should still take place in time to allow the Commission to adopt an informed opinion on the DBP and the Eurogroup to hold a proper discussion well before the draft budget law is planned to be adopted by the national parliament.

The DBPs translate the budgetary plans from the Stability Programmes into concrete and detailed macro-fiscal projections and measures for the forthcoming year. They are synthetic documents that present the actual measures that the government is placing before the national parliament.

The DBPs are then examined by the Commission to check their compliance with the SGP requirements and the fiscal CSRs issued under the European Semester. Section 3.1.3.2 describes the relevant requirements. Then, as detailed in Section 3.1.3.3, the Commission issues an Opinion on each plan by the latest on 30 November, which is meant to allow changes to be made to the draft budget before its adoption.

The Commission assesses the DBPs for ex ante and in-year compliance with the Member State's obligations under the SGP, covering both the preventive and corrective arms of the Pact, as appropriate for each Member State. The methodology and the rationale used for the assessment of compliance of the DBPs is the same that applies to the assessment of the Stability and Convergence Programmes in spring, as outlined in Section 1.3.

#### *3.1.3.2. The reporting requirements*

The content of the DBPs must comply with Regulation (EU) 473/2013 and the Code of Conduct on the Two-Pack, which set out guidelines on their content and format. Member States are expected to follow those guidelines, and to justify any departure from them. In order to facilitate comparisons across countries, Member States are expected, as far as possible, to follow the model structure for the plans presented in the Code of Conduct on the Two-Pack, summarising quantitative information in a standardised set of tables. <sup>(117)</sup> That standardisation of the format and content of the plans should ensure equality of treatment. The DBPs should show whether the draft budget is consistent with the SGP.

#### *Economic and budgetary forecasts and plans*

The DBPs should contain projections for the main variables relative to government finances as well as their relevant components, including a detailed description of the discretionary measures included in the draft budget. They should provide detailed information on the underlying macroeconomic scenario in order to allow their fiscal information to be assessed in the appropriate context. From the fiscal side, they should contain general government budgetary targets broken down by subsector along with detailed information on general government debt. Those overall figures allow an assessment of compliance of the overall strategy with the SGP. General government expenditure and revenue projections should be given both at unchanged policy (explaining the assumptions, methodologies and relevant parameters) and in terms of targets. There should also be a description of the discretionary measures taken by the central government (and other subsectors of the general government, where possible) that will bridge the gap between the targets and the unchanged policy figures, in order to assess possible risks linked to the attainment of such targets. Discretionary measures should be presented in terms of an exhaustive technical description of the measures taken by all sub-sectors, along with information concerning the motivation, design and implementation of the measures. The time profile of measures should be given in

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<sup>(117)</sup> The tables to be supplied are available in the Code of Conduct on the Two Pack:  
[http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/coc/2014-11-07\\_two\\_pack\\_coc\\_amended\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf)



such a way as to distinguish between measures with a transitory budgetary effect, which does not lead to sustained change in the intertemporal budgetary position, and those that have a permanent impact. <sup>(118)</sup>

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

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

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

The figures presented must be based on realistic and cautious macroeconomic forecasts that have been produced or endorsed by an independent body (Section 3.2.2 provides more details) and Member States are required to indicate whether this is the case.

#### *Quality of the data*

The quality of the data should be in line with the standards established at European level (see Section 3.1.2.2).

#### *3.1.3.3. Preparing the Commission opinion on the Draft Budgetary Plans*

The Commission must issue an opinion on each DBP as soon as possible after its submission and at the latest by 30 November.

Unlike the CSRs under the European Semester, the opinions on the DBPs are adopted by the Commission, not the Council. Once adopted, those opinions will be made public and presented to the Eurogroup, alongside a Commission assessment of the overall budgetary situation and prospects in the euro area as a whole. That assessment may outline measures to reinforce the coordination of budgetary and macroeconomic policy in the euro area. Furthermore, the Commission should present its opinion to the national parliament of the Member State concerned at its request, after it has been made public. The opinion will serve as an additional element to be taken into account as a relevant factor in any subsequent steps under the SGP, especially where an excessive deficit materialises, following risks identified in the opinion not being addressed by the Member State.

