



European
Commission

ISSN 2443-8014 (online)

Vade Mecum on the Stability & Growth Pact

2018 Edition

INSTITUTIONAL PAPER 075 | MARCH 2018

EUROPEAN ECONOMY



*Economic and
Financial Affairs*

European Economy Institutional Papers are important reports analysing the economic situation and economic developments prepared by the European Commission's Directorate-General for Economic and Financial Affairs, which serve to underpin economic policy-making by the European Commission, the Council of the European Union and the European Parliament.

Views expressed in unofficial documents do not necessarily represent the views of the European Commission.

LEGAL NOTICE

Neither the European Commission nor any person acting on behalf of the European Commission is responsible for the use that might be made of the information contained in this publication.

This paper exists in English only and can be downloaded from https://ec.europa.eu/info/publications/economic-and-financial-affairs-publications_en.

Luxembourg: Publications Office of the European Union, 2018

PDF ISBN 978-92-79-77456-0 ISSN 2443-8014 doi:10.2765/698908 KC-BC-18-007-EN-N

© European Union, 2018

Reuse is authorised provided the source is acknowledged. The reuse policy of European Commission documents is regulated by Decision 2011/833/EU (OJ L 330, 14.12.2011, p. 39). For any use or reproduction of material that is not under the EU copyright, permission must be sought directly from the copyright holders.

European Commission
Directorate-General for Economic and Financial Affairs

Vade Mecum on the Stability and Growth Pact

2018 Edition

ACKNOWLEDGEMENTS

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, Servaas Deroose, Deputy Director-General, Lucio Pench, Director for Fiscal Policy and Policy Mix, and Gilles Mourre, Head of Unit for Fiscal Policy and Surveillance.

Roberta Torre was the coordinator of the Vade mecum, building on former versions from Roberta Torre and Anne Van Bruggen, Angela D'Elia, Lourdes Acedo Montoya and Christine Frayne.

This version of the manual benefitted from inputs by Alessandra Cepparulo, Anton Mangov, Matthew McGann, Ralph Schmitt-Nilson, and Roberta Torre. Comments and suggestions on the updated version were provided by Stefan Ciobanu, Angela D'Elia, Servaas Deroose, Reinhard Felke, Leo Flynn, Jean-Paul Kepenne, Karolina Leib, Pim Lescrauwaet, Kieran Mc Morrow, Gilles Mourre, Lucio Pench, Lucia Piana, and Karl Scerri. Suggestions from the Alternates of the Economic and Financial Committee are gratefully acknowledged, too.

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.

Comments on this document would be gratefully received and may be sent to:

Gilles Mourre
European Commission
Directorate-General for Economic and Financial Affairs
Directorate for Fiscal Policy and Policy Mix
Office CHAR 12-040
B-1049 Brussels
e-mail: gilles.mourre@ec.europa.eu

or

Roberta Torre
European Commission
Directorate-General for Economic and Financial Affairs
Directorate for Fiscal Policy and Policy Mix
Office CHAR 12-021
B-1049 Brussels
e-mail: roberta.torre@ec.europa.eu

CONTENTS

0.	Introduction	11
1.	The preventive arm of the stability and growth pact (SGP)	17
1.1.	Legal basis, rationale and monitoring	17
1.1.1.	Legal basis of the preventive arm	18
1.1.2.	Rationale behind the preventive arm	22
1.1.3.	Bringing the economic policy advice together – the European Semester	24
1.1.4.	Monitoring under the preventive arm – the role of the Stability and Convergence Programmes	25
1.2.	The Medium-Term Objective (MTO): concept and role	26
1.2.1.	Defining the Medium-Term Objective	26
1.2.1.1.	Calculating the appropriate Medium-Term Objective	28
1.2.1.2.	Revising the Medium-Term Objective	30
1.2.2.	The Medium-Term Objective as an anchor	30
1.3.	Assessment of the Stability and Convergence Programmes (SCPS)	31
1.3.1.	The reporting requirements	32
1.3.2.	The assessments of the SCPs	34
1.3.2.1.	Is the MTO set at an appropriate level?	36
1.3.2.2.	Is the Member State at its MTO or on an appropriate adjustment path towards it? The change in the structural balance	36
1.3.2.3.	Taking into account the implementation of structural reforms	39
1.3.2.4.	Taking into account investment	43
1.3.2.5.	Considering the impact of adverse economic events	46
1.3.2.6.	Is the Member State compliant with the requirements of the expenditure benchmark?	48
1.3.2.7.	The assessment of compliance with the preventive arm	53
1.4.	The procedure in case of observed significant deviation, including the introduction of sanctions for the euro area Member States	57
2.	The corrective arm of the stability and growth pact	59
2.1.	Legal basis, rationale and procedural steps	59
2.1.1.	Legal basis of the corrective arm	60
2.1.2.	Rationale behind the corrective arm of the SGP	65
2.1.3.	Overview of procedural steps under the corrective arm of the SGP	66
2.2.	Launching an Excessive Deficit Procedure	69
2.2.1.	Establishing the existence of an excessive deficit or debt	69
2.2.1.1.	Establishing non-compliance with the deficit criterion	70
2.2.1.2.	Establishing non-compliance with the debt criterion	70
2.2.1.3.	Establishing non-compliance with the debt criterion in the transition period	73
2.2.2.	Preparing an Article 126(3) report	74
2.2.2.1.	Assessing the breach of the deficit criterion in the Article 126(3) report	74
2.2.2.2.	Assessing the breach of the debt criterion in the Article 126(3) report	78
2.2.2.3.	Concluding the Article 126(3) report	80
2.2.3.	Preparing an Article 126(7) recommendation or an Article 126(9) notice	81
2.2.4.	Sanctions: recommending a non-interest bearing deposit	84
2.3.	Steps following a recommendation under 126(7) TFEU or a notice under 126(9) TFEU	84
2.3.1.	Member States' reporting on action taken and continuous monitoring of compliance	85
2.3.2.	Assessing compliance with an Article 126(7) recommendation or an Article 126(9) notice	86
2.3.2.1.	The assessment of effective action following Article 126(7) recommendations or 126(9) decisions to give notice	87
2.3.3.	Cases for extending the deadline for correction – Effective action	91
2.3.3.1.	A general and severe downturn in the euro area or EU as a whole	91

2.3.4.	Continuous monitoring of the EDPs placed in abeyance and the correction of the excessive deficit	92
2.4.	Procedure following a lack of effective action to a council EDP recommendation or decision to give notice	93
2.4.1.	Issuing a Commission recommendation on a lack of effective action under 126(8) TFEU	93
2.4.2.	Procedures following a lack of effective action in response to a recommendation under Article 126(7) TFEU: Imposing sanctions to euro area Member States and the application of macroeconomic conditionality	94
2.4.3.	Procedures following a lack of effective action in response to a notice under Article 126(9) TFEU: Imposing sanctions to euro area Member States	96
2.5.	Abrogation of the EDP	96
3.	The institutional context of budgetary surveillance linked to the stability and growth pact (SGP)	99
3.1.	The cycle of integrated budgetary and economic surveillance	99
3.1.1.	The integration of the preventive and the corrective arms and the annual cycle of monitoring	99
3.1.1.1.	The Draft Budgetary Plans for the euro area	101
3.1.1.2.	Assessing compliance with the reporting requirement for the Draft Budgetary Plans	101
3.1.1.3.	Preparing the Commission opinion on the Draft Budgetary Plans	103
3.1.2.	The wider EU's annual cycle of economic surveillance	104
3.1.2.1.	The main steps of the European Semester	104
3.1.2.2.	Introducing concepts of structural policy into the SGP: the role of the Economic Partnership Programmes (EPPs)	106
3.2.	National budgetary processes and the SGP	107
3.2.1.	National balanced-budget rules and the MTO	108
3.2.2.	The role of independent bodies in the national budgetary processes	110
3.2.2.1.	The mandates of the independent bodies	110
3.2.2.2.	Key role in preparing the forecasts underlying the budgetary process	111
	GLOSSARY	209
	LIST OF ABBREVIATIONS	214

ANNEXES

Annex 1	Links to the relevant legal texts	112
Annex 2	Annual update of the minimum benchmarks	115
Annex 3	Tables to be supplied in the stability and convergence programmes	117
Annex 4	The medium-term reference rate of potential growth and the convergence margin for the assessment of 2018 based on spring 2017 Commission forecast	127
Annex 5	Calculating the minimum linear structural adjustment (MLSA) for the application of the debt criterion during the transition period	128
Annex 6	Voting modalities under the SGP	132
Annex 7	The fiscal compact	133
Annex 8	A numerical example of the expenditure benchmark	136
Annex 9	A numerical example of an assessment of effective action to an article 126(7) recommendation or Article 126(9) notice	139
Annex 10	Parameters underlying the Commission's cyclical adjustment methodology	143
Annex 11	Model structure and tables to be contained in draft budgetary plans	146
Annex 12	Tables to be included under the additional reporting introduced in the two pack	157
Annex 13	A numerical example of the flexibility clauses in the preventive arm	163
Annex 14	Plausibility analysis for estimating impact of structural reforms	171
Annex 15	A commonly agreed position on flexibility within the stability and growth pact	174
Annex 16	Improving the predictability and transparency of the SGP: A stronger focus on the expenditure benchmark in the preventive arm	185
Annex 17	Improving the assessment of effective action in the context of the excessive deficit procedure	191
Annex 18	The Commission's "constrained judgement" approach	203
Annex 19	Implementation of discretion in the autumn 2017 fiscal surveillance exercise	203/7

LIST OF BOXES

Box 0.1:	The Stability and Growth Pact since its inception	12
Box 1.1:	Article 121 TFEU	19
Box 1.2:	Article 136 TFEU	20
Box 1.3:	Key features of the TSCG	21
Box 1.4:	Calculating the structural balance	27
Box 1.5:	The Commission forecasts and the "no-policy-change" assumption used therein	35
Box 1.6:	Defining the appropriate adjustment path	37
Box 1.7:	The pension reform clause	41
Box 1.8:	The operationalisation of the "structural reform clause"	42
Box 1.9:	The operationalisation of the "investment clause"	45
Box 1.10:	The convergence margin	50
Box 1.11:	How the net expenditure growth rate for year t is computed?	52
Box 2.1:	Article 126 of TFEU	61
Box 2.2:	Protocol 12 on the Excessive Deficit Procedure	63
Box 2.3:	The treatment of financial support in determining the existence of an excessive deficit	76
Box 2.4:	Rules in the 2011 reform of the SGP for systemic pension reforms Criteria for taking into account systemic pension reforms in the context of the EDP	77
Box 2.5:	Considering "stock-flow adjustments" for the assessment of the debt criterion	78

Box 2.6:	Additional ad hoc information requests from euro area Member States	85
Box 2.7:	Issuing an autonomous Commission recommendation to euro area Member States at risk of non-compliance with their EDP deadline	92
Box 2.8:	European Funds conditionality in 2014-2020	94
Box 3.1:	Euro area Member States experiencing financial difficulties – a lightening of the budgetary surveillance obligations under the Two Pack for countries under a macroeconomic adjustment programme	106
Box 3.2:	Common principles for the national correction mechanisms	109

0. INTRODUCTION

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

The Vade mecum is a compiled-style document that brings together all the elements relevant to the implementation of the SGP. The reader should see it as a compendious encyclopaedia with stand-alone articles digging into specific dimensions. Therefore, given the necessary repetitions entailed by that format, it is not meant for linear reading. While each Section strives for a comprehensive presentation of relevant technical and legal aspects, the main text aims to remain broadly accessible for non-specialists. In that respect, the relevant economic concepts and historical background underlying the procedure have been systematically recapped, while many technical details was put in annexes (19 in total). The Vade mecum describes the working of the SGP step by step at the time of writing (with February 2018 as a cut-off date). It should not be considered to be definitive, since it presents the current practice in the implementation of the SGP which might evolve as the need arises. The Vade mecum will be updated annually to reflect in a timely manner any significant change in the evolution of the rules and/or surveillance practice.

With respect to the 2017 issue, the changes relate to surveillance practice and concern:

- revised timing of the freezing principle following the discussion at the EFC, applicable starting from the assessment of compliance with the 2018 fiscal requirements under the preventive arm of the SGP [Box 1.6];
- further explanation on the Significant Deviation Procedure, in light of its recent implementation [Section 1.4];
- annual update of the minimum benchmarks [Annex 2] and update of reference rates for the expenditure benchmark for 2018 [Annex 4];
- references to the ongoing work on transparency over discretionary revenue measures [Section 1.3.2.7] as well as to the Commission proposal on the integration of the substance of the Treaty on Stability, Coordination and Governance into the Union legal framework [Box 0.1 and Box 1.3];
- the implementation of discretion by the Commission in the autumn 2017 fiscal surveillance exercise [Annex 19];
- detailed explanation of the constrained judgement approach [Annex 18]; and
- some factual corrections and clarifications.

Last but not least, the current text highlights that since the adoption of the Opinion of the Economic and Financial Committee of 29 November 2016, the Commission has gone one step further in streamlining

(¹) COM (2015) 600 Final <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0600&from=EN>

the use of surveillance indicators by giving a stronger role to the expenditure benchmark when assessing compliance with the preventive arm of the SGP.

The SGP is rooted in the Treaty on the Functioning of European Union (TFEU), in particular Articles 121 and 126, and Protocol N° 12 annexed to the Treaties (Box 1.1, 2.1 and 2.2). Article 136 is a basis for measures specific to those Member States whose currency is the euro (Box 1.2). The SGP is implemented through secondary legislation in the form of *Regulation (EC) N° 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies* and *Regulation (EC) N° 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure*. Those two Regulations respectively specify the so-called preventive arm and corrective arm of the SGP (with the latter being also known as the Excessive Deficit Procedure). Further details for the SGP's implementation are to be found in a Code of Conduct on the SGP⁽²⁾, entitled “*Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence programmes*”, agreed by the ECOFIN Council. The SGP has evolved over the years through amendments to the legislation. Box 0.1 and Graph 0.1 present a short overview of its history.

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

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

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

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

BOX 0.1: THE STABILITY AND GROWTH PACT SINCE ITS INCEPTION

The secondary legislation governing the SGP was adopted in 1997, as the budgetary pillar of the Economic and Monetary Union, applying for the whole EU without exception. The first amendment of the SGP occurred in 2005 and involved changes to both the preventive and the corrective arms. The main aim of those changes was to better take into account economic circumstances and country-specific characteristics. In the preventive arm, the horizontal requirement of achieving a budgetary position of close to balance or surplus in nominal terms was

(²) <http://data.consilium.europa.eu/doc/document/ST-9344-2017-INIT/en/pdf>

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

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

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

In March 2012, twenty-five EU Member States⁽³⁾ signed the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), which contains the Fiscal Compact⁽⁴⁾. Building on the directive for national budgetary frameworks, it includes provisions to ensure that the national processes are able to fulfil European obligations and that national policy is in line with the requirements of the SGP. Its main features are also set out in Table 0.1. The Fiscal Compact aims to respond, along with the SGP, to the need to maintain sound and sustainable public finances and to prevent government deficit and debt becoming excessive. The TSCG foresees that, by 1st 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 this end.⁽⁵⁾

⁽³⁾ All except the Czech Republic and the United Kingdom. Croatia, which was not member of the European Union at the time, is also not a signatory of the TSCG.

⁽⁴⁾ Beside euro area Member States, Denmark, Bulgaria and Romania declared themselves bound by the provisions of the Fiscal Compact.