Following the Commission's assessment of DBPs (see Section 1.3), the opinion will either indicate a (broad) positive assessment of the plan or will point out the underlying risks that could stem from the implementation of the plan for the forthcoming year. In the case of particularly serious non-compliance with the SGP the opinion will indicate a negative opinion and request submission of a revised plan. The

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<sup>(118)</sup> To ensure that the Commission can use the information received by the Member States in a consistent manner across countries and over time, all Member States should provide information as much as possible based on the Commission's methodologies for making budgetary forecasts under the no-policy change assumption and for the classification of one-off measures, published in the Report on Public Finances in EMU 2016 (Part II, Chapter 1) and 2015 (Part II, Chapter 3), respectively.

opinion will be based on the adequacy and likely impact of the discretionary measures included in the draft budget in meeting the Member State’s obligation with respect to the SGP.

In the case of particularly serious non-compliance with the SGP, an opinion will be adopted according to the timetable set out in Table 3.1. In such cases, the Commission must consult the Member State within one week of receiving the DBP and will then adopt its opinion requesting a revised plan within two weeks of the submission of the DBP.

According to the Code of Conduct on the Two-Pack, if as a result of the consultation process the Member State concerned decides to modify the draft budget, notably through additional measures, to avoid being issued a negative opinion, the changes to the DBP should be publicly announced. They should also ideally be embedded, if feasible, in an updated DBP before the expiry of the two-week deadline for the adoption of an opinion requesting a revised DBP.

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

Table 3.1: Process for the autumn assessment of DBPs

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

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

- if an obvious breach of the Treaty deficit or debt criteria would follow from the implementation of the DBP;
- for Member States in the preventive arm of the SGP, if the fiscal effort envisaged in the DBP falls clearly short of the fiscal effort recommended by the Council in accordance with existing Council recommendation issued in accordance with Article 121(4) TFEU;

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

### 3.2. NATIONAL BUDGETARY PROCESSES

While the European dimension of budgetary policy is set through overarching fiscal rules and associated sanctions, the detailed characteristics and implementation of budgetary choices remain the competence of the Member States. However, recent reforms have brought about a shift in the approach by which Member States conduct fiscal policy domestically.

Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States<sup>(119)</sup> sets out minimum standards that Member States have to comply with in terms of their national budgetary framework, which is defined as comprising the arrangements, procedures, rules and institutions that underlie the conduct of budgetary policies. It establishes requirements on fiscal statistics and accounting, on the preparation of macroeconomic and budgetary forecasts, the setting up and monitoring of fiscal rules, the medium-term budgetary planning, and the transparency of general government finances. In addition, it specifies that compliance with national fiscal rules should be overseen by an independent body or one with functional autonomy with respect to the fiscal authorities.

Following on the heels of the directive, the TSCG committed those of its Contracting Parties that are bound by the Fiscal Compact chapter<sup>(120)</sup> to introducing a balanced-budget rule in structural terms – defined essentially as a country attaining its MTO– into their national law, with independent bodies being charged with monitoring compliance with that rule.

Regulation (EU) 473/2013 incorporated a large part of the TSCG requirements in the Union framework. Specifically, it provided for the setting up of independent bodies to be involved in the budgetary process, through the preparation or endorsement of forecasts and the monitoring of national fiscal rules (including, in particular, those incorporating the MTO in the national budgetary processes). Section 3.2.1 considers the requirement of translating the MTO into national fiscal rules and Section 3.2.2 considers the role of independent bodies, in more detail.

#### 3.2.1. National balanced-budget rules and the MTO

The TSCG commits its Contracting Parties, which are bound by the Fiscal Compact, to incorporating the MTO and the adjustment path towards it into national law through “provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the budgetary process”. In addition, they should put in place correction mechanisms to be triggered automatically in the event of significant deviations from the MTO or the adjustment path towards it, which should include an obligation for the Contracting Party to implement measures to correct the deviations over a defined period of time. In that sense, the TSCG adds a national layer to Union law, requiring the Contracting Parties to integrate the requirements of the preventive arm of the SGP in their

<sup>(119)</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32011L0085:EN:NOT>

<sup>(120)</sup> Fiscal Compact refers to the provisions of the TSCG that are specifically related to budgetary surveillance. The Contracting Parties that are bound by the provisions of the Fiscal Compact are all 19 euro-area Member States and 3 non-euro-area Member States (Bulgaria, Denmark and Romania).

national legislation. As foreseen by Article 8 of the TSCG, in February 2017 the Commission published a report on the measures adopted by the Contracting Parties in that regard. <sup>(121)</sup> <sup>(122)</sup>

The requirement to incorporate the MTO and the adjustment path towards it into national law aims to ensure that compliance with the MTO is at the heart of the budgetary decisions taken by national governments. The TSCG follows the specifications of the SGP in defining the MTO, including the requirement that compliance with the MTO be judged on the basis of the structural balance and the expenditure benchmark and that a temporary deviation from the MTO or the adjustment path towards it can be permitted in exceptional circumstances (known as the escape clause, as defined in the SGP). Importantly, it goes beyond the SGP by stipulating a tighter lower bound of -0.5% of GDP for the MTO (compared to -1% of GDP in the SGP for euro-area Member States) for all Contracting Parties except those with debt significantly below 60% of GDP and for whom risks in terms of long-term sustainability of public finances are low. The lower bound is set at -1% of GDP for those countries. Given the methodology to set the minimum MTO (as set out in Section 1.2.2), there should be no contradiction between the SGP and the TSCG requirements in most cases.

Under the TSCG the Commission was to propose “common principles” underlying the design of the requested corrective mechanisms. The Commission Communication on *Common principles for the national correction mechanisms* was published on 20 June 2012. <sup>(123)</sup> The Common principles concern: the legal status of enshrining the correction mechanism in national law; consistency with the EU framework, especially as regards the notion of a “significant deviation” and the definition of possible escape clauses; the activation of the correction mechanism within well-defined circumstances; the nature of the correction on the basis of predetermined rules; operational instruments; the definition of escape clauses; and independent bodies tasked to support the credibility and transparency of the correction mechanism.

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

### 3.2.2. The role of independent bodies in the national budgetary processes

#### 3.2.2.1. The mandates of the independent bodies

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

- monitor compliance with numerical fiscal rules, including those incorporating the MTO into the national budgetary process. The independent bodies will provide public assessments with respect to national fiscal rules, including with respect to the activation and operation of the national correction mechanism and the escape clauses;
- prepare or endorse the macroeconomic forecasts (and, if so chosen by the Member State, the budgetary forecasts) underlying the national medium-term fiscal plans (which may be the SCPs themselves) and the draft budgets.

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<sup>(121)</sup> [https://ec.europa.eu/info/sites/info/files/c20171201\\_en.pdf](https://ec.europa.eu/info/sites/info/files/c20171201_en.pdf)

<sup>(122)</sup> The TSCG foresees that, by January 2018, steps shall be taken to bring the substance of the TSCG into the EU legal framework, on the basis of an assessment of experience with its implementation. On 6 December 2017, the Commission put forward a legislative proposal to that end.

<sup>(123)</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0342:FIN:EN:PDF>

Regulation (EU) 473/2013 leaves open the possibility that those two functions could be served by two –or even more– independent bodies, provided they fulfil requirements attesting to their independence. It defines independent bodies as bodies that are structurally independent or bodies endowed with functional autonomy vis-à-vis the budgetary authorities of the Member State, and which are underpinned by national legal provisions ensuring a high degree of functional autonomy and accountability, including:

- i. a statutory regime grounded in national laws, regulations or binding administrative provisions;
- ii. not taking instructions from the budgetary authorities of the Member State concerned or from any other public or private body;
- iii. the capacity to communicate publicly in a timely manner;
- iv. procedures for nominating members on the basis of their experience and competence;
- v. adequate resources and appropriate access to information to carry out their given mandate.

#### *3.2.2.2. Key role in preparing the forecasts underlying the budgetary process*

Regulation (EU) 473/2013 requires that the macroeconomic forecasts underlying the DBPs, national medium-term fiscal plans and the draft budgets be produced or endorsed by independent bodies. Member States should indicate in those documents whether the endorsement or production model has been chosen. In addition, they should indicate whether independent bodies have prepared or endorsed the budgetary forecasts. Given the link between the national medium-term fiscal plans and the Stability Programmes, <sup>(124)</sup> the requirements relating to the involvement of independent bodies in the preparation of the forecasts effectively also translate to the Stability Programmes.

In order to ensure that independent bodies are able to fulfil their task in preparing or endorsing the macroeconomic forecasts in line with the requirements on forecasts set out in Directive 2011/85/EU, Member States should define and adopt transparent forecasting procedures, setting out specific criteria and procedural safeguards. The Code of Conduct on the Two-Pack further specifies some considerations for national arrangements framing the involvement of independent bodies in the production or endorsement of macroeconomic forecasts.

Specifically, in the case of macroeconomic forecasts produced by the independent body, the independent body should have in place a dedicated procedure for that purpose as set out in Directive 2011/85/EU, which should be consistent with the stages of the national budgetary process and related timetable. The Ministry of Finance should provide support to facilitate the production of macroeconomic forecasts by the independent body, such as access rights to relevant budgetary information, including budgetary execution data. Additionally, national legislation or the internal procedures of the Ministry of Finance should define rules governing the handling of forecasts received from the independent body.