⁽⁵⁾ https://ec.europa.eu/info/sites/info/files/economy-finance/com_824_0.pdf

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

Objective	Specification	Adjustment path	Enforcement specification
Requirement of a close to balance or in surplus position	<p>Country specific Medium-Term Objective in structural terms:</p> <ul style="list-style-type: none"> - Provide a safety margin with respect to the 3% deficit limit - Ensure rapid progress towards sustainability - Allow room for budgetary manoeuvre <p>For euro area and ERMII MS: limits of -1% of GDP</p> <p><i>(TSCG: limit is -0.5%, unless debt <<60% and low risks to sustainability)</i></p> <p>*Expenditure benchmark: expenditure net of discretionary measures should grow ≤ medium-term potential GDP</p>	<p>0.5% of GDP as a benchmark:</p> <p>More in good times</p> <p>Less in bad times</p> <p>Possible temporary deviations from the MTO or the adjustment path towards it:</p> <ul style="list-style-type: none"> - Implementation of major structural reforms which have a verifiable impact on the long-term sustainability of public finances – emphasis on pension reform - *Unusual event outside the control of the MS concerned which has a major impact on its financial position - *Periods of severe economic downturn for the euro area or the Union as a whole provided this does not endanger fiscal sustainability in the medium term 	<p>*Procedure for correcting significant deviation (0.5% in one year or cumulatively over two years from the MTO or the adjustment path towards it)</p> <p><i>(TSCG: Automatic correction mechanism in national legal order monitored by independent national institution)</i></p> <p>*For euro area: financial sanctions in case of repeated non-compliance (interest-bearing deposit of 0.2% of GDP)</p>

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

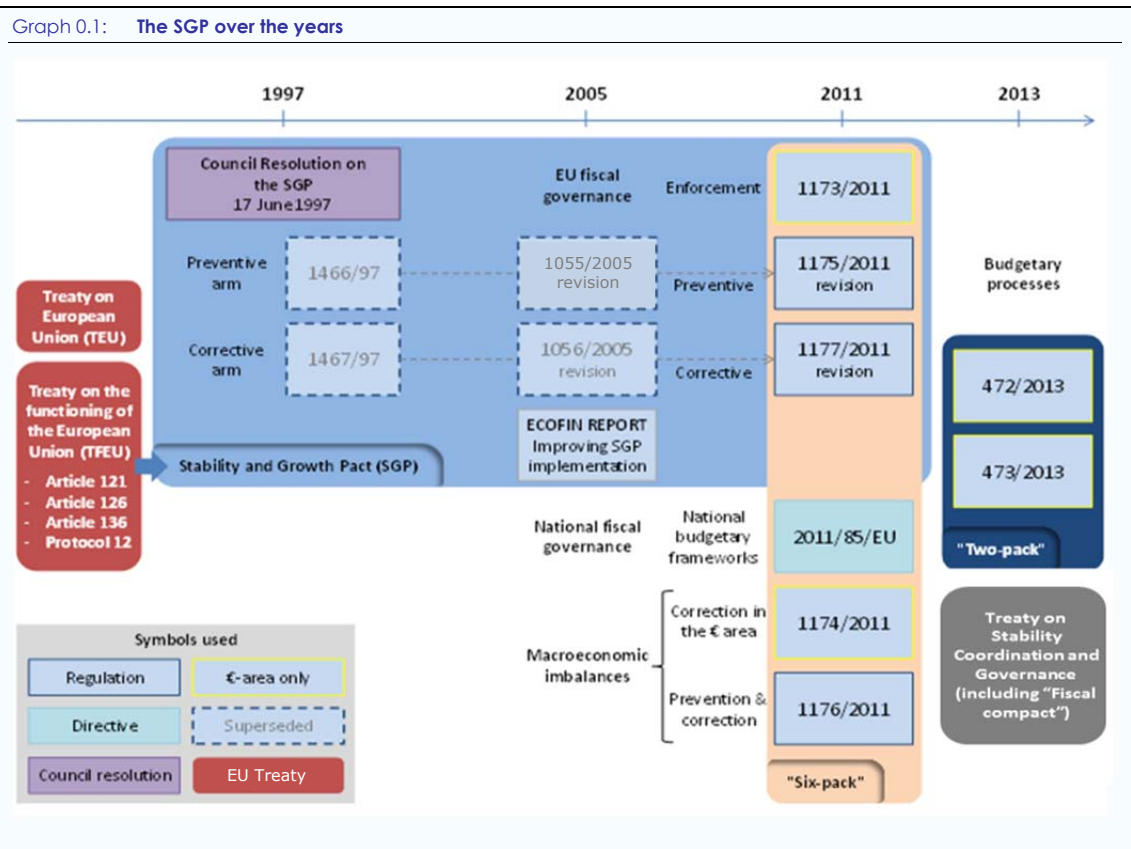
Objective	Specification	Adjustment path	Enforcement specification
Correct gross policy errors	<p>Sets limits:</p> <p>Deficit of 3% of GDP</p> <p>Debt of 60% of GDP or sufficiently diminishing</p> <p>*Definition of sufficiently diminishing = respect of debt reduction benchmark</p> <p>*Debt reduction benchmark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

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

Table 0.3: The main features of the Two Pack

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

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



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

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

1.1. LEGAL BASIS, RATIONALE AND MONITORING

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

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

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

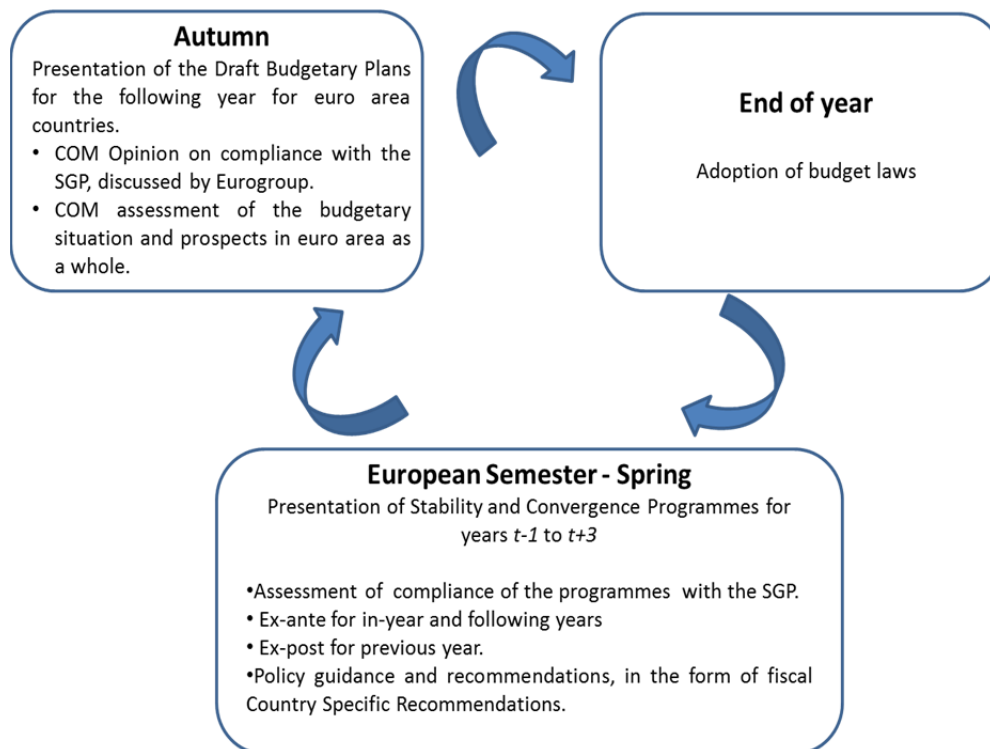
The assessments of the SCPs cover both the preventive and the corrective arms of the Pact depending on the circumstances of each Member State. Nevertheless, under Regulation (EC) 1466/97 the SCPs play a specific role under the preventive arm, as they serve as the means for assessing ex ante compliance with the preventive arm.

Since the entry into force of the Two Pack in 2013, the surveillance cycle is completed in autumn with an assessment of euro area Member States' Draft Budgetary Plans (DBPs) for the next year (see

⁽⁶⁾ The growth of government expenditure which is not financed by corresponding changes to revenue measures.

Section 3.1).⁽⁷⁾ The Commission adopts an Opinion on each DBP which focuses on the (ex ante) assessment of compliance with obligations under the SGP. In that way, guidance is provided to the Member States throughout the whole budgetary cycle. At the same time, the Commission also presents an overall assessment of the budgetary situation and prospects in the euro area as a whole, based on the plans submitted.⁽⁸⁾ Graph 1.1 gives an overview of the annual cycle of surveillance.

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



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

1.1.1. Legal basis of the preventive arm

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

⁽⁷⁾ Euro area Member States under a macroeconomic adjustment programme are subject to a regular monitoring under Regulation (EU) 472/2013 and, therefore, exempted from the requirement to submit a Stability Programme or a Draft Budgetary Plan.

⁽⁸⁾ See <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2017:800:FIN>

The secondary legislation, which implements the preventive arm of the Pact, has been adopted on this basis – as per Article 121(6) TFEU.

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

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

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

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

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

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

Parliament and of the Council of 16 November 2011.⁽⁹⁾⁽¹⁰⁾ It is further specified in the Code of Conduct on the SGP.⁽¹¹⁾ In December 2016, the Council endorsed an agreement reached at the Economic and Financial Committee, aiming at improving the predictability and transparency of the EU's fiscal rulebook, the Stability and Growth Pact.⁽¹²⁾ This agreement provides for a stronger focus on the expenditure benchmark and further clarification, noticeably in the preventive arm.⁽¹³⁾⁽¹⁴⁾

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

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

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.⁽¹⁵⁾

⁽⁹⁾ Annex 1 contains links to all relevant legislation. The consolidated text is available under: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1466:20111213:EN:PDF>

⁽¹⁰⁾ The Amsterdam European Council Resolution on the SGP of 17 June 1997 and the Report of the Economic and Financial Affairs Council on “Improving the implementation of the Stability and Growth Pact”, endorsed by the European Council in its conclusions of 22 March 2005, also form part of the preventive arm of the Pact, but do not contain additional operational requirements.

⁽¹¹⁾ Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence programmes. <http://data.consilium.europa.eu/doc/document/ST-9344-2017-INIT/en/pdf>

⁽¹²⁾ <http://www.consilium.europa.eu/media/22629/st15205en16.pdf>

⁽¹³⁾ 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 29 November 2016 (see Annex 17).

⁽¹⁴⁾ Compliance with Council recommendations adopted prior to that opinion will continue to be assessed on the basis of the methodology described in the 2016 edition of the Vade mecum.

⁽¹⁵⁾ Paragraph 3 was added to Article 136 from 1 May 2013, following a Treaty amendment under Article 48(6) TEU.

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

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

Box 1.3: KEY FEATURES OF THE TSCG

The TSCG commits its Contracting Parties to greater budgetary and economic coordination, and signals their commitment to abiding by the rules of the SGP. The provisions on the budgetary side are contained in the fiscal compact, which covers Articles 3 to 8 of the TSCG.⁽²⁰⁾ The Fiscal Compact (see Annex 7) aims to complement EU budgetary surveillance through the following provisions:

- Contracting Parties commit to translating the MTO concept into their national law, through provisions of binding force and permanent character. If their debt level is significantly below 60% of GDP and there are low risks to sustainability, their MTO should not be below a structural balance of -1% of GDP, otherwise a tighter constraint of -0.5% of GDP applies. A temporary deviation from the medium-term objective or the adjustment path towards it will only be possible in exceptional circumstances, as defined in the SGP. In case of significant observed deviations from the MTO or the adjustment path towards it –the SGP concept– correction mechanisms will be triggered automatically at the national level.
- In addition, independent bodies in charge of monitoring compliance with the balanced-budget rule –defined as a country attaining its MTO– have to be put in place at the national level.
- Contracting parties that do not adequately enshrine those provisions in their national law may face financial sanctions of up to 0.1% of the Member State’s GDP, imposed by the Court of Justice of the European Union.
- When the ratio of a Contracting Party’s general government debt to gross domestic product exceeds the 60 % of

⁽¹⁶⁾ By virtue of Protocol N° 15 on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland annexed to the TFEU, chapter IV of the Directive, which concerns numerical fiscal rules, does not apply to the United Kingdom.

⁽¹⁷⁾ The 2012 Interim Progress Report on the implementation of this directive is available here: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0761:FIN:EN:PDE>, the accompanying Staff Working Document here: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SWD:2012:0433:FIN:EN:PDE>

⁽¹⁸⁾ Croatia is also not a signatory of the TSCG, as it was not a Member of the European Union in March 2012.

⁽¹⁹⁾ Non-euro area signatories may also declare themselves bound by the provisions of the fiscal compact. This is the case for Denmark, Bulgaria and Romania. On the other hand, Hungary, Poland and Sweden ratified the TSCG but did not opt in to the Fiscal Compact: <http://www.consilium.europa.eu/en/documents-publications/agreements-conventions/agreement/?aid=2012008>

⁽²⁰⁾ The TSCG foresees that, by 1st 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 this end.

GDP reference value, the Contracting Party shall reduce it at an average rate of one twentieth per year as a benchmark, as foreseen in Regulation (EC) 1467/97 as amended by Regulation (EU) 1177/2011.

- The Contracting Parties commit themselves to supporting Commission recommendations at all stages of deficit EDPs, insofar as the deficit criterion is concerned, unless a qualified majority of them is opposed. That mechanism complements the so-called reversed qualified majority voting that applies to the imposition of financial sanctions under Regulation (EU) 1173/2011 for the EDP.
- Finally, Contracting Parties subject to an excessive deficit procedure (EDP) will have to put in place a budgetary and economic partnership programme detailing the structural reforms that must be put in place and implemented to ensure an effective and durable correction of the excessive deficit.
- The Contracting Parties will report ex ante on their debt issuance plans to the Council and to the Commission, to enhance the coordination of national debt issuance.

In 2013, two Regulations based on Article 136 TFEU (see Box 1.2) in combination with Article 121(6) TFEU applying only to the euro area entered into force. Although those Regulations –commonly referred to as the Two Pack– do not add to the SGP policy requirements, they bring about changes to the surveillance cycle. For that reason, a large part of their requirements has been incorporated seamlessly into the operation of the SGP.

Regulation (EU) 472/2013 of the European Parliament and of the Council of 21 May 2013 *on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability*⁽²¹⁾ streamlines the requirements placed on financially fragile countries and embeds those provisions in the EU framework for policy co-ordination and surveillance. In particular, for Member States under a macroeconomic adjustment programme, it suspends the reporting requirements under the SGP and integrates the budgetary targets of the programme into the applicable recommendations and decisions under the SGP. Regulation (EU) 473/2013 of the European Parliament and of the Council of 21 May 2013 *on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit for the Member States of the euro area*⁽²²⁾ complements the surveillance cycle for all euro area Member States and increases the reporting and monitoring requirements for Member States under EDP. Building on Directive 2011/85/EU, Regulation 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.

Regulation 473/2013 states that “The specification of the content of the draft budgetary plans shall be set out in a harmonised framework established by the Commission in cooperation with the Member States”. That harmonised framework is the Code of Conduct on the Two Pack entitled “Specifications on the implementation of the Two Pack and guidelines on the format and content of draft budgetary plans, economic partnership programmes and debt issuance reports”.⁽²³⁾

1.1.2. Rationale behind the preventive arm

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

⁽²¹⁾ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0001:0010:EN:PDF>

⁽²²⁾ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0011:0023:EN:PDF>

⁽²³⁾ http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf

basis of both the preventive arm of the SGP, which deals with budgetary policy, and the macroeconomic imbalances procedure.⁽²⁴⁾

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

Since the Six-Pack reform of the SGP, compliance with the requirements of the preventive arm is assessed using a two-pillar approach. The assessment of the structural balance, which constitutes one pillar, is complemented by an analysis of the growth rate of an expenditure aggregate net of discretionary revenue measures (i.e. an assessment of compliance of the expenditure benchmark), which constitutes the other pillar. Compliance with the preventive arm is assessed through an overall assessment which takes both 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, while nationally financed government investment is smoothed over four years. The underlying rationale is to focus on government spending (i) that is independent of cyclical conditions (by netting out the cyclical elements of unemployment spending), (ii) within the government's control (by netting out interest expenditures) and (iii) has to be paid for out of tax revenues (by netting out spending on programmes directly funded by the European Union), 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 which ensures adherence to the MTO over time– unless any excess growth is matched by discretionary revenue measures yielding additional revenues (see Section 1.3.2.6). Member States on the adjustment path to the MTO must ensure that their expenditure grows at a rate below that medium-term rate of potential GDP growth –the difference in growth rate is known as the convergence margin– unless the excess growth is matched by additional funds from discretionary revenue measures. This does not limit or in any way determine the size of government spending. All that is required is that any excess expenditure growth over the benchmark rate is funded by equivalent discretionary revenue-increasing measures.

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

⁽²⁴⁾ Regulation (EU) 1176/2011: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011R1176&from=EN>

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

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

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

Since 2011, the preventive arm of the SGP has become part of the European Semester for economic governance. The European Semester was introduced in 2010 and was revised and streamlined in 2015. It aims to ensure that the surveillance of budgetary and economic policies takes place in parallel. That process of integrated surveillance allows for consistent policy guidance at European level within a timetable permitting that guidance to inform the national setting of policy in good times.