Analogously, for the macroeconomic forecasts produced by public sector entities and submitted for endorsement to the independent body, Member States should lay down implementing aspects of the endorsement process (including deadlines for action and the consequences arising from the forecast-related decisions of the independent body), without prejudice to the independent assessment of the endorsing body. The independent body should make clear whether or not it endorses the forecasts and provide the underlying justifications. It is understood that, while endorsement would enable the use of the relevant forecasts for fiscal planning purposes, if the independent body decides that conditions are not met to endorse the macroeconomic forecasts underpinning the programme/plan, that lack of endorsement would typically trigger a review of the forecasts in the light of comments issued by the independent body. A revised forecast may be produced and submitted for assessment to the independent body, which would have to issue a new decision.

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<sup>(124)</sup> In fact, national medium-term fiscal plans and Stability Programmes may be the same document.

Irrespective of the choice of having forecasts produced or endorsed independently, Member States should have in place specific mechanisms to cope with situations in which there are different views between the independent body and the Ministry of Finance on the main variables of the forecast. They could, for example, take the form of arrangements to reach an agreement. <sup>(125)</sup>

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<sup>(125)</sup> Beyond the aforementioned requirements deriving from Union legislation and the TSCG, national legislation in some euro-area Member States has entrusted independent bodies with additional tasks (e.g. sustainability computations, costing, promotion of budgetary transparency) or provided a higher degree of specification of the tasks referred to in Union legislation. The exact nature and degree of detail of such tasks may depend on political appetite at the national level, which can itself be influenced by specific considerations, such as identified weaknesses in national fiscal-policy processes, the federal (or heavily decentralised) structure of some Member States, or severe fiscal consolidation challenges.

## ANNEX 1

### LINKS TO THE RELEVANT TEXTS INCLUDING LEGISLATION

#### **Treaties**

Treaty of the Functioning of European Union (including Protocol No. 12)

<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT&from=EN>

Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (including the Fiscal Compact)

[https://www.consilium.europa.eu/media/20399/st00tscg26\\_en12.pdf](https://www.consilium.europa.eu/media/20399/st00tscg26_en12.pdf)

#### **Regulation on the preventive arm of the SGP**

Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies

Original from 1997:

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1997:209:0001:0005:EN:PDF>

Consolidated following Council Regulation (EC) No 1055/2005 of 27 June 2005 and Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1466:20111213:EN:PDF>

#### **Regulation on the corrective arm of the SGP**

Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure

Original from 1997:

<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31997R1467&from=EN>

Consolidated following Council Regulation (EC) No 1056/2005 of 27 June 2005 and Council Regulation (EU) No 1177/2011 of 8 November 2011

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1467:20111213:EN:PDF>

#### Other texts linked to the SGP or its application

Resolution of the European Council on the Stability and Growth Pact, Amsterdam, 17 June 1997

[http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997Y0802\(01\):EN:HTML](http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997Y0802(01):EN:HTML)

European Council Presidency conclusions of 22-23 March 2005, endorsing and including the ECOFIN Council report of 20 March 2005 on “Improving the implementation of the Stability and Growth Pact

[http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/coc/2005-03-23\\_council\\_presidency\\_conclusions\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2005-03-23_council_presidency_conclusions_en.pdf)

Council Regulation (EC) No 479/2009 of 25 May 2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:145:0001:0009:EN:PDF>

Regulation (EU) No 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0001:0007:EN:PDF>

Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0041:0047:EN:PDF>

Code of Conduct: “Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes”, revised version 16 June 2017

<http://data.consilium.europa.eu/doc/document/ST-9344-2017-INIT/en/pdf>

Communication from the Commission on “Making the best use of the flexibility within the existing rules of the Stability and Growth Pact”, of 13 January 2015

<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0012&from=en>

Commonly agreed position on Flexibility in the Stability and Growth Pact, of 12 February 2016

<http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf>

Opinion of the Economic and Financial Committee on “Improving the predictability and transparency of the SGP: A stronger focus on the expenditure benchmark in the preventive arm”, of 6 December 2016

<http://data.consilium.europa.eu/doc/document/ST-14814-2016-INIT/en/pdf>

Opinion of the Economic and Financial Committee on “Improving the assessment of effective action in the context of the excessive deficit procedure – A specification of the methodology”, of 6 December 2016