The European Semester is launched each year by the presentation of the Annual Growth Survey (AGS)⁽²⁵⁾ by the Commission at the end of the previous year. In that document, the Commission presents its assessment of the economic situation in the European Union and sets out its priorities for the coming year in terms of the economic and budgetary policies and reforms to boost growth and employment. Since the European Semester 2016, the Commission produces the recommendations for the euro area at the same time as the AGS. That common timing reflects common challenges of the euro area ahead of country specific discussions. In addition, an Alert Mechanism Report (AMR) is published under the Macroeconomic Imbalances Procedure (MIP). The AMR identifies which countries deserve closer attention. The start of the European Semester is therefore marked by the discussion of the AGS and the euro area recommendations in the Council which then reports on its conclusions to the European Council. The March European Council subsequently issues general policy guidance for Member States. At the end of February, the Commission releases Country Reports, for all Member States. 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. They also analyse more specifically 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, which is published in the context of the Macroeconomic Imbalance Procedure.

Following the publication of the Country Reports and the adoption of the European Council conclusions, Member States submit their Stability or Convergence Programmes (SCPs) in April – see Section 1.1.4. Those programmes 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 the relevant policy areas. The Commission proposal includes its opinion for relevant Member States (all except Member States subject to a macroeconomic adjustment programme) on their Stability or Convergence Programme. At the same time, the scope of recommendations is larger than fiscal policy and provides guidance to Member States on how to increase growth and jobs, including by removing bottlenecks preventing growth and job creation, and to promote sustainable public finances.

⁽²⁵⁾ http://ec.europa.eu/europe2020/making-it-happen/annual-growth-surveys/index_en.htm

Based on the Commission's proposals, the ECOFIN Council then adopts, for each Member State, the so-called "Country-Specific Recommendations". The Council opinions on the Stability and Convergence Programmes are usually to be found in the recitals and the first recommendation of the Country-Specific Recommendations. The recommendations for each Member State are discussed and are endorsed by the European Council in June. In line with Article 2-ab of Regulation (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 line, unless any divergence from it can be backed up by strong public explanations.

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

In accordance with Regulation (EC) 1466/97, Member States are required to submit annually 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.⁽²⁶⁾ 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.

The function of the SCPs is to allow the Commission and the Council to assess compliance with the MTO and the adjustment path towards it, including compliance with the expenditure benchmark. In order for such an assessment to be made, a range of economic and budgetary data must be included in the SCPs, as set out in the tables annexed to the Code of Conduct on the SGP, which have been jointly agreed by the Member States and the Commission in Council committees. Those tables are replicated in Annex 3.⁽²⁷⁾ The forecasts contained in the SCPs must be prepared in a sound and realistic manner, consistent with the requirements of Directive 2011/85/EU on the requirements for budgetary frameworks of the Member States, and should therefore be based on the most likely macro-fiscal scenario or a more prudent one. As a result of the Two Pack, euro area Member States must base their Stability Programmes on macroeconomic forecasts produced or endorsed by an independent body. Section 3.2.2 discusses that requirement in more detail. For all countries, as part of the SCPs, both the macroeconomic and budgetary forecasts must be compared with the most recent available Commission forecasts and, if appropriate, those of other independent bodies.

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

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

⁽²⁶⁾ That requirement applies to all countries, except euro area Member States under a macroeconomic adjustment programme in line with Regulation (EU) 472/2013.

⁽²⁷⁾ The annex includes also the additional table to be filled to request the structural reform clause (Section 1.3.2.3).

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

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

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

1.2.1. Defining the Medium-Term Objective

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

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

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

(ii) *ensure sustainability or rapid progress towards sustainability.* 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. Signatories to the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) (which covers, inter alia, all euro area Member States) have further committed themselves to MTOs of at least -0.5% of GDP,⁽²⁸⁾ unless their debt ratio is significantly below 60% of GDP and the risks in terms of the long-term sustainability of their public finances are low. In those cases, the lower limit for the balance remains at -1% of GDP.

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

⁽²⁸⁾ This applies also to those non-euro area signatories that have declared themselves bound by the provisions of the Fiscal Compact (Denmark, Bulgaria and Romania).

BOX 1.4: CALCULATING THE STRUCTURAL BALANCE

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

In algebraic terms $CAB = (BAL/Y) - \varepsilon * OG$ where BAL stands for general government balance, Y for GDP and the cyclical component, $\varepsilon * OG$, for the product of the semi-elasticity of the budget balance to the cycle, ε , and the output gap, OG. The output gap, which measures the cyclical position of an economy, is defined as the difference between actual and potential output. The latter is estimated by the Commission using a production function method, endorsed by the ECOFIN Council on 12 July 2002, which allows the identification of the different components of potential output.⁽²⁹⁾ All methodological improvements are agreed by the Member States and discussed in a dedicated forum, the Output Gap Working Group (OGWG) within the EU's Economic Policy Committee.⁽³⁰⁾

The semi-elasticity of the budget balance to the cycle (ε) measures the effect of output movements on the general government balance, when assuming the economy is running at its potential (i.e. in the absence of the business cycle). 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 OGWG.

The budgetary semi-elasticity is equal to the difference of the semi-elasticity of revenue and the semi-elasticity of expenditure. On the revenue side, the elasticities of individual revenue items are estimated by the OECD (personal income taxes, corporate income taxes, indirect taxes, social security contributions, non-tax revenue). They correspond to the percentage change in a particular type of revenue associated with a percentage change in output. They are then aggregated using the share of each in total revenue as weights, so as to derive the elasticity of the level of total revenues (in monetary terms) with respect to output. Subtracting one from the value of the revenue elasticity gives the value of the elasticity of the 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 Commission updated in 2014 the value of the semi-elasticities of the relevant taxes and expenditures, using the individual elasticities updated by the OECD⁽³¹⁾ in the context of the Output Gap Working Group. The individual elasticities underlying the semi-elasticities will be revised every nine years. The weights (tax and spending structure, revenue/expenditure-to-GDP ratio) are computed by the Commission services as an average over the period 2002-2011⁽³²⁾ and are to be updated every six years to reflect changes in the government receipts and spending. Annex 10 shows the semi-elasticities and weights currently in use.

The average budgetary semi-elasticity used for the EU is 0.5⁽³³⁾ and ranges from 0.31 to 0.65 across Member States, suggesting significant differences in the cyclicity 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-

⁽²⁹⁾ 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.

⁽³⁰⁾ Following discussions in the OGWG, the autumn 2016 fiscal surveillance exercise complemented the standard production function methodology with the use of a "constrained judgement" approach. This involved the use of a "plausibility tool" developed in the OGWG to identify countries where there were strong concerns that the commonly agreed methodology could produce output gaps subject to a large degree of uncertainty. The implementation of that approach is explained in Annex 18.

⁽³¹⁾ For more details, see G. Mourre, C. Astarita and S. Princen, "Adjusting the budget balance for the business cycle: the EU methodology", *European Economy. Economic Papers*, November 2014, and Price, R. W., Dang T. and Guillemette Y. (2014), "New tax and expenditure elasticity estimates for EU budget surveillance", *OECD Economics Department Working Paper* No. 1174.

⁽³²⁾ For more details, see G. Mourre, G-M. Isbasoiu, D. Paternoster and M. Salto, "The cyclically-adjusted budget balance used in the EU fiscal framework: a revised computation", *European Economy. Economic Papers*, March 2013.

⁽³³⁾ It is a non-weighted average between all 28 Member States.

GDP ratio moves only slowly with the business cycle, especially in Member States where non-tax revenue is relatively low. In contrast, the semi-elasticity for expenditure ranges from -0.38 to -0.62, which accounts for the larger part of the disparity in the budgetary semi-elasticity across Member States. Its value broadly corresponds to the share of total expenditures in GDP. 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,⁽³⁴⁾ 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.

1.2.1.1. Calculating the appropriate Medium-Term Objective

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

⁽³⁴⁾ Report on Public Finances in EMU, December 2015: http://ec.europa.eu/economy_finance/publications/eip/pdf/ip014_en.pdf

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

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

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

(b) **Sustainability or rapid progress towards sustainability:** For each Member State a minimum value for the MTO that ensures sustainability or rapid progress to sustainability taking into account implicit liabilities and debt (MTO^{ILD}) is computed. 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.

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

Component (i) represents the budgetary balance that would stabilise the debt ratio at 60% of GDP. It corresponds to the product of 60% with the forecast average nominal growth until 2060 as calculated by the Ageing Working Group (AWG).⁽³⁵⁾

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 up 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.

(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.

⁽³⁵⁾ The calculation is based on the real GDP forecast and an average inflation rate of 2%. Data sources are the latest available T+10 forecast and the AWG estimates beyond T+10. The Ageing Working Group in cooperation with the European Commission (DG ECFIN) revises their projections of GDP growth every three years. For the most recent projections see 2015 Ageing Report (Underlying Assumptions and Projection Methodologies), http://ec.europa.eu/economy_finance/publications/european_economy/2015/pdf/ee3_en.pdf

The three bounds on the MTO are then combined to yield country-specific greatest lower bound for the MTO, which corresponds to the lowest MTO that fulfils all the criteria defined above. It is known as the minimum MTO:⁽³⁶⁾

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

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

1.2.1.2. *Revising the Medium-Term Objective*

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

Regulation (EC) 1466/97 requires that the MTOs are revised every three years. In addition to the three-yearly revisions of the minimum MTOs, Member States undertaking structural reforms with a major impact on the sustainability of the public finances can also have their minimum MTOs revised on a case-by-case basis, in agreement with the Commission. In particular, the introduction of major pension reforms having an impact on long-term fiscal sustainability could result in a revision of the minimum MTO.⁽³⁷⁾

The regular revision of the MTOs follows the publication of the Ageing Report which occurs every three years and provides up-to-date data on the ageing challenge facing the Member States. Even if the minimum benchmarks are updated yearly, the minimum MTOs remain frozen for three years.

1.2.2. *The Medium-Term Objective as an anchor*

The MTO is the central concept of the preventive arm that serves to ensure sustainable public finances and compliance with the 3% of GDP deficit criterion in all but the most unusual adverse circumstances. According to the preventive arm of the SGP, Member States must attain the MTO or be on an appropriate adjustment path towards it. As the MTO is designed to ensure sustainability⁽³⁸⁾, 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.

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

⁽³⁶⁾ At the time of the 2012 update of the MTO, the Commission proposed that 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.

⁽³⁷⁾ In 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.

⁽³⁸⁾ However, in certain cases, the MTO may not be sufficiently stringent to ensure compliance with the debt rule. Therefore, failure to nominate an adequate MTO could be considered as a distinct and aggravating relevant factor in assessing compliance with the debt criterion.

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

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

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

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

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

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

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

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

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

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

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

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

Compliance with the MTO requirement is evaluated both *ex ante*, in year and *ex post* on the basis of an overall assessment with the structural balance as the reference, and including an analysis of the expenditure aggregate net of discretionary revenue measures. If, following an overall assessment, the *ex post* analysis concludes that a significant deviation from the adjustment path to the MTO (or the MTO itself)⁽³⁹⁾ has occurred, the Commission will address a warning under Article 121(4) TFEU to the Member State concerned, launching a Significant Deviation Procedure. The warning will be followed by a Council recommendation, based on a Commission recommendation, for necessary policy measures to address the deviation. If the Member State then fails to take appropriate action within the given deadline a decision on no effective action and, for euro area Member States, the imposition of sanctions, in the form of an interest-bearing deposit, are possible. Section 1.4 provides more details.

1.3.1. The reporting requirements

The content of the SCPs should comply with the requirements of Regulation (EC) 1466/97 and the Code of Conduct on the SGP, which sets out guidelines on their content and format. Member States are expected to follow those guidelines and to justify any departure from them. The standardisation of the format and content of the programmes is intended to ensure equality of treatment. Overall, the SCPs should include data to enable a quantitative assessment of the Member State's fiscal outturns and plans, which conform to the requirements set out in the legislation, and should show that government policy is in line with the policy guidelines agreed on at Union level. Annex 3 replicates the tables to be supplied.⁽⁴⁰⁾

Economic and budgetary forecasts and plans

In order to enable the Council and the Commission to assess compliance with the MTO requirement, including an assessment of the expenditure benchmark, the SCPs must present a fully-fledged multi-annual macroeconomic scenario, projections for the main fiscal variables as well as their relevant components, and a description and quantification of the envisaged budgetary strategy. Given that the MTO is the overarching goal of the preventive arm to ensure a prudent and sustainable budgetary policy over the medium-term, Member States should report in their SCPs the MTO that they are aiming at as well as the planned adjustment path towards it. In addition, Member States must also 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,⁽⁴¹⁾ including a description and quantification of the policies and measures, with information on expenditure and revenue ratios and on their main components (including one-off and other temporary measures); the planned growth path of government expenditure, and of government revenue at unchanged policies (explaining the underlying assumptions, methodologies and relevant parameters), along with a quantification of the planned discretionary revenue measures. The budget balances should be broken down by subsector of general government and structural reforms should be specifically analysed when they are flagged as contributing to the achievement of the objectives of the programme.

⁽³⁹⁾ For Member States at their MTO, a significant deviation is assessed with respect to a requirement of 0% of GDP, which is usually reflected in the first recommendation of the CSR as “ensure that the medium-term budgetary objective continues to be adhered to” or “avoid deviating from the medium-term budgetary objective”.

⁽⁴⁰⁾ The same reporting requirements hold also for Member States in the corrective arm. However, Annex 3 includes also the additional table to request the structural reform clause, which is applicable only to Member States in the preventive arm interested in availing of the clause.

⁽⁴¹⁾ The requirement to report public finance data to the Commission in the context of the EDP stems from Council Regulation (EC) 479/2009 of 25 May 2009 *on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community*.

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. Stability and Convergence Programmes should show how developments have compared with the budgetary targets in the previous programme or update, including the Draft Budgetary Plan submitted each autumn by euro area Member States.

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.

Since the entry into force of the Two Pack in May 2013 (Regulation (EU) 473/2013, Article 4(1)), euro area Member States are obliged to publish their national medium-term fiscal plans at the same time as their Stability Programmes, i.e. no later than 30 April each year. Those plans should be based on macroeconomic forecasts that have been produced or endorsed by an independent body and must include at least all the information contained in the Stability Programmes. In fact, national medium-term fiscal plans and stability programmes may be the same document. If a Member State 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. It should also specify whether the macroeconomic forecasts underpinning the programme have been produced or endorsed by an independent body. As specified in the Code of Conduct on the Two-Pack,⁽⁴²⁾ it is understood that, while the endorsement would enable the use of the relevant forecasts, a negative decision would typically trigger a review of the forecast in the light of the comments issued by the independent body and a revised forecast may be submitted for assessment to the independent body.⁽⁴³⁾ Regarding the annual Draft Budgetary Plans –to be submitted by 15 October–, Member States must also indicate whether the underlying macroeconomic forecast has been produced or endorsed by an independent body. Section 3.1.1.2 provides more details.

As part of the SCP, the macroeconomic and budgetary forecasts should be compared to the most recent available Commission forecasts and, if appropriate, those of other independent bodies. Significant differences between the chosen macro-fiscal scenario and the Commission forecast should be explained in detail, especially if the level or growth of external assumptions departs significantly from the Commission forecasts. In order to enhance cross-country comparability and to ensure high quality, the concepts used should be in line with the standards established at Union level, in particular in the context of the European System of Accounts (ESA).⁽⁴⁴⁾ Moreover, the forecasts presented should be prepared in a manner that is consistent with the requirements of Directive 2011/85/EU on requirements for budgetary frameworks of the Member States, which relate primarily to the credibility of the forecasts and the transparency with which they are prepared and presented.

⁽⁴²⁾ http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf

⁽⁴³⁾ Irrespective of the choice of having the forecasts produced or endorsed by an independent body, Member States should have specific mechanisms in place to cope with situations in which there are different views between the Ministry of Finance and the independent body in terms of the main variables of the forecasts. They could, for example, take the form of arrangements to reach an agreement.

⁽⁴⁴⁾ 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*.

Consistency of policy measures

In addition to those data, the SCPs should provide information on the consistency of the budgetary objectives and the measures to achieve them, with the broad economic policy guidelines and the National Reform Programmes.⁽⁴⁵⁾ 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 SGP indicates that each Member State should appropriately define a scenario at unchanged policies and make the underlying assumptions, methodologies and relevant parameters public, so that it is clear from the plans in the SCPs what part of the Member States' plans are based on concrete enacted measures and what part requires additional policy choices. For future years, whose budget has not yet been adopted, the scenario at unchanged policies will imply the extrapolation of revenue and expenditure trends and the inclusion of measures that are known in sufficient detail. While there is no further guidance on what should be included in the SCPs' scenario at unchanged policies, the no policy change assumption underpinning the Commission forecasts (Box 1.5) provides a useful benchmark for what is, and what is not, compatible with such a scenario.

1.3.2. The assessments of the SCPs

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

The assessment of compliance contains three key elements:

Is the MTO set at an appropriate level? That question is discussed in Section 1.3.2.1.

Is the Member State at the MTO or on the adjustment path towards the MTO, by considering the position of the structural balance? That question is discussed in Sections 1.3.2.2 to 1.3.2.5.

Are expenditure plans in line with the expenditure benchmark? That question is discussed in Section 1.3.2.6.

Section 1.3.2.7 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) taking the SCP⁽⁴⁶⁾ targets after recalculating the structural

⁽⁴⁵⁾ Euro area Member States under EDP which have submitted an Economic Partnership Programme (EPP), should provide in their Stability Programmes information on the implementation of their EPP or any additional information requested in the Council opinion on their EPP. See Section 3.1.2.2.

⁽⁴⁶⁾ The same applies to DBP targets set by euro area Member States in autumn.

balance based on the commonly agreed methodology⁽⁴⁷⁾ and (ii) taking into account the risks attached to the SCP scenario, as embodied in, for instance, the most recent Commission forecasts. It is the latter that is then used to set each Member State's requirements in terms of structural adjustment under the preventive arm.

Box 1.5: THE COMMISSION FORECASTS AND THE "NO-POLICY-CHANGE" ASSUMPTION USED THEREIN

European Economic Forecasts are produced independently by Commission staff. As of 2018, they are produced four times per year (winter, spring, summer and autumn), with spring and autumn forecasts being produced after Eurostat validation of public finances data. The European Economic Forecasts concentrate on the Member States, the EU and the euro area, but also include the outlook for candidate countries as well as some major non-EU countries. They cover a medium-term forecast horizon of up to two years, with an additional year being added in each autumn round.

The forecasts are framed by a common set of "external assumptions" for commodity prices, exchange rates and interest rates. Furthermore, European Economic Forecasts are produced under the assumption of "no policy change". In the autumn forecasts, the fiscal policy measures contained in euro area Member States' draft budgetary plans are fully reflected, to the extent that they have been adopted or at least credibly announced and specified in sufficient detail by the cut-off date of the forecast.

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. A NPC forecast may also include the adoption of a limited number of working assumptions, especially to deal with possible structural breaks or specific multi-year patterns observed in the past that are deemed likely to recur.

The Commission has recently 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 a NPC forecast mentioned above more operational and to help decide how to treat specific cases or transactions in a NPC forecast setting. They were published in Chapter 1.2 of the 2016 Report on Public Finances in EMU,⁽⁴⁸⁾ which also includes examples and a discussion on cases which may require some interpretation.

Indeed, there will always be a need for interpretation and judgement to make NPC forecasts. 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 forecasts are not the same as "most likely" forecasts: 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.

The Commission's no-policy-change forecasts are widely used as a basis for economic surveillance, and they are crucial to fiscal surveillance.

⁽⁴⁷⁾ 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.

⁽⁴⁸⁾ Report on Public Finances in EMU, December 2016: http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip045_en.pdf

1.3.2.1. Is the MTO set at an appropriate level?

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

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

For the in-year and ex ante assessments the achievement of the MTO is assessed by seeing whether the Member State is planning and forecast to have a structural balance at least as tight as its MTO. As a matter of convention, from an ex post perspective, the Commission considers the structural balance to be in line with the MTO, if it is within ¼% of GDP of its value.⁽⁴⁹⁾ If the Member State is not at its MTO⁽⁵⁰⁾ in one of the years under consideration, it must nonetheless be on an appropriate adjustment path towards it. The adjustment delivered or set out for future years in the SCP (and, for euro area Member States also in the DBP) should be defined by an annual improvement in the structural balance, respecting the rules of the preventive arm of the SGP.

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

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

For Member States with debt in excess of 60% of GDP or with pronounced risks of overall debt sustainability⁽⁵¹⁾, a faster adjustment path, i.e. above 0.5% of GDP is expected (see Box 1.6, for detailed modulation). All Member States should undertake a greater adjustment in good economic times, while the effort may be more limited in bad economic times.

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

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

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

⁽⁴⁹⁾ Still, such a deviation from the MTO of less than ¼% of GDP enters in the (corrected) required adjustment in the following year.

⁽⁵⁰⁾ 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.

⁽⁵¹⁾ In that context, risks to overall debt sustainability are measured, among other information, by the S1 indicator. That indicator shows the adjustment effort required over five years, in terms of a steady improvement in the structural primary balance, to bring debt ratios to 60% of GDP in 2030, taking also into account the costs arising from an ageing population. For more information, see the 2015 Fiscal Sustainability Report: http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip018_en.pdf

The “Commonly agreed position on flexibility within the SGP” endorsed by the ECOFIN Council of 12 February 2016⁽⁵²⁾ gives a detailed breakdown of the required annual adjustment – the so-called matrix of requirements (see Box 1.6) – that was originally proposed by the Commission in its Communication on Flexibility⁽⁵³⁾ within the SGP, 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 1.3.2.5).

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 $t-1$ (see Box 1.6 for a detailed explanation). However, in order to avoid situations where the freezing of the requirements could lead to unwarranted consequences, namely required adjustments that turn out to be either too large (should outturn data signal a worsening of the economic conditions so that the country is considered to be either in exceptionally or very bad times) or no longer necessary to progress towards the MTO, the conditions ex post prevail over the frozen requirements. 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 effort is varied so that Member States can adapt their fiscal adjustments over the economic cycle while taking into account their fiscal consolidation needs.

All Member States are expected to accumulate savings in good times so as to be able to have sufficient latitude for the operation of the so-called automatic stabilisers (e.g. higher welfare spending and lower tax revenues) during the downturns. In good times, revenues of the State increase due to more vigorous economic activity and expenditure related to unemployment falls and usually multipliers are smaller than in bad times. More in general, the economy is expected to be more resilient, such that a bigger structural effort can be undertaken with limited impact on the economy and a larger adjustment can be attained. Thus, the larger the positive (negative) output gap, the greater (lower) the required adjustment effort. The matrix of requirements below also takes into account the direction into which 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 also greater for Member States with unfavourable overall fiscal positions, i.e. whether fiscal sustainability is at risk or the debt-to-GDP ratio is above the 60% of GDP reference value of the Treaty.

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

⁽⁵²⁾ <http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf>

⁽⁵³⁾ Communication from the Commission *Making the best use of the flexibility within the existing rules of the Stability and Growth Pact*, COM(2015) 12 of 13.01.2015:
<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0012&from=en>

In normal times, interpreted as an output gap between -1.5% and +1.5% of potential GDP, all Member States with a debt-to-GDP ratio below 60% would be required to make an effort of 0.5% of GDP, whereas Member States with debt levels above 60% would need to make an adjustment greater than 0.5% of GDP. The latter is conventionally understood to be 0.6% of GDP at least.

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

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

The output gap thresholds set at -3% and -4% of potential GDP are supported by past data: since the 1980s, output gaps in Member States have been below -4% in only one year out of twenty, while they reached -3% in one year

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

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 that Member States are able to plan adequately and adopt the appropriate budgetary measures to ensure compliance with their obligations under the preventive arm of the Pact, the required adjustment path to the MTO for year t is frozen in the spring of year $t-1$. Thus 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 the benchmark for assessing the appropriateness of the change in the structural balance for year t in the in-year assessment that occurs during year t , and in the ex post assessment that occurs in year $t+1$. In order to avoid unwarranted consequences of fluctuations in the output gap and the structural balance beyond the control of the governments, if the output gap turns out to be larger than -3% of potential GDP (i.e. the Member State is found to be in very bad times or exceptionally bad times) or the Member State is found to have achieved the MTO, the initial requirements are ‘unfrozen’. Following the Opinion of the Economic and Financial Committee of 29 November 2016 and the subsequent discussion and endorsement by the Committee, such “unfreezing” may take place in 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.

1.3.2.3. Taking into account the implementation of structural reforms

The Stability and Growth Pact provides the necessary flexibility within the rules to support structural reforms without compromising fiscal responsibility. Regulation (EC) 1466/97 allows Member States implementing major structural reforms to deviate temporarily from the MTO or the adjustment path towards it, if those reforms have positive budgetary effects in the long-term, including by raising potential growth. The deviation is allowed provided the Member State remains in the preventive arm, that an appropriate safety margin with respect to the 3% of GDP deficit reference value is preserved⁽⁵⁴⁾ and that the budgetary position is expected to return to the MTO within the programme horizon (i.e. by the year $t+4$ at the latest, with t being the year of submission of the SCP). The Commission Communication on Flexibility within the SGP⁽⁵⁵⁾ provided additional guidance on the best possible use of the flexibility embedded in the existing fiscal rules to strengthen the link between structural reforms and fiscal responsibility. On that basis, the Council agreed on the implementation of the flexibility within the SGP, as reflected in the commonly agreed position endorsed by the ECOFIN Council of 12 February 2016.⁽⁵⁶⁾ Box 1.8 describes the structural reform clause. The full text of the “Commonly agreed position on flexibility” is set out in Annex 16.

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

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

There are two possible channels through which reforms can affect public finances in the long-run. First, some structural reforms may generate a direct positive budgetary impact, as for instance is the case of pension reforms, health care reforms or reforms to the public administration. Second, some structural reforms may have an indirect sustainability-enhancing effect, in cases where they result in higher

⁽⁵⁴⁾ 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.

⁽⁵⁵⁾ COM (2015) 12 final provisional.

⁽⁵⁶⁾ <http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf>

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.”

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 which are direct consequence of the reform, and the indirect budgetary impact linked to potential output effects of the reform. In fact, Annex 1 to the Code of Conduct on the SGP –which details the structure of the Stability and Convergence Programmes– establishes that the growth and budgetary implications of “major” structural reforms should be detailed by Member States when submitting their economic and budgetary projections. Based on the information provided⁽⁵⁷⁾ by the Member State, the Commission will pass an informed judgement, which may include a plausibility assessment, on whether the reform meets the sustainability-enhancing condition to qualify for application of the clause. That plausibility analysis could draw upon the methodology outlined in Annex 15, while having in mind uncertainties and risks associated with quantitative estimations of impacts of structural reforms.

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

All the reforms must be fully implemented before being considered as eligible for the clause. The reforms must be adopted by the national authorities through provisions of binding force, whether legislative or not, in accordance with the applicable domestic laws and procedures. However, the effective implementation of adopted reform may take time and may be subject to delays and setbacks. 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 legal framework in which the SGP operates –notably the European Semester process and the Excessive Imbalances Procedure (EIP)⁽⁵⁸⁾– allows the Commission and the Council to assess the challenges and imbalances requiring structural reforms, and for monitoring 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 – subsumed, as relevant, in the National Reform Programme (NRP) or Corrective Action Plan (CAP).⁽⁵⁹⁾ 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 an Excessive Imbalances Procedure (EIP) and has submitted a Corrective Action Plan (CAP) with the necessary information, the implementation of the reforms will then be monitored through the EIP. In both cases, Member States will be expected to provide in-depth and transparent documentation quantifying the short-term costs –if any– of the reforms and both the medium-term

⁽⁵⁷⁾ According to the Code of Conduct on the SGP, sufficient, detailed information is to be provided in the Stability and Convergence Programmes. Therefore, since 2015, Member States applying for the use of the structural reform clause are requested to include in both the SCP and the NRP a table with detailed description (including the budgetary impact) of each structural reform (see Annex 3).

⁽⁵⁸⁾ Regulation (EU) 1176/2011.

⁽⁵⁹⁾ 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.

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 1.7: 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 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.⁽⁶⁰⁾ 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 for 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 forgone social contributions or other revenues.

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

The structural reform clause is granted in the context of the assessment of the SCPs, specifically in the relevant Country Specific Recommendation (CSR). 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. The “Commonly agreed position on flexibility within the SGP” –see Annex 16– gives further details on how the Commission and the Council will set the requirements (via the CSR) if the structural reform is planned but not yet fully implemented.

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 1.3.2.7) from the MTO or the path towards it, the Commission will launch a Significant Deviation Procedure, following the steps set out under Article 121(4) TFEU and Articles 6(2) or 10(2) of Regulation (EC) 1466/97.

⁽⁶⁰⁾ The Code of Conduct on the SGP stipulates 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.

BOX 1.8: THE OPERATIONALISATION OF THE “STRUCTURAL REFORM CLAUSE”

The structural reform clause allows Member States to temporarily deviate from the MTO or the appropriate adjustment path towards it. However, the deviation should not lead to a breach of the 3% of GDP deficit threshold and at the time of the assessment of the application for use of the clause ⁽⁶¹⁾, a safety margin in relation to that threshold should be continuously preserved. As indicated in Box 1.6, the requirements in terms of change in the structural balance (and expenditure benchmark) for each year are set and kept unchanged on the basis of the spring forecast of the year before. Therefore, the temporary deviation linked to structural reforms submitted in the SCPs in year t will be allowed from year $t+1$ onwards.

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

- In case of an eligible pension reform (see Box 1.7), the allowed deviation from the adjustment path towards the MTO or from the MTO itself would amount to the direct incremental impact of the reform on the general government balance. There is no cap for the amount of allowed deviation in that case, provided that an appropriate safety margin with respect to the 3% of GDP deficit reference value is preserved.
- In case of other structural reforms, the Council agreement establishes that the allowed deviation from the MTO, or the adjustment path towards it, will not exceed 0.5% of GDP, thereby establishing a cap to the maximum allowed deviation.

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

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 is restricted to one single time per period of adjustment towards the MTO;
- the maximum initial distance, which the structural balance can be from the MTO, is 1.5% of GDP in year t . 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. Moreover, according to the commonly agreed position on flexibility within the SGP endorsed by the ECOFIN Council of 12 February 2016,⁽⁶²⁾ if the same Member State is also given the benefit of the investment clause (see Section 1.3.2.4), the cumulative temporary deviation allowed under the two clauses will not exceed 0.75% of GDP.

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

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

⁽⁶¹⁾ For the sake of predictability, clauses are not retracted once granted, if compliance with the Minimum Benchmark is altered due to future Minimum Benchmark revisions.

⁽⁶²⁾ <http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf>

$SB_{t+1} = SB_t + \min[\text{adj_matrix}_{t+1} - \text{deviation}, \{(MTO - \text{deviation}) - SB_t\}]$ $SB_{t+2} = SB_{t+1} + \min[\text{adj_matrix}_{t+2}, \{(MTO - \text{deviation}) - SB_{t+1}\}]$ $SB_{t+3} = SB_{t+2} + \min[\text{adj_matrix}_{t+3}, \{(MTO - \text{deviation}) - SB_{t+2}\}]$ $SB_{t+4} = SB_{t+3} + \min[\text{adj_matrix}_{t+4}, \{MTO - SB_{t+3}\}]$ <p>Where:</p> <ul style="list-style-type: none"> - SB_{t+1} denotes the structural balance in % of GDP in year t+1 - adj_matrix_{t+1} denotes the appropriate adjustment towards the MTO in year t+1 resulting from the matrix in Box 1.6 - deviation denotes the temporary allowed deviation - $\{(MTO - \text{deviation}) - SB_t\}$ denotes the distance between the MTO minus the temporary allowed deviation and the structural balance prevailing the previous year. <p>Expressing the above in terms of the adjustment required in year t+1, gives:</p> $\text{reform_adj}_{t+1} = \min\{\text{adj_matrix}_{t+1} - \text{deviation}, [(MTO - \text{deviation}) - SB_t]\}$
--

1.3.2.4. Taking into account investment

Under the preventive arm of the SGP, some investments aiming at, ancillary to, and economically equivalent to major structural reforms, may under certain conditions justify a temporary deviation from the MTO or from the adjustment path towards it. The Commission provided its first guidance in 2013 on the application of those provisions in line with Articles 5(1) and 9(1) of Regulation (EC) 1466/97, i.e. as a specific application of the “structural reform clause”. That guidance, commonly referred to as the “investment clause” was further specified through the Commission Communication on Flexibility within the SGP.⁽⁶³⁾ On that basis, the Council decided on the implementation of the flexibility within the SGP, as reflected in the commonly agreed position endorsed by the ECOFIN Council of 12 February 2016.⁽⁶⁴⁾ The investment clause is described in Box 1.9. The full text of the “Commonly agreed position on flexibility” is set out in Annex 16.