<http://data.consilium.europa.eu/doc/document/ST-14813-2016-INIT/en/pdf>

Proposal for a Council Directive laying down provisions for strengthening fiscal responsibility and the medium-term budgetary orientation in the Member States, of 6 December 2017

[https://ec.europa.eu/info/sites/info/files/economy-finance/com\\_824\\_0.pdf](https://ec.europa.eu/info/sites/info/files/economy-finance/com_824_0.pdf)



### **The macroeconomic imbalances procedure**

Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0025:0032:EN:PDF>

Regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0008:0011:EN:PDF>

### **Legislation and other documents related to the Two-Pack**

Regulation (EU) No 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0001:0010:EN:PDF>

Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area

<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0473&from=EN>

Commission Delegated Regulation (EU) No 877/2013 of 27 June 2013, supplementing Regulation (EU) No 473/2013 on reporting obligations of euro-area Member States subject to the excessive deficit procedure

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:244:0023:0031:EN:PDF>

Code of Conduct: “Specifications on the implementation of the Two-Pack and guidelines on the format and content of draft budgetary plans, economic partnership programmes and debt issuance reports”, of 8 November 2016

[http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/coc/2014-11-07\\_two\\_pack\\_coc\\_amended\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf)

### **Further explanation of technical aspects**

On the Commission’s “Constrained judgement” approach to assess the output gap: 2017 Report on Public Finances in EMU, Part II, Chapter 3

[https://ec.europa.eu/info/publications/economy-finance/report-public-finances-emu-2017\\_en](https://ec.europa.eu/info/publications/economy-finance/report-public-finances-emu-2017_en)

On the no-policy change assumption in the Commission’s forecast: 2016 Report on Public Finances in EMU, Part II, Chapter 1

[https://ec.europa.eu/info/sites/info/files/ip045\\_en\\_0.pdf](https://ec.europa.eu/info/sites/info/files/ip045_en_0.pdf)

On one-off measure-classification principles used in fiscal surveillance: 2015 Report on Public Finances in EMU, Part II, Chapter 3

[https://ec.europa.eu/info/publications/economy-finance/report-public-finances-emu-2015\\_en](https://ec.europa.eu/info/publications/economy-finance/report-public-finances-emu-2015_en)

On the Commission's cyclical adjustment methodology and the semi-elasticities and weights currently used: 2018 Report on Public Finances in EMU, Part II, Chapter 2

[https://ec.europa.eu/info/sites/info/files/economy-finance/ip095\\_en.pdf](https://ec.europa.eu/info/sites/info/files/economy-finance/ip095_en.pdf)

On the role of revenue windfalls in fiscal surveillance under the preventive arm of the SGP: 2018 Report on Public Finances in EMU, Part II, Chapter 3

[https://ec.europa.eu/info/sites/info/files/economy-finance/ip095\\_en.pdf](https://ec.europa.eu/info/sites/info/files/economy-finance/ip095_en.pdf)

On the methodology underlying the calculation of the sustainability component of the minimum Medium-Term Budgetary Objective: The 2018 Ageing Report: Underlying Assumptions and Projection Methodologies

[https://ec.europa.eu/info/sites/info/files/economy-finance/ip065\\_en.pdf](https://ec.europa.eu/info/sites/info/files/economy-finance/ip065_en.pdf)

On the risks to overall debt sustainability: The 2018 Fiscal Sustainability Report: Volume 1

[https://ec.europa.eu/info/sites/info/files/economy-finance/ip094\\_en\\_vol\\_1.pdf](https://ec.europa.eu/info/sites/info/files/economy-finance/ip094_en_vol_1.pdf)