A temporary deviation from the MTO, or the adjustment path towards it, may be granted for the financing of certain specific investments with positive, direct and verifiable long-term budgetary effects on growth and on the sustainability of public finances under certain conditions. In particular, the Member State’s GDP growth is forecast to be negative or to remain well below its potential (resulting in negative output gap greater than 1.5% of potential GDP), the Member State remains in the preventive arm and 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.⁽⁶⁵⁾

⁽⁶³⁾ Communication from the Commission *Making the best use of the flexibility within the existing rules of the Stability and Growth Pact*, COM(2015) 12 of 13.01.2015:

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

⁽⁶⁴⁾ <http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf>

⁽⁶⁵⁾ The Code of Conduct on the SGP stipulates 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).

The deviation allowed must be linked to the national expenditure on projects co-funded by the EU under the Structural and Investment Funds,⁽⁶⁶⁾ Trans-European-Network (TEN) or Connecting Europe Facility (CEF) and to national co-financing of investment projects also co-financed by the European Fund for Strategic Investments (EFSI), with positive, direct and verifiable long-term budgetary effects. Moreover, co-financed expenditure should not substitute for nationally financed investments, so that total public investments are not decreased.

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

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. Specifically, 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 economically equivalent to the implementation of structural reforms. In its assessment the Commission will consider whether the eligible investment occurs against the background of structural actions aiming at improving the productive capacity of the economy. In that sense, investment is considered as aiming at, ancillary to, and economically equivalent to major structural reforms. However, the granting of the temporary deviation under the investment clause will not be conditional on a specific assessment of structural reforms comparable to the assessment undertaken for the application of the structural reform clause.

The investment clause is granted in the context of the assessment of the SCPs, specifically in the relevant Country Specific Recommendation. 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 Country Specific Recommendation. *Ex ante*, the potential deviation will depend on the commitments of the EU Structural Funds towards each Member State as well as on the level of planned co-financing. *Ex post*, the allowed deviation will depend on the effective payments of EU Structural Funds and on the 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.

⁽⁶⁶⁾ See Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013.

BOX 1.9: THE OPERATIONALISATION OF THE “INVESTMENT CLAUSE”

As for the “structural reform clause” (Box 1.8):

- the application of the investment clause is restricted to one single time per period of adjustment towards the MTO;
- the maximum initial distance, which the structural balance can be from the MTO, is 1.5% of GDP in year t.

Moreover, according to the commonly agreed position on flexibility within the SGP endorsed by the ECOFIN Council of 12 February 2016,⁽⁶⁷⁾

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

As for the “structural reform clause”, the allowed deviation is adjusted according to the Member State’s distance to its MTO so as to equalise the impact on the debt level. A Member State at its MTO is allowed to depart from it for three years. For 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.

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

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 investment clause will be: ⁽⁶⁸⁾

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

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

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

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

Where:

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

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

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

⁽⁶⁷⁾ <http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf>

⁽⁶⁸⁾ It has to be noted that for Member States benefitting from the clause while they are above the MTO, that formula displays a ceiling and not a compulsory adjustment path.

1.3.2.5. *Considering the impact of adverse economic events*

Since the Six-Pack reform of the Stability and Growth Pact in 2011, the pace of fiscal consolidation may be adapted for all Member States as long as such an adaptation does not endanger fiscal sustainability in the medium-run, in cases of a severe economic downturn in the euro area or in the EU as a whole. Parallel provisions apply to 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 medium-term budgetary objective referred to in the third subparagraph, provided that this does not endanger fiscal sustainability in the medium term.”

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

Apart from a severe economic downturn for the euro area or the Union 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 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) 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 such 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 change in the structural balance, the 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 itself.

That exceptional treatment is therefore linked to some principles⁽⁶⁹⁾:

- 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.

⁽⁶⁹⁾ 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.

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 the additional means to tackle the unusual event in year t (with respect to the 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 additional means to tackle the unusual event in years t and t+1 (with respect to the same t-1 baseline).

At the same time, in line with the specific 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, but this can only be confirmed in the ex-post assessment.

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. ⁽⁷⁰⁾ In general, any activation of the clause should be of a temporary nature, i.e., as rule, not going beyond t+1, though 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 MTO and those still on the adjustment path toward it should be granted the same type/quality of deviation. Therefore, in order to do so, it is necessary to require the Member States to adjust onto a trajectory that is parallel to their original path. While for Member States on the adjustment path to their MTO the deviation is expressed in terms of the change in the structural balance, 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 in the Commonly Agreed Position on Flexibility under the structural reform and investment clauses (see Boxes 1.8 and 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 related to i) the exceptional refugee inflows towards the Member States and ii) security costs to tackle the terrorist threat in specific Member States.

In relation to the refugee crisis, the Commission used the unusual event provisions when assessing (ex post) the temporary deviation from the requirements for 2015, 2016 and 2017 due to the additional costs in each of those three years resulting from the exceptional inflow of refugees compared to the previous

⁽⁷⁰⁾ 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.

year. ⁽⁷¹⁾ 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. The same approach was applied (in 2016 and 2017) to the treatment of additional costs relating to the terrorist threat. The budgetary costs related to both refugee inflows and the terrorist threat are not considered as one-offs, as the additional expenditure is not necessarily temporary and non-recurrent.

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

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

Applying the expenditure benchmark

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

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

For Member States that have not attained their MTO:

- Annual expenditure growth should not exceed a specific lower rate, which is set below the reference medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures. The difference between the appropriate growth rate for net expenditure and the reference medium-term rate of potential GDP growth is referred to as the convergence margin and is set so as to ensure the appropriate adjustment towards the MTO (i.e. in line with the required change in the structural balance). 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 spending,

⁽⁷¹⁾ In the case of Italy in 2017, due to the long-standing nature of the crisis and in light of the European Council conclusions of October 2016, the change in the costs in that year compared to the average over 2011-2013 was considered.

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 smoothing 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.⁽⁷²⁾

In order to avoid a (partial) double-counting of the investment 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: in addition, 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 Country-Specific Recommendations 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 structural balance but indicates the maximum growth rate of expenditure compatible with the Member State remaining at the MTO.⁽⁷³⁾

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

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

The medium-term rate of potential GDP growth is calculated 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

⁽⁷²⁾ 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 29 November 2016 (see Annex 16).

⁽⁷³⁾ 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 29 November 2016 (see Annex 16).

set out by the Output Gap Working Group for the years beyond the scope of the Commission forecast. As from spring 2015, the medium-term rate of potential GDP growth applied to set the requirements for year t is calculated on the basis of the Commission spring forecast in t-1. Annex 4 gives the medium-term rates used for the assessments of the 2015 and 2016 budgetary figures.⁽⁷⁴⁾

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 MTO, 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. It is calculated based on the assumption that any decrease in the share of public expenditure not financed by additional revenue measures (which would occur if net expenditure grows more slowly than GDP) would then translate into an exactly proportional improvement of the structural balance (the coefficient being equal to the share of public 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.

The medium-term potential growth and the convergence margin are calculated on a yearly basis to set the requirements for the following year.

Box 1.10: THE CONVERGENCE MARGIN

The convergence margin is Member State-specific. It is applied to the medium-term rate of potential GDP.

For Member States not at their MTO, 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. As discussed in Box 1.6, Member States' required annual fiscal adjustment is varied so as to take into account the economic cycle as well as their debt levels and sustainability risks: it can be therefore lower or higher than the benchmark of 0.5% of GDP and reflects that greater or lower adjustment need.

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 limited below GDP (denominator) growth.⁽⁷⁵⁾

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:

⁽⁷⁴⁾ The reference rates in use for the budgetary figures of 2015 were computed on the basis of the Commission winter forecast 2013. Following the introduction of yearly update of the reference rate (in spring 2015), a transitional arrangement was put in place, only for the assessment of 2016, according to which the less demanding reference rate between the old and the updated one is used.

⁽⁷⁵⁾ For example, for a Member State with a 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 p.p., i.e. the lower rate will be 0.04 p.p. higher. Assuming real GDP growth of 2%, the 1 p.p. increase in primary expenditure in fact corresponds to a lower rate 8% higher (0.54 compared to 0.50).

$$L = R - C.$$

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:

$$C = (\text{distance MTO}/P) * 100 * -1$$

where the "distance MTO" term corresponds to the (positive) difference between the structural balance at the start of the year and the MTO. 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⁽⁷⁶⁾.

For Member States not yet at their MTO, the required annual fiscal adjustment is varied so as to take into account the economic cycle as well as their debt levels and sustainability risks (see Box 1.6). 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 which constrains net expenditure growth.

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 (see Box 1.6 for further details on the implementation of the so-called freezing of the requirements).

While potential GDP is measured in real terms, expenditure plans are typically set in nominal terms. Therefore, to convert the expenditure benchmark into nominal terms to allow for the comparison the GDP deflator is used as a measure of inflation.⁽⁷⁷⁾ 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).

⁽⁷⁶⁾ 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 fulfilling the MTO.

⁽⁷⁷⁾ The GDP deflator fulfils two criteria: First, it is conceptually sound and coherent with the aim of the preventive arm. Since the expenditure benchmark is based on a potential rate of GDP growth, aligning growth rates of both net expenditure and revenues (where growth rate is proxied by GDP growth) and using a common deflator ensures a constant differential and allows the Member State respecting the expenditure benchmark to remain at its MTO. Second, on a practical level, the GDP deflator typically displays less volatility than other measures of inflation and is therefore more conducive to supporting transparent and stable policy-making.

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
2018	2019	Deflator for 2018 of 2017 spring Commission forecast
t	t+1	Deflator for t of 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).

Box 1.11: HOW THE NET EXPENDITURE GROWTH RATE FOR YEAR T IS COMPUTED?

Step 1 – The first step in the calculation requires the computation of *modified* expenditure aggregates for years t⁽⁷⁸⁾ and t-1, referred to as Gt and Gt-1, respectively.

	Variable (for t unless otherwise mentioned, in nominal terms)	Source
+	Government expenditure aggregate	SCPs (table 2a, ESA code TE)
-	Interest expenditure	SCPs (table 2a, ESA code D.41)
-	Government expenditure on EU programmes which is fully matched by EU funds revenue	SCPs (table 2c, row 1)
-	Gross fixed capital formation 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) – 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) – SCPs (table 2c, row 1a) <i>if available</i> ESTAT (and ECB) for past data
-	Cyclical unemployment benefit expenditure	SCPs (table 2c, row 2)
=	<i>modified</i> expenditure aggregate Et	

Step 2 – Expenditure *net of discretionary revenue measures* is obtained by subtracting from the *modified* expenditure aggregate Et 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* (ΔR_t) of discretionary revenue measures having an incremental effect on revenues collected in t, including the revenue increase mandated by law – both revenue-increasing *and* -decreasing measures are to be taken into account. Member States should provide the estimate of 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: $gt = (Gt - \Delta R_t - Gt-1) / Gt-1$

Annex 8 provides a numerical example of how the net expenditure growth rate is calculated and applied.

⁽⁷⁸⁾ Year t is the year of budgetary execution being assessed (either *ex ante*, *in-year* or *ex post*).

Concluding the assessment on the expenditure benchmark

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

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

1.3.2.7. The assessment of compliance with the preventive arm

Regulation (EC) 1466/97 specifies how a deviation from the MTO or the adjustment path towards it will be measured. More specifically, the Regulation 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 of the SCPs⁽⁷⁹⁾ (and also of DBPs for euro area Member States), therefore, evaluates the overall compliance of the Member State with the requirements of the preventive arm and can reach a conclusion of compliance, (some) deviation⁽⁸⁰⁾ 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 procedural steps set out under Article 121(4) TFEU (hereafter Significant Deviation Procedure – SDP), as outlined in Section 1.4. The assessment should also include a discussion of the figures underlying the two indicators, i.e. structural balance and expenditure benchmark, to enable a clear understanding of the basis of the overall conclusion.

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

- (a) for a Member State that has not reached the MTO,⁽⁸¹⁾ 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.

Articles 6(3) (for stability programmes) and Article 10(3) (for convergence programmes) further provide that "The deviation of expenditure developments shall not be considered significant if the Member State concerned has overachieved the medium-term budgetary objective, taking into account the possibility of significant revenue windfalls and the budgetary plans laid out in the [stability][convergence] programme

⁽⁷⁹⁾ Taking the plans (after recalculating the structural balance based on the commonly agreed methodology, implemented through the CONV simplified routine), and then taking into account the risks attached to the SCP/DBP scenario, as embodied in, for instance, the most recent Commission forecasts.

⁽⁸⁰⁾ "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.

⁽⁸¹⁾ 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.

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

In considering compliance with the preventive arm, the analysis of Member States exceeding their MTO will therefore 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 laid out in the stability or convergence programmes do not jeopardise the MTO over the programme period, the deviation in the expenditure benchmark for year t is left out of consideration (also for the assessment of the two-year deviations comprising year t)⁽⁸²⁾. However, if the overachievement of the MTO is explained by significant revenue windfalls, the deviation in the expenditure benchmark will be considered (also for the assessment of the two-year deviations comprising year t). As a convention, the Commission considers a Member State to be at its MTO if it is within $\frac{1}{4}$ percentage points of GDP from its MTO. That convention has been applied over time, and aims to account for the inevitable uncertainty in judging the precise position of the structural balance.

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

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

A Member State that did not achieve its MTO in t will need to have been or plan to be on an appropriate adjustment path to the MTO in that year. This will require comparing the actual change in the structural balance to the appropriate adjustment path and to assess compliance with the expenditure benchmark, with respect to the requirements frozen in spring of the year $t-1$ (see Box 1.6).⁽⁸³⁾ The frozen requirements do not apply if the economic conditions have deteriorated to very bad or exceptionally bad times or if the Member State has achieved or is in reach of its MTO (i.e. the distance of the structural balance at year $t-1$ to the MTO is smaller than the frozen requirement).

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

In addition, Member States that exceeded their MTO in $t-1$ can deviate from the requirements of the expenditure benchmark without it being considered significant, as long as the MTO is maintained, unless the overachievement of the MTO is explained by significant revenue windfalls.

As part of the incorporation of the MTO objective into the national legal order, those countries that are signatories of the TSCG and bound by the Fiscal Compact must implement automatic correction mechanisms at the national levels which will operate in the event of significant observed deviations. The

⁽⁸²⁾ That is, the two-year deviation for year t , computed over years $t-1$ and t , as well as to the two-year deviation for year $t+1$, computed over years t and $t+1$.

⁽⁸³⁾ For a Member State under a Significant Deviation Procedure which has not corrected its significant deviation, the adjustment path should reflect the requirements of its Council recommendation requesting the correction of the significant deviation.

Commission's Communication on *Common principles for the national correction mechanisms*⁽⁸⁴⁾ gives the principles underlying the design of the requested corrective mechanisms.⁽⁸⁵⁾ Moreover, the Two Pack requires that euro area Member States have in place independent bodies to oversee the operation of those mechanisms. Section 3.2.1 goes over those requirements in more detail.

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

- If the Member State is compliant with both indicators, the overall conclusion will be one of compliance with the preventive arm. On an ex ante basis, 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.⁽⁸⁶⁾ On an ex ante basis, a conclusion of a risk of significant deviation means that if the plans turn out as forecast, the Member State will be in significant deviation with respect to the preventive arm and would have a Significant Deviation Procedure (SDP, (i.e. the procedural steps set out under Article 121(4) TFEU and Articles 6(2) and 10(2) of Regulation (EC) 1466/97) 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 SDP.

In the overall assessment, particularly when only one indicator points to a significant deviation, the Commission analyses the factors which lead to the discrepancy between the two indicators. It informs the Council about 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 (see Annex 13).

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.⁽⁸⁷⁾ Finally, a

⁽⁸⁴⁾ (COM/2012/0342 final).

⁽⁸⁵⁾ See Box 3.2 in Section 3.2.1.

⁽⁸⁶⁾ Articles 6(3) and 10(3): "A deviation from the medium-term budgetary objective or from the appropriate adjustment path towards it shall be evaluated *on the basis of an overall assessment* [...]. The assessment of whether the deviation is significant shall, in particular, *include* the following criteria [...]"

⁽⁸⁷⁾ 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.

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 Economic and Financial Committee 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 Opinion of the Economic and Financial Committee of 29 November 2016.⁽⁸⁸⁾ As indicated to Member States and reflected in the recitals of the 2017 Country Specific Recommendations, 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 SDP, which starts with a Commission warning to the Member State in question and can lead to an interest-bearing deposit being required, for euro area Member States. Section 1.4 presents it in more detail.

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

Δ SBal	Adjustment delivered	Deviation	Breach of the threshold of significance
Dev. from the EB			
Benchmark Respected	Compliance	<i>Need an overall assessment</i> (cannot lead to a significant deviation procedure)	<i>Need an overall assessment</i> (can lead to a significant deviation procedure)
Deviation	<i>Need an overall assessment</i> (cannot lead to a significant deviation procedure)	<i>Need an overall assessment</i> (cannot lead to a significant deviation procedure)	<i>Need an overall assessment</i> (can lead to a significant deviation procedure)
Breach of the threshold of significance	<i>Need an overall assessment</i> (can lead to a significant deviation procedure)	<i>Need an overall assessment</i> (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)

⁽⁸⁸⁾ 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 29 November 2016 (see Annex 16).

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

The ex post assessment of the preventive arm is of particular importance as, in the event where a significant deviation from adjustment path to the MTO is found, the Commission will launch a SDP. It is based on outturn data. Graph 1.3 sets out the various steps to be followed, while Annex 6 provides details on the voting arrangements.

The purpose of the Significant Deviation Procedure 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 Significant Deviation Procedure, 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 Significant Deviation Procedure 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 was particularly serious and warranted 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.

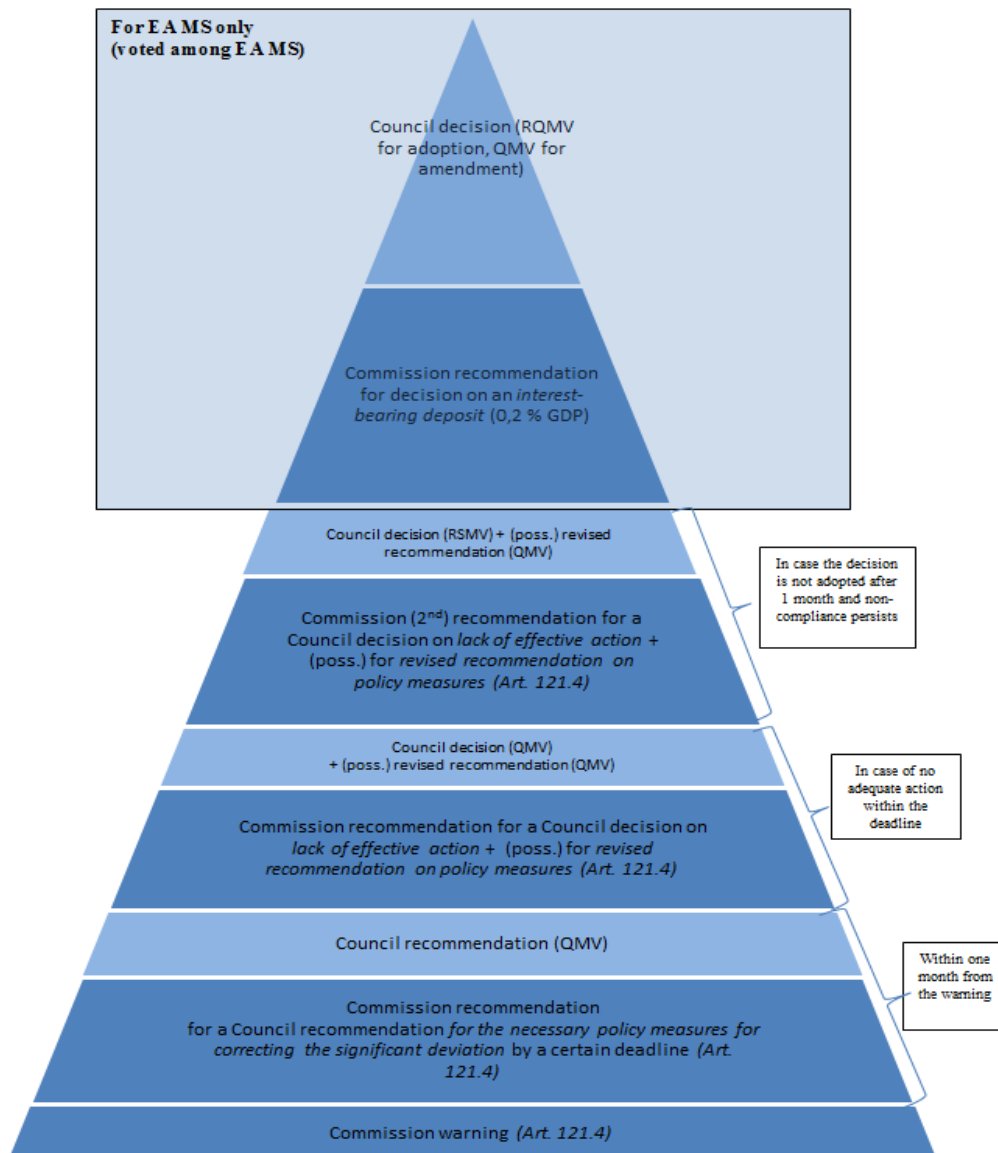
If the Council does not adopt the decision on no effective action and the lack of appropriate action by the Member State in question persists, the Commission will make a new recommendation for a Council decision on no effective action within one month of the previous one. That new recommendation will 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 significant deviation procedure, only euro area Member States vote on decisions concerning other euro participants, and the vote of the Member State concerned is not taken into account in any case. The Council submits a report to the European Council on all decisions taken.

The adoption of a Council decision on no effective action is the start of the sanctions procedure for euro area Member States. 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 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 which reflects the Commission’s credit risk and the relevant investment period. It will be returned to the Member State with the interest accrued once the situation which led to a decision of non-effective action relative to the Council recommendations under Article 121(4) 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, where 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.

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



2. THE CORRECTIVE ARM OF THE STABILITY AND GROWTH PACT

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

2.1. LEGAL BASIS, RATIONALE AND PROCEDURAL STEPS

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

The corrective arm of the Pact implements the steps set out under Article 126 TFEU and Protocol N° 12 on the Excessive Deficit Procedure. Its operation is set out in Council Regulation (EC) 1467/97 and its subsequent amendments, and details relating to its implementation are further specified in the Code of Conduct on the SGP.⁽⁸⁹⁾

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

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

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

⁽⁸⁹⁾ http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf

European Structural and Investment Funds for all Member States.⁽⁹⁰⁾ The comprehensive sanctions toolbox and its functioning are described in greater detail in Section 2.4.

2.1.1. Legal basis of the corrective arm

The primary legal basis of the corrective arm of the SGP is Article 126 TFEU and Protocol N° 12 to the Treaty. Article 126 TFEU specifies that Member States shall avoid excessive deficits and defines budgetary discipline in terms of compliance with specific bounds for government deficit and debt levels (see Box 2.1).⁽⁹¹⁾ It sets out the steps to be taken when one or both of those conditions are not complied with. The actual reference values against which the deficit and debt criteria are based are defined in Protocol N° 12 (see Box 2.2).

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

⁽⁹⁰⁾ All Member States, except the United Kingdom, can be subject to a suspension of commitments or payments of the European Structural and Investment Funds under the macroeconomic conditionality provisions.

⁽⁹¹⁾ 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.

Box 2.1: Article 126 of TFEU

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

The reference values are specified in the Protocol on the excessive deficit procedure annexed to the Treaties.
3. If a Member State does not fulfil the requirements under one or both of these criteria, the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State. The Commission may also prepare a report if, notwithstanding the fulfilment of the requirements under the criteria, it is of the opinion that there is a risk of an excessive deficit in a Member State.
4. The Economic and Financial Committee shall formulate an opinion on the report of the Commission.
5. If the Commission considers that an excessive deficit in a Member State exists or may occur, it shall address an opinion to the Member State concerned and shall inform the Council accordingly.
6. The Council shall, on a proposal from the Commission, and having considered any observations which the Member State concerned may wish to make, decide after an overall assessment whether an excessive deficit exists.
7. Where the Council decides, in accordance with paragraph 6, that an excessive deficit exists, it shall adopt, without undue delay, on a recommendation from the Commission, recommendations addressed to the Member State concerned with a view to bringing that situation to an end within a given period. Subject to the provisions of paragraph 8, these recommendations shall not be made public.
8. Where it establishes that there has been no effective action in response to its recommendations within the period laid down, the Council may make its recommendations public.
9. If a Member State persists in failing to put into practice the recommendations of the Council, the Council may decide to give notice to the Member State to take, within a specified time limit, measures for the deficit reduction which is judged necessary by the Council in order to remedy the situation. In such a case, the Council may request the Member State concerned to submit reports in accordance with a specific timetable in order to examine the adjustment efforts of that Member State.
10. The rights to bring actions provided for in Articles 258 and 259 may not be exercised within the framework of paragraphs 1 to 9 of this Article.
11. As long as a Member State fails to comply with a decision taken in accordance with paragraph 9, the Council may decide to apply or, as the case may be, intensify one or more of the following measures:
 - to require the Member State concerned to publish additional information, to be specified by the Council, before issuing bonds and securities,

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

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

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

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

When the Council adopts the measures referred to in paragraphs 6 to 9, 11 and 12, it shall act without taking into account the vote of the member of the Council representing the Member State concerned.

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

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

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

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

Box 2.2: Protocol 12 on the Excessive Deficit Procedure

THE HIGH CONTRACTING PARTIES,

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

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

Article 1

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

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

Article 2

In Article 126 of the said Treaty and in this Protocol:

- ‘government’ means general government, that is central government, regional or local government and social security funds, to the exclusion of commercial operations, as defined in the European System of Integrated Economic Accounts;
- ‘deficit’ means net borrowing as defined in the European System of Integrated Economic Accounts;
- ‘investment’ means gross fixed capital formation as defined in the European System of Integrated Economic Accounts;
- ‘debt’ means total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government as defined in the first indent.

Article 3

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

Article 4

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

The implementation of the corrective arm of the Pact is governed by secondary legislation, based on Article 126(14) TFEU, in the form of Regulation (EC) 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, as amended by Regulation (EC) 1056/2005 of 27 June 2005 and Council Regulation (EU) 1177/2011 of 8 November 2011.⁽⁹²⁾ It is further specified in the Code of Conduct on the SGP.

In addition, Regulation (EU) 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area added a system of effective preventive and graduated enforcement mechanisms to the Pact. That Regulation complements the sanctions envisaged under Article 126(11) TFEU by an earlier and graduated system of sanctions on the basis of Article 136 TFEU for euro area Member States only. This is to ensure that sanctions are more effective by being applicable at a time when Member States are able to react. In fact, restricting them to Article 126(11) TFEU means that they would only be levied on Member States that would be, by definition, in a very difficult financial situation. All countries – except the United Kingdom – may also be

⁽⁹²⁾ Annex 1 contains links to all relevant legislation. The consolidated text is available under: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1467:20111213:EN:PDF>

subject to the suspension of commitments or payments under the European Structural and Investment Funds following a Council decision on a lack of effective action under the EDP.⁽⁹³⁾

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

The Code of Conduct on the SGP has been complemented by specification on the implementation of the Excessive Deficit Procedure.⁽⁹⁴⁾

Council Regulation (EC) 479/2009 of 25 May 2009⁽⁹⁵⁾ on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community defines the statistical and reporting obligations on Member States, in terms of the data to be provided for the application of the EDP.

As described in Box 1.3, Member States which have adhered to the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) have committed themselves to voting through a procedure equivalent to reverse qualified majority voting (RQMV – see Annex 6) on all votes concerning euro area Member States for deficit EDPs, and to presenting an economic partnership programme when subject to an EDP.⁽⁹⁶⁾

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

Regulation (EU) 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability⁽⁹⁷⁾ streamlines the requirements placed on financially fragile countries and embeds those provisions in the EU framework for policy coordination and surveillance, suspending the reporting requirements under the SGP for Member States under a macroeconomic adjustment programme.

Regulation (EU) 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit for the Member States of the euro area⁽⁹⁸⁾ complements the surveillance cycle for all euro area countries and increases monitoring and reporting requirements for countries under EDP. 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.⁽⁹⁹⁾ The Regulation also

⁽⁹³⁾ Regulation (EU) 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) 1083/2006:
<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:347:0320:0469:EN:PDF>

⁽⁹⁴⁾ In addition, the Amsterdam European Council resolution on the SGP of 17 June 1997 and the Report of the Economic and Financial Affairs Council on “Improving the implementation of the Stability and Growth Pact”, endorsed by the European Council in its conclusions of 22 March 2005, also form part of the corrective arm of the Pact, but do not introduce additional operational requirements.

⁽⁹⁵⁾ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:145:0001:0009:EN:PDF>

⁽⁹⁶⁾ The commitment to RQMV applies only to Contracting Parties whose currency is the euro. The commitment to present an economic and budgetary partnership programme applies also to DK, RO and BG.

⁽⁹⁷⁾ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0001:0010:EN:PDF>

⁽⁹⁸⁾ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0011:0023:EN:PDF>

⁽⁹⁹⁾ The content and format of such reports is defined in Commission Delegated Regulation 877/2013 (see annex 12).

allows the Commission to issue an autonomous recommendation to Member States at risk of missing their deadline for correction (see Box 2.7). Moreover, with the launch of an EDP, euro area Member States must present an economic partnership programme (EPP), which sets out the fiscal structural reforms necessary to ensure an efficient and lasting correction of the excessive deficit.

The Code of Conduct on the Two Pack sets out the specifications on the implementation of the Two Pack and the guidelines on the format and content of draft budgetary plans, economic partnership programmes and debt issuance reports.⁽¹⁰⁰⁾

2.1.2. Rationale behind the corrective arm of the SGP

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

Establishing a clear limit to a Member State's deficit and debt is necessary in a context of enhanced spillovers and interdependence between EU –especially euro area– Member States, as was shown clearly in the recent crisis. The spillovers from unsound fiscal policy constrain monetary policy and render its role more difficult. High debt levels in some Member States may cause difficulties to other Member States, especially in difficult times. Large deficits can have a 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 important adverse consequences. High public sector debt levels are in general associated with high interest payments in percentage of GDP, which could crowd out investments; moreover, high levels of debt impose constraints on the use of countercyclical fiscal policy in recessions and the ability to absorb the indebtedness of other sectors at times of stress, which could act as a drag on growth. 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.

The debt requirement was operationalised with the 2011 amendment of the SGP –commonly referred to as the Six Pack– through the so-called debt reduction benchmark. At that time, a number of Member States were already in EDP and, consequently, had their fiscal consolidation paths already defined. In order to ensure that those Member States had time to adapt their structural adjustments to comply with the new debt benchmark, a transition period of three years after the correction of their excessive deficit was introduced. During that period, those Member States must make sufficient progress towards compliance with the debt benchmark rather than actually be compliant with the formula that applies outside the transition period (see Sections 2.2.1.2 and 2.2.1.3).