## ANNEX 2

### UPDATE OF THE MINIMUM BENCHMARKS AND MINIMUM MEDIUM-TERM BUDGETARY OBJECTIVES

Table A2.1: Minimum benchmark results: current vs new methodology

| Country           | Minimum benchmark for 2019<br>(current methodology) | Minimum benchmark for 2020<br>(new methodology) |
|-------------------|---|---|
| <b>BE</b>         | -1.4  | -1.5  |
| <b>BG</b>         | -1.9  | -1.3  |
| <b>CZ</b>         | -1.5  | -1.5  |
| <b>DK</b>         | -0.9  | -1.3  |
| <b>DE</b>         | -1.3  | -1.5  |
| <b>EE</b>         | -0.8  | -0.7  |
| <b>IE</b>         | -1.0  | -1.2  |
| <b>EL</b>         | -2.0  | -0.7  |
| <b>ES</b>         | -1.0  | -0.8  |
| <b>FR</b>         | -1.0  | -1.4  |
| <b>HR</b>         | -1.1  | -1.2  |
| <b>IT</b>         | -0.8  | -1.4  |
| <b>CY</b>         | -0.8  | -0.8  |
| <b>LV</b>         | -1.6  | -0.9  |
| <b>LT</b>         | -1.3  | -0.9  |
| <b>LU</b>         | -1.2  | -1.3  |
| <b>HU</b>         | -1.1  | -1.5  |
| <b>MT</b>         | -1.5  | -1.5  |
| <b>NL</b>         | -0.8  | -1.5  |
| <b>AT</b>         | -1.5  | -1.5  |
| <b>PL</b>         | -0.8  | -1.4  |
| <b>PT</b>         | -1.0  | -1.3  |
| <b>RO</b>         | -1.5  | -1.2  |
| <b>SI</b>         | -0.9  | -1.1  |
| <b>SK</b>         | -1.5  | -1.4  |
| <b>FI</b>         | -0.5  | -1.0  |
| <b>SE</b>         | -0.8  | -1.4  |
| <b>UK</b>         | <b>-0.8</b>   | <b>-1.4</b>                                     |
| <i>EU average</i> | <i>-1.2</i>   | <i>-1.2</i>                                     |

Table A2.2: Updated minimum MTOs and current MTOs <sup>(126)</sup>

| Country       | Current minimum MTO<br>2017-2019 | New minimum MTO<br>2020-2022 | Binding factor* | Current MTO set for 2019** | Applicability of the Fiscal Compact*** |
|---------------|----------------------------------|------------------------------|-----------------|----------------------------|--|
| <b>BE</b>     | -0.50                            | 0.00                         | ILD             | 0.00                       | Yes                                    |
| <b>BG</b>     | -2.25                            | -1.25                        | ILD             | -1.00                      | Yes                                    |
| <b>CZ</b>     | -1.50                            | -0.75                        | ILD             | <b>-1.00</b>               | No                                     |
| <b>DK</b>     | -1.00                            | -1.00                        | EA-ERM2         | -0.50                      | Yes                                    |
| <b>DE</b>     | -0.50                            | -1.00                        | ILD             | -0.50                      | Yes                                    |
| <b>EE</b>     | -1.00                            | -0.75                        | MB              | -0.50                      | Yes                                    |
| <b>IE</b>     | -0.50                            | -1.00                        | EA-ERM2         | -0.50                      | Yes                                    |
| <b>EL****</b> | na                               | 0.25                         | ILD             | na                         | Yes                                    |
| <b>ES</b>     | -1.00                            | -1.00                        | MB              | 0.00                       | Yes                                    |
| <b>FR</b>     | -1.00                            | -1.00                        | EA-ERM2         | -0.40                      | Yes                                    |
| <b>HR</b>     | -1.75                            | -1.25                        | MB              | <b>-1.75</b>               | No                                     |
| <b>IT</b>     | -0.50                            | 0.50                         | ILD             | <b>0.00</b>                | Yes                                    |
| <b>CY</b>     | -1.00                            | -1.00                        | ILD             | 0.00                       | Yes                                    |
| <b>LV</b>     | -1.00                            | -1.00                        | MB              | -1.00                      | Yes                                    |
| <b>LT</b>     | -1.00                            | -1.00                        | MB              | -1.00                      | Yes                                    |
| <b>LU</b>     | -1.00                            | 0.50                         | ILD             | <b>-0.50</b>               | Yes                                    |
| <b>HU</b>     | -1.50                            | -1.00                        | ILD             | <b>-1.50</b>               | No                                     |
| <b>MT</b>     | -0.50                            | -1.00                        | ILD             | 0.00                       | Yes                                    |
| <b>NL</b>     | -1.00                            | -1.00                        | EA-ERM2         | -0.50                      | Yes                                    |
| <b>AT</b>     | -0.75                            | -0.75                        | ILD             | -0.50                      | Yes                                    |
| <b>PL</b>     | -1.25                            | -1.50                        | MB              | -1.00                      | No                                     |
| <b>PT</b>     | 0.25                             | 0.00                         | ILD             | 0.25                       | Yes                                    |
| <b>RO</b>     | -1.75                            | -1.25                        | MB              | -1.00                      | Yes                                    |
| <b>SI</b>     | 0.25                             | -0.25                        | ILD             | 0.25                       | Yes                                    |
| <b>SK</b>     | -1.00                            | -1.00                        | EA-ERM2         | -0.50                      | Yes                                    |
| <b>FI</b>     | -1.00                            | -1.00                        | MB              | -0.50                      | Yes                                    |
| <b>SE</b>     | -1.25                            | -1.50                        | MB              | -1.00                      | No                                     |
| <b>UK</b>     | -0.75                            | -0.50                        | ILD             | <b>-0.75</b>               | No                                     |

\* Binding factor refers to the component that gives rise to the most demanding value for the minimum MTO (ILD = lower bound taking into account implicit liabilities and debt; EA-ERM2 = lower bound for euro area or ERM2 Member States; MB = Minimum Benchmark).