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

⁽¹⁰⁰⁾ http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf

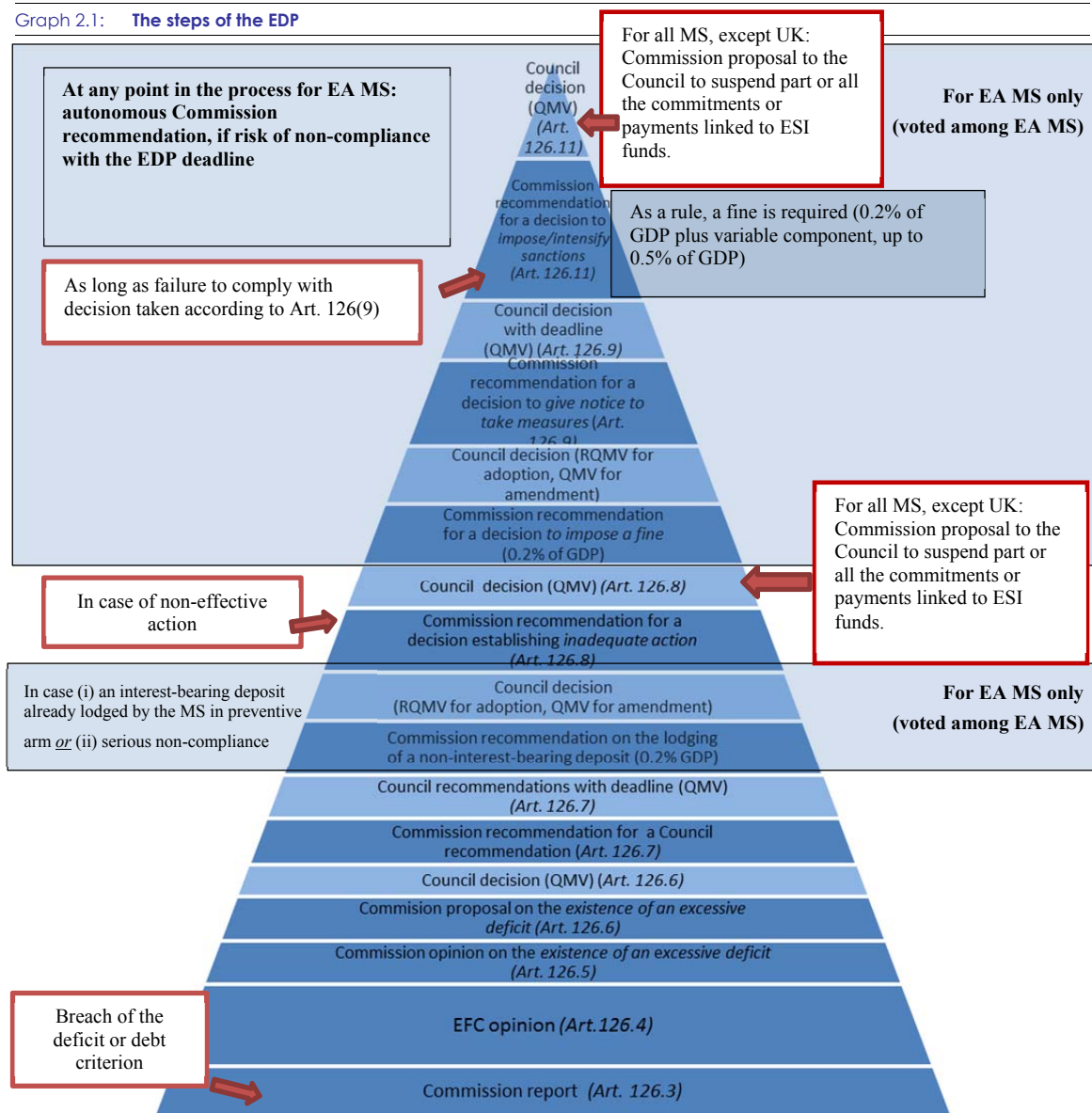
2.1.3. Overview of procedural steps under the corrective arm of the SGP

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

Following the Commission's report and the ensuing opinion from the Economic and Financial Committee, if the Commission considers that an excessive deficit exists or may occur, the Commission issues an opinion to the Member State concerned under Article 126(5) TFEU; then, the Commission prepares a proposal for an Article 126(6) TFEU Council decision on the existence of an excessive deficit; and finally, the Commission prepares a so-called Article 126(7) TFEU recommendation to be adopted by the Council, which sets a time limit to correct the Member State's public finance imbalances and to be compliant with both the deficit and the debt requirements. The recommendation contains annual deficit targets both in nominal and in structural terms, which are linked by an underlying macroeconomic scenario set on the basis of the Commission forecasts. Moreover, a quantification of the policy response required to attain those targets, in terms of the total amount of measures to be taken, is also given.⁽¹⁰¹⁾

⁽¹⁰¹⁾ All the underlying data relevant to the definition of the EDP recommendation to bring an end to the situation of an excessive government deficit are publicly available through the Commission Staff Working Documents accompanying the recommendation.

Graph 2.1: The steps of the EDP



Note: EA: euro area, MS: Member States, QMV: qualified majority voting, RQMV: reverse qualified majority voting. Annex 6 sets out the voting modalities under the SGP in detail.

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 in the recommendation. According to Regulation (EC) 1467/97 that deadline should be within six months, or within three if the situation is judged to be particularly serious. For euro area Member States, the Commission 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.

The Commission undertakes a first assessment, which looks at whether the Member State is on track to correct its excessive deficit, i.e. if it has taken effective action, following the submission of the Member State's report on action taken. Depending on the outcome of 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. With the Two Pack, for euro area Member States, the continuous monitoring is based – on a request by the Commission– on regular reports submitted by the Member State every six months. At any point in the EDP process euro area Member States may be issued an autonomous recommendation by the Commission if the latter perceives a risk of non-compliance with the deadline to correct the excessive deficit. Conversely, as long as a Member State is judged as having taken effective action, it may be issued with revised recommendations, including the possibility of extending the deadline for correction, if unexpected adverse economic events with a major impact on public finances impede its ability to correct its excessive deficit by the deadline initially recommended despite its action.

The stepping up of the EDP involves a Council decision following a Commission recommendation under Article 126(8) TFEU that effective action has not been taken. For euro area Member States, this is the next trigger for the imposition of sanctions in the form of a fine corresponding to 0.2% of GDP in the preceding year as a rule. Following a Council decision that effective action has not been taken, the Commission must propose to suspend part or all of the commitments under the European Structural and Investment Funds (applicable to all Member States except the United Kingdom). In the case where immediate action is sought, or where there has been significant non-compliance, the Commission may instead propose a suspension of part or all of the payments rather than commitments.⁽¹⁰²⁾

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

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

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

⁽¹⁰²⁾ For more details on the conditions for macroeconomic conditionality, see Box 2.8.

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

The Commission forecasts (and the no-policy change assumption used therein – see Box 1.5) play an important role at the various stages of the EDP. At the opening of the EDP the deficit is regarded as “temporary” if it moves back below the Treaty reference value following the end of the unusual event or the severe economic downturn according to the Commission forecast (Regulation (EC) 1467/97). The forward-looking part of the debt benchmark (Section 2.2.1.2) also relies on the Commission forecast (same text). The no-policy change assumption also plays a role in the formulation of EDP recommendations (Section 2.2.3). In 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, 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 rule.

2.2. LAUNCHING AN EXCESSIVE DEFICIT PROCEDURE

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

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

2.2.1. Establishing the existence of an excessive deficit or debt

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

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

the Commission forecasts. A planned breach of the debt criterion needs to be confirmed by outturn data in order to trigger the opening of an EDP.⁽¹⁰³⁾

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.⁽¹⁰⁴⁾

It should be noted that special transitional arrangements apply to the debt rule for Member States that were in EDP in November 2011, when the latest amendments of the SGP –commonly known as the Six Pack– were adopted. Member States in that situation must show compliance with the debt benchmark according to the special transition arrangements for the three years after the correction of their excessive deficit.⁽¹⁰⁵⁾ This is covered in Section 2.2.1.3, below.

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

A Member State is non-compliant with the deficit requirement if its general government deficit is greater than 3% of GDP. No other considerations are taken into account before producing an Article 126(3) report on the basis of the deficit criterion. Indeed, the Commission has committed itself⁽¹⁰⁶⁾ to prepare a report whenever there is the risk of an excessive deficit or whenever the planned or actual government deficit exceeds the reference value of 3% of GDP.

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

A Member State is non-compliant with the debt requirement if its general government debt is greater than 60% of GDP and is not sufficiently diminishing and approaching 60% of GDP at a satisfactory pace. The 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 1/20th per year as a benchmark*”. The Regulation then lays down that “*the requirement under the debt criterion shall also be considered to be fulfilled if the budgetary forecasts of the Commission indicate that the required reduction in the differential will occur over the three-year period encompassing the two years following the final year for which data is available*”. It further provides that “*the influence of the cycle on the pace of debt reduction*” should be taken into account. Those elements are translated into a debt reduction benchmark which has been agreed with the Member States in the Economic and Financial Committee of the Council and is set out in the Code of Conduct on the SGP.

When a Member State’s debt exceeds 60% of GDP, compliance with the debt criterion should be examined. A breach of the 60% threshold from below automatically triggers the production of an Article 126(3) report, unless the debt-to-GDP ratio goes below the threshold reference value within the Commission forecast horizon.⁽¹⁰⁷⁾ In all other cases, a breach of the debt criterion is judged by

⁽¹⁰³⁾ 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).

⁽¹⁰⁴⁾ This is the case, for example, of the EDP launched in June 2013 for Malta: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/2013-05-21_mt_126-3_en.pdf ; and in January 2014 for Croatia: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/2013-11-15_hr_126-3_en.pdf

⁽¹⁰⁵⁾ France and Spain will enter the transition period when their EDPs are abrogated. Cyprus, Greece, Ireland, Portugal, Slovenia and the United Kingdom are currently in their transition periods.

⁽¹⁰⁶⁾ Resolution of the European Council on the Stability and Growth Pact Amsterdam, 17 June 1997: [EUR-Lex - 31997Y0802\(01\) - EN - EUR-Lex](#)

⁽¹⁰⁷⁾ This to ensure consistency of treatment with countries having debt-to-GDP ratio above 60% and meeting the forward-looking debt benchmark.

considering the debt reduction benchmark in three configurations: the backward-looking version, by taking into account the impact of the cycle and the forward-looking version. The backward- and forward-looking benchmarks are computed over a three-year horizon to avoid treating debt peaks as normal factors, hence, catering for the volatility that would imply a one-year rule. Moreover, the length and depth of economic cycles are asymmetric and unknown and cannot, of course, be guaranteed to fit into a six-year time period. This means that meeting the debt reference benchmark on either the backward- or forward-looking measures might at time require large fiscal efforts in bad times. As this is undesirable in itself, the debt reduction benchmark is also adjusted for the effect of the cycle. Only if a Member State is in breach of all those conditions has the Commission the obligation to present an Article 126(3) report.⁽¹⁰⁸⁾ More specifically, a breach of the debt criterion is judged according to the steps set out in Graph 2.2, namely:

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

and

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

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

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

and

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

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

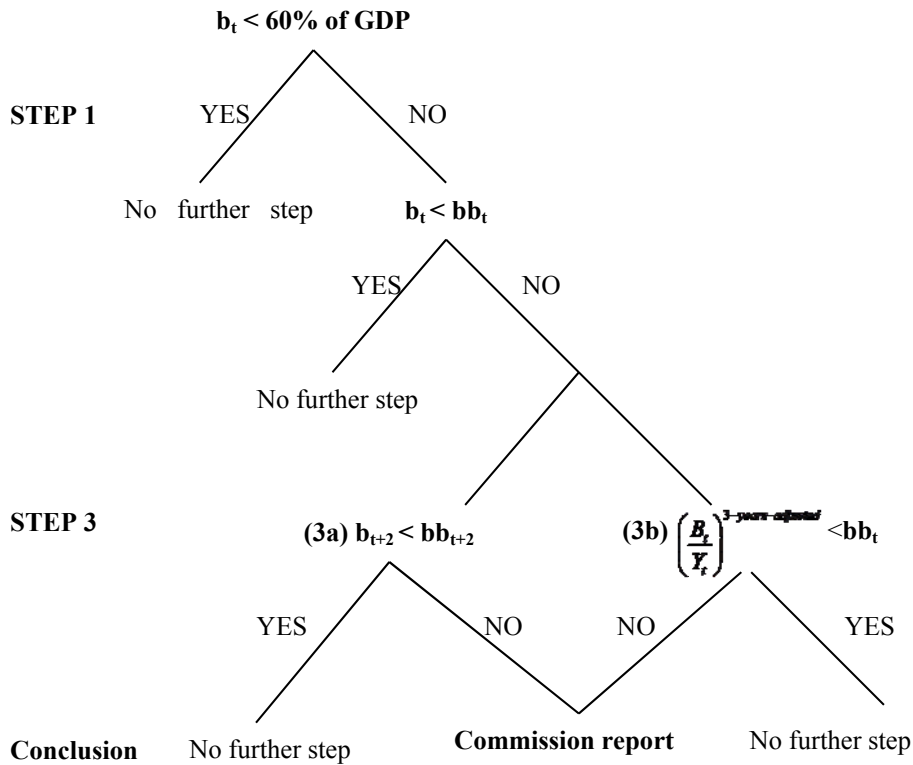
where bb_{t+2} stands for the forward-looking benchmark debt ratio; b_{t+1} and b_{t+2} stand for the debt forecast in year $t+1$ and $t+2$ as estimated by the Commission under the “no-policy-change” assumption (see Box 1.5) on the basis of the fiscal outcome of year t . If the Member State is being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

and

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

⁽¹⁰⁸⁾ As explained in Section 2.2.2.3, as long as the Commission considers that the Member State’s situation has not changed since the last Article 126(3) report, it is not bound to produce another report.

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



The steps set out in Graph 2.2 do not apply when there is a breach of the 60% threshold from below, as neither the backward- nor the forward-looking benchmark can be meaningfully computed in case a Member State goes above the 60% threshold for the first time in year t . In such a case, the identified breach of the debt criterion automatically triggers the production of an Article 126(3) report,⁽¹⁰⁹⁾ in which due consideration is given to all the relevant factors (Section 2.2.2.2).

The correction of the cycle

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

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

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

⁽¹⁰⁹⁾ 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, C_t for the cyclical component of the budget balance. The cyclical components and potential growth are calculated according to agreed methodologies.⁽¹¹⁰⁾

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⁽¹¹¹⁾ 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 is constructed (see Annex 5) taking into account both the influence of the cycle and the forward-looking nature of the debt benchmark. In order to ensure continuous and realistic progress towards compliance during the transition period, Member States should simultaneously respect the two conditions below:

- first, the annual structural adjustment should not deviate by more than $\frac{1}{4}$ % of GDP from the linear structural adjustment ensuring that the least stringent condition consistent with the respect of the debt benchmark is met by the end of the transition period (minimum linear structural adjustment);
- second, at any time during the transition period, the remaining annual structural adjustment should not exceed $\frac{3}{4}$ % of GDP.⁽¹¹²⁾

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 realistic (second condition), while providing some room for manoeuvre during the transition period.

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

⁽¹¹⁰⁾ Following the ECOFIN Council meetings of July 2002/May 2004, the production function (PF) approach for the estimation of output gaps now constitutes the reference method.

⁽¹¹¹⁾ 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.

⁽¹¹²⁾ That condition does not apply if the first condition implies an annual effort above $\frac{3}{4}$ % of GDP.

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 Draft Budgetary Plans (DBPs) in the associated Commission Opinion. The process is the following:

- Year 1: First year of the transition period

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

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

- Year 2: Second year of the transition period

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

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

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

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

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

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

2.2.2. Preparing an Article 126(3) report

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

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

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

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

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

A deficit above 3% of GDP is considered exceptional when it results either (i) from an unusual event outside of the Member State's control and with a major impact on its public finances, or (ii) from a severe economic downturn. A severe economic downturn is defined⁽¹¹³⁾ as a negative real growth of GDP or as an accumulated loss of output during a protracted period of very low real growth of GDP relative to its potential. The excess over 3% is considered temporary if the Commission forecasts indicate that the deficit will fall below 3% following the end of the unusual event or the severe economic downturn.

The report presents an overall assessment of the deficit situation and the context in which it occurred. Article 126(3) 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 *Making the best use of flexibility within the existing rules of the Stability and Growth Pact*⁽¹¹⁴⁾ clarifies that Member States' contributions to the European Fund for Strategic Investments (EFSI)⁽¹¹⁵⁾ 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, Regulation (EU) 473/2013 requires that the extent to which the Member State has taken into account the Commission's Opinion on the its Draft Budgetary Plan should also be considered as a relevant (mitigating or aggravating) factor.

⁽¹¹³⁾ Article 2(2) of Regulation (EC) 1467/97.