\*\* Are highlighted in bold cases where the current MTO is lower than the new minimum MTO.

\*\*\* Contracting parties that are bound by the Fiscal Compact. They are subject to more stringent MTO-related requirements than the one envisaged in the SGP. A limit of -0.5% of GDP is required except for Member States with debt significantly below 60% of GDP and where risks in terms of long-term sustainability of public finances are low, in which case a limit of -1.0% is possible.

\*\*\*\* MTO to be set for the first time after the economic adjustment programme.

<sup>(126)</sup> These values represent a lower bound for the MTOs to be nominated by Member States in their SCPs. In order to promote ownership of the MTOs, it is up to each Member State to choose an MTO that reflects its individual needs.

## ANNEX 3

### UPDATE OF FISCAL SEMI-ELASTICITIES

| Country            | Revenue      |               | Expenditure   |               | Budget balance |              |
|--------------------|--------------|---------------|---------------|---------------|----------------|--------------|
|                    | 2014         | 2018          | 2014          | 2018          | 2014           | 2018         |
| BE                 | 0,015        | -0,006        | -0,591        | -0,621        | 0,605          | 0,615        |
| BG                 | -0,084       | -0,077        | -0,391        | -0,375        | 0,308          | 0,298        |
| CZ                 | -0,012       | -0,033        | -0,446        | -0,428        | 0,433          | 0,395        |
| DK                 | -0,001       | -0,017        | -0,620        | -0,606        | 0,619          | 0,589        |
| DE                 | -0,009       | -0,011        | -0,560        | -0,515        | 0,551          | 0,504        |
| EE                 | 0,037        | 0,025         | -0,406        | -0,461        | 0,443          | 0,486        |
| IE                 | 0,019        | 0,021         | -0,508        | -0,501        | 0,528          | 0,522        |
| EL                 | -0,023       | -0,030        | -0,506        | -0,554        | 0,483          | 0,524        |
| ES                 | 0,011        | 0,006         | -0,528        | -0,591        | 0,539          | 0,597        |
| FR                 | 0,002        | 0,004         | -0,601        | -0,626        | 0,603          | 0,630        |
| HR                 | -0,011       | -0,042        | -0,479        | -0,485        | 0,467          | 0,443        |
| IT                 | 0,038        | 0,022         | -0,501        | -0,522        | 0,539          | 0,544        |
| CY                 | 0,071        | 0,064         | -0,452        | -0,440        | 0,523          | 0,504        |
| LV                 | -0,028       | -0,038        | -0,408        | -0,416        | 0,380          | 0,378        |
| LT                 | 0,022        | -0,008        | -0,391        | -0,407        | 0,413          | 0,399        |
| LU                 | 0,003        | -0,012        | -0,442        | -0,474        | 0,445          | 0,462        |
| HU                 | -0,019       | -0,041        | -0,511        | -0,494        | 0,492          | 0,453        |
| MT                 | 0,007        | 0,063         | -0,449        | -0,416        | 0,456          | 0,479        |
| NL                 | 0,066        | 0,054         | -0,579        | -0,551        | 0,646          | 0,605        |
| AT                 | 0,012        | -0,006        | -0,569        | -0,577        | 0,580          | 0,571        |
| PL                 | 0,027        | 0,026         | -0,494        | -0,473        | 0,521          | 0,499        |
| PT                 | -0,019       | -0,021        | -0,525        | -0,559        | 0,506          | 0,538        |
| RO                 | -0,045       | -0,054        | -0,384        | -0,375        | 0,339          | 0,321        |
| SI                 | -0,006       | -0,036        | -0,483        | -0,504        | 0,477          | 0,468        |
| SK                 | -0,005       | -0,041        | -0,398        | -0,422        | 0,393          | 0,381        |
| FI                 | -0,030       | -0,054        | -0,604        | -0,636        | 0,574          | 0,582        |
| SE                 | -0,020       | -0,014        | -0,609        | -0,567        | 0,590          | 0,553        |
| UK                 | 0,120        | 0,094         | -0,471        | -0,456        | 0,591          | 0,550        |
| <b>EU-28</b>       | <b>0,024</b> | <b>0,017</b>  | <b>-0,539</b> | <b>-0,537</b> | <b>0,563</b>   | <b>0,554</b> |
| <b>EU-28 (avg)</b> | <b>0,005</b> | <b>-0,006</b> | <b>-0,497</b> | <b>-0,502</b> | <b>0,502</b>   | <b>0,496</b> |

Note: EU-28 calculations are based on elasticities and weights of the EU28 while the EU-28 (average) is the arithmetic average of the 28 countries. The 2014 columns refer to Mourre et al. (2014) estimates, while the 2018 columns refer to the re-estimations presented in this paper.

Source: Commission 2018 Spring forecast, Mourre et al. (2014) and European Commission Services.

## ANNEX 4

### VOTING MODALITIES UNDER THE SGP

In all voting under the SGP, the Member State concerned does not vote. For the corrective arm of the Pact, non-euro-area Member States do not participate in the voting on euro-area Member States. This is also the case in the preventive arm, for all the Council legal acts adopted within the context of a Significant Deviation Procedure following a Commission warning and for the vote to impose an interest-bearing deposit on euro-area Member States.

Unless otherwise specified, all votes are taken under qualified majority voting (QMV). A qualified majority is reached when 55% of Member States participating in the decisions comprising at least 65% of population of those States are in favour of a proposal.

The exceptions to the use of qualified majority voting are the following:

Reversed simple majority voting (RSMV) –whereby an unweighted majority of Member States is needed to reject a Commission proposal for a Council decision– is used to vote on a Council decision establishing a lack of effective action in response to Council recommendations following a Commission warning in the preventive arm, the second time such a decision is recommended by the Commission.

Reversed qualified majority voting (RQMV) –whereby a qualified majority of Member States is needed to reject a Commission proposal for a Council decision– is used:

- To impose sanctions in the form of an interest-bearing deposit under the preventive arm
- To impose or convert the interest-bearing deposit into a non-interest bearing deposit under the corrective arm, following an Article 126(6) decision
- To impose a fine under the corrective arm, following an Article 126(8) decision on a lack of effective action
- To suspend commitments under the European Structural and Investment Funds (applicable to commitments from 1 January of the forthcoming year), following a stepping up of the EDP procedure.

It should be noted that the imposition of a fine with a variable component following an Article 126(11) decision on a lack of effective action in response to a notice under Article 126(9) TFEU is decided using normal QMV. In a similar vein, a Commission proposal on the suspension of payments under the European Structural and Investment Funds is subject to normal qualified majority voting in the Council.

The euro-area Contracting Parties of the TSCG have committed themselves to supporting the Commission's recommendations on all aspects of EDPs on the basis of the deficit criterion for euro-area Member States, as long as there is no qualified majority against the recommendations. For the purposes of Union law, this is a behavioural, rather than a legal, commitment, and mimics the use of RQMV.

## LIST OF ABBREVIATIONS

|           |   |
|-----------|---|
| CAPB      | Cyclically-adjusted primary balance   |
| CSR       | Country Specific Recommendation   |
| DBP       | Draft Budgetary Plan  |
| ECB       | European Central Bank   |
| ECOFIN    | Economic and Financial Affairs Council  |
| EDP       | Excessive deficit procedure   |
| EFC       | Economic and Financial Committee  |
| EFSF      | European Financial Stability Facility   |
| EFSI      | European Fund for Strategic Investment  |
| EMU       | Economic and Monetary Union   |
| EPP       | Economic Partnership Programme  |
| ERM2      | European Exchange Rate Mechanism  |
| ESI funds | European Structural and Investment Funds  |
| ESA(2010) | European System of National and Regional Accounts                                   |
| ESM       | European Stability Mechanism  |
| GDP       | Gross domestic product  |
| MLSA      | Minimum Linear Structural Adjustment  |
| MTBF      | Medium-term budgetary framework   |
| MTO       | Medium-term budgetary objective   |
| NRP       | National Reform Programme   |
| OECD      | Organisation for Economic Co-operation and Development                              |
| pp        | Percentage points   |
| SCPs      | Stability and convergence programmes  |
| SDP       | Significant Deviation Procedure   |
| SFA       | Stock Flow Adjustments  |
| SGP       | Stability and Growth Pact   |
| TFEU      | Treaty on the Functioning of the European Union                                     |
| TSCG      | Treaty on Stability, Coordination and Governance in the Economic and Monetary Union |





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