⁽¹¹⁴⁾ COM(2015) 12: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0012&from=en>

⁽¹¹⁵⁾ As reflected also in the "Commonly agreed position on flexibility within the SGP", endorsed by the ECOFIN Council on 12 February 2016. <http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf>

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 transitory period, if such breach would not have been registered in the absence of the solidarity operations.

When assessing “sufficient progress towards compliance” through the Minimum Linear Structural Adjustment (MLSA) during the transition period, both the debt and the deficit figures are netted out from 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 of recapitalisation of the banking sector under the EDP, namely that they are regarded as one-off or temporary measures and as relevant factors for financial stability, which means that they do not count against the Member State in the context of the excessive deficit procedure.

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

For a Member State in which the capital injection would lead to an apparent breach of the debt or deficit criterion of the Pact, 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 limited, so that it allows them to keep the nominal deficit close to the 3% reference value, and temporary. The EDP recommendation in such a case would consider that such operations are usually of a one-off nature.

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

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

In addition, for 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 condition that overall fiscal sustainability is maintained. The pension reforms that are eligible for consideration are those introducing a multi-pillar system that includes a mandatory, fully funded pillar and publicly managed pillar with an associated cost to the public finances. Special consideration should be given to the features of the overall pension system created by the reform, namely whether it promotes long-term sustainability while not increasing risks for the medium-term budgetary position. In order to take the impact of any reforms into account, the net cost of the reform is measured as its direct impact on the general government deficit.⁽¹¹⁶⁾ That impact stems from the fact that some revenue that used to be recorded as government revenue is diverted to a fully-funded pension fund classified in a sector other than general government. Moreover, some pensions and other social benefits, previously accounted for as government expenditure, will be paid by the pension scheme once the reform has been implemented. Thus, net costs do not include interest expenditure linked to the higher accumulation of debt due to forgone social contributions or other revenues. That consideration should be part of a broader assessment of the overall features of the pension system created by the reform, namely whether it promotes long-term sustainability while not increasing risks for the medium-term budgetary position. In that way, Member States that reform their pensions systems in a way that improves the long-term sustainability of their public finances but introduces short and medium-term costs, are able to deviate slightly from the 3% of GDP limit without being placed in excessive deficit. Box 2.4 explains in detail how pension reforms are to be taken into account in the corrective arm of the Pact.

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

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

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

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

⁽¹¹⁶⁾ As defined in Article 1 of Regulation (EU) 479/2009 amended by Commission Regulation (EU) 220/2014 of 7 March 2014.

CRITERIA FOR TAKING INTO ACCOUNT SYSTEMIC PENSION REFORMS IN THE CONTEXT OF THE EDP

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

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

Furthermore, the net costs of the systemic pension reform must be determined. Regulation (EC) 1467/97 is not explicit in what constitutes the net cost of such a reform, only referring to the “net costs of the publicly managed pillar”. The Code of Conduct on the SGP defines 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). Any lump-sum payments linked to the systemic pension reform should also be factored in the calculation of “net costs”. Such a lump-sum payment might take place if the new mandatory, funded pension scheme not only allows for the acquisition of new pension rights but also enables the government to transfer some of the rights already accumulated (in the public pillar) to the new scheme.

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

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

The same factors that may be taken into account for the opening of a deficit-based EDP are also borne in mind in the overall assessment for a 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 it 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 appears to be a risk that minimum MTOs may not be sufficiently stringent under what can be considered as normal economic conditions to ensure debt rule compliance in the medium and long term. In those cases, failure to nominate an adequate MTO could be considered a distinct and aggravating relevant factor in the Article 126(3) report. 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⁽¹¹⁷⁾), and other relevant factors, including implementation of structural reforms improving the sustainability of public finances, i.e. implying a downward shift in the path of the debt ratio at least in the medium term. 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. Since the entry into force of the Two-Pack, the extent to which the Member State has taken into account the Commission’s Opinion on its Draft Budgetary Plan (see Section 3.1.1.3) is also a relevant factor to be considered (Article 12(1) of Regulation (EU) 473/2013).

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

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

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 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.⁽¹¹⁸⁾ 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 2.5.

⁽¹¹⁷⁾ For a Member State breaching the 60% reference value from below, the current practice is to consider the cyclically-adjusted debt-to-GDP ratio in the context of the relevant factors, as in 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.

⁽¹¹⁸⁾ 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.

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

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

Currency holdings

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

In the context of an Article 126(3) report, gross debt would be adjusted by the increase in the government’s cash reserve. Such a situation may arise when the government decides to take advantage of favourable market conditions and raise more funds than it needs (pre finances itself). 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 or not an EDP, the Article 126(3) report is sent to the Economic and Financial Committee of the Council which has two weeks to formulate an opinion, based on Article 126(4) TFEU.

Following the Commission’s report and the ensuing opinion from the Economic and Financial Committee, if the Commission considers that an excessive deficit exists or may occur, the Commission addresses an opinion to that effect to the Member State concerned and informs the Council accordingly, under Article 126(5) 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 a Council recommendation on the provisions to take 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 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 underlying analysis of the macro-fiscal situation of the Member State, a timeframe within which the excessive deficit should be corrected and annual targets for the nominal and structural deficit linked by an underlying macroeconomic scenario. Moreover, the recommendation also specifies what those targets imply for the expenditure benchmark, that is, 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 under Article 126(9) TFEU to euro area Member States which have been found by the Council in an Article 126(8) decision not to have taken effective action –on the basis of the methodology defined in Section 2.3.2– to comply with an Article 126(7) recommendation or with a revised notice under Article 126(9) TFEU.

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 notice. Otherwise, a notice under Article 126(9) TFEU follows the abovementioned specifications for the preparation of Article 126(7) recommendations, including due consideration to relevant factors.

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

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

In addition, the Article 126(7) recommendation should specify what those annual targets imply for the expenditure benchmark, that is, the maximum allowable growth rate of expenditure net of discretionary

revenue measures and a detailed specification of the measures with the corresponding deadlines for their adoption is explicit in the Article 126(9) notice.

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 achieve annual budgetary targets which, on the basis of the forecast underpinning the recommendation, are consistent with a minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation.*”

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

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

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

Judging whether or not one year is sufficient to correct an excessive deficit requires a careful consideration of the magnitude of the necessary structural adjustment against both the urgency of the adjustment in terms of the fiscal risk borne by the Member State in question and the economic feasibility of such an effort. The Regulation also indicates that relevant factors are taken into account when setting the deadline for the correction of the excessive deficit. Thus, while the correction of an excessive deficit is expected to take place within the year following its identification, relevant factors including the implementation of major structural reforms 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.⁽¹¹⁹⁾ Any additional year should be considered taking into account again both the economic feasibility and the urgency for the Member State to correct its excessive deficit in that additional year.

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

⁽¹¹⁹⁾ The Communication from the Commission on *Making the best use of the flexibility within the existing rules of the Stability and Growth Pact*, COM(2015) 12 of 13.01.2015 clarifies the role of structural reforms as a relevant factor to be considered, where relevant, in the EDP context. <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0012&from=en>

targets for the nominal and structural deficits, which are defined on the basis of an underlying macroeconomic scenario, as per the Commission forecasts. For Member States with debt above 60% of GDP, the fiscal path has to take into account the need to comply with the debt benchmark so that the fiscal trajectory leads to the debt complying with at least the forward-looking element of the debt reduction benchmark at the end of the correction period, on a no-policy change basis (see Box 1.5). As a result, the level 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 of the Two Pack, for euro area Member States under a macroeconomic adjustment programme, the programme's deficit targets should be integrated in the Article 126(7) recommendation or Article 126(9) notice, as relevant. In addition, the measures needed to achieve 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, that is, the maximum allowable growth rate of expenditure net of discretionary revenue measures consistent with, and conducive to, the fulfilment of the targets for the headline deficit and the underlying improvement in the structural balance. Thus, 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.

The expenditure benchmark is net of the possible fiscal policy (discretionary) measures assumed 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.

The expenditure benchmark set in the EDP recommendation is expressed in nominal terms for all the years covered by the EDP recommendation.

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

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

Along with the Article 126(7) recommendations (or notices), the Commission can request that euro area Member States be subject to additional reporting requirements (see Annex 12), as set out in Regulation

(EU) 473/2013 of the Two Pack.⁽¹²⁰⁾ 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 EDP and make it incumbent on the Member States to submit updates to the Commission every six months while under an Article 126(7) recommendation and every three months when under notice pursuant to Article 126(9) TFEU. The reports submitted should follow the specifications and templates of Commission Delegated Regulation (EU) 877/13 of 27 June 2013 supplementing Regulation (EU) 473/2013 of the European Parliament and of the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area.⁽¹²¹⁾

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 may issue a recommendation for a further Council decision requiring the Member State to lodge a non-interest bearing deposit.⁽¹²²⁾ This will systematically happen if the Member State in question had lodged an interest-bearing deposit following non-compliance with the recommendations in the preventive arm after a Commission warning, or on a case-by-case basis if the Commission identifies particularly serious non-compliance with the budgetary policy obligations laid out in the SGP. When the Commission decides to issue a recommendation for a Council decision on sanctions, it will do so within 20 days of the Council's adoption of the Article 126(6) decision. The amount of the non-interest bearing deposit is to equal 0.2% of the previous year's GDP, as a default and maximum value. The deposit will be lodged with the Commission – if the Member State had already lodged an interest-bearing deposit, it will be turned into a non-interest bearing one and any difference in the applicable amount (taking into account the interest accrued) will be returned to the Member State or made up by it.

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

While the default position is for the Commission to ask for a deposit equal to 0.2% of the previous year's GDP, the Commission may recommend that the Council reduce the amount or cancel the non-interest bearing deposit altogether. 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.

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

⁽¹²⁰⁾ 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.

⁽¹²¹⁾ <http://eur-lex.europa.eu/JOHtml.do?uri=OJ:L:2013:244:SOM:EN:HTML>

⁽¹²²⁾ Regulation (EU) 1173/2011.

out the reporting requirements on Member States in EDP and Section 2.3.2 describes how compliance with the recommendations (or notices) is judged. Section 2.3.3 considers the cases in which the deadline for correction can be extended. Section 2.3.4 describes the continuous monitoring that takes place when EDPs are placed in abeyance and discusses the correction of the excessive deficit.

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

Article 126(7) recommendations and Article 126(9) notices contain a deadline for the Member State concerned to adopt the necessary measures to comply with the recommendation. Depending on whether the situation is deemed particularly serious or not, that deadline can be within three or six months in a recommendation and 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 government expenditure and revenue and for the discretionary measures on both the expenditure and the revenue side which should be consistent with the Council's requirements, as well as information on the measures already taken and on the nature of those envisaged to achieve the targets. 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. Annex 12 gives the tables that should be used for the regular reporting for euro area Member States under those additional reporting requirements (see Section 2.3.4 for more details).

Regulation (EU) 473/2013 also requires euro area Member States to submit an Economic Partnership Programme (EPP) together with the report on the action taken following an Article 126(7) recommendation.⁽¹²³⁾⁽¹²⁴⁾ The EPP is a one-off document where Member States define a roadmap for the fiscal structural reforms which they consider necessary to ensure an efficient and lasting correction of their excessive deficit. Section 3.1.2.2 presents more details on the EPPs.

In addition, the Commission is allowed by Regulation (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 2.6 provides more details.

Box 2.6: 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.

⁽¹²³⁾ Non-euro area signatories of the TSCG who have chosen to be bound by the fiscal compact prior to adopting the euro (Bulgaria, Denmark and Romania) have also committed themselves to submitting an EPP. However, that commitment falls outside of the EU law framework.

⁽¹²⁴⁾ Member States subject to a macroeconomic adjustment programme do not have to submit EPPs, which is substituted by the programme conditionality.

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 it is the terms of that programme that determine the information flow from the Member State to the Commission and the Council.

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

Following the submission by the Member State of the report on action taken along with any other information requested by the Commission when relevant, the Commission undertakes a first formal assessment to evaluate compliance with the terms of the recommendation or notice according to an agreed methodology, as endorsed by the ECOFIN Council on 6 December 2016 and as explained in the version of the Code of Conduct endorsed by the ECOFIN Council on 16 June 2017.⁽¹²⁵⁾⁽¹²⁶⁾ That first assessment is done by assessing whether the Member State is forecast to meet the nominal and structural targets, according to the Member State's plans and Commission's forecasts (as it usually takes place at a time where no outturn data are available yet). Thus, the first assessment of compliance with the nominal targets and the structural adjustments is of a preliminary nature and focuses on the credibility of the Member State's plans. Indeed, according to the Code of Conduct on the SGP, that preliminary assessment should consider whether the Member State concerned has publicly announced or taken measures that seem sufficient to ensure adequate progress towards the correction of the excessive deficit within the time limits set by the Council.

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

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

In relation to the treatment of unusual events such as natural disasters or, in recent years, the refugee inflows towards the Member States and security costs to tackle the terrorist threat, the corrective arm envisages a similar provision to that contained in the preventive arm (see Section 1.3.2.5) with regard to opening an EDP. An excessive deficit is defined as exceptional where it results “from an unusual event outside the control of the Member State concerned and with a major impact on the financial position of general government” (Article 2(1) of Regulation (EC) 1467/97), provided that the deficit remains close to 3% of GDP. That provision (consistently with the “close and temporary” overarching principle for countries with debt above 60% of GDP) avoids that Member States are put in EDP if the breach of the

⁽¹²⁵⁾ Economic and Financial Affairs Council conclusions of the meeting of 6 December 2016: <http://www.consilium.europa.eu/media/22629/st15205en16.pdf>; Code of Conduct:

<http://data.consilium.europa.eu/doc/document/ST-9344-2017-INIT/en/pdf> (see also Annex 17).

⁽¹²⁶⁾ Compliance with EDP recommendations adopted prior to that agreement will continue to be assessed on the basis of the methodology as described in the 2016 edition of the Vade mecum.

deficit criterion is fully explained by the additional budgetary costs related to the unusual event. In addition, further room is available to take into account unforeseen exceptional costs in the assessment of “effective action” when assessing compliance with the EDP recommendation. However, decisions on EDP abrogation do not allow for any flexibility regarding the respect of the nominal deficit threshold (including the forecast period). This means that 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.

Section 2.3.2.1 details how those factors are taken into account in the assessment of effective action.

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

After the opening of an EDP and alongside the first assessment of effective action following an Article 126(7) recommendation, euro area Member States’ Economic Partnership Programme (EPP) is also assessed. To that end, the Commission prepares a proposal for a Council opinion on the EPP, following the guidance set out in Section 3.1.2.2.

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

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

Following the specifications provided in the Code of Conduct on the SGP which are based on Regulation (EC) 1467/97, the logical and procedural steps for the assessment of effective action are summarised in a decision tree, endorsed by the ECOFIN Council in December 2016, which is described in Graph 2.3. Thus, the Commission first examines whether the Member State concerned has met or is forecast to meet the recommended headline deficit target and the underlying improvement in the structural balance.⁽¹²⁷⁾ Compliance with both requirements leads to the EDP being held in abeyance.

If, on the contrary, the Member State fails or is a risk of failing to meet the recommended headline deficit or/and the required improvement in the structural balance, the Commission engages in a more detailed examination to identify the reasons for any shortfall. 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 despite the effects of the action taken not being reflected in the deficit figures. Thus, it is essential to determine whether the targets were missed due to an inadequate policy response or due to forecast errors or adverse economic outturns.

⁽¹²⁷⁾ The structural balance is defined as the cyclically-adjusted general government balance net of one off and other temporary measures (see Box 1.4).

To that end, the careful analysis first uses the expenditure benchmark to assess fiscal effort.⁽¹²⁸⁾ 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 expenditure benchmark is not met, there is a presumption the Member State has not delivered on its policy commitments.

The Commission uses quantitative and qualitative economic judgement in making its final assessment where relevant, in particular of the outcome of the expenditure benchmark, as part of the careful analysis which the Commission uses to determine whether the Member State concerned has delivered or not on its policy commitments. In other words, the careful analysis evaluates 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 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

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, though, 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 Communication on Flexibility within the rules of the SGP⁽¹²⁹⁾ restated that the assessment of effective action remains as per the agreed methodology,⁽¹³⁰⁾ which is focused on the delivery of the required budgetary effort. At the same time, the lack of implementation of the agreed⁽¹³¹⁾ 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 not conclusive indication stemming from the top-down and bottom-up metrics.⁽¹³²⁾

The experience gained since the entry into force of the Six Pack in 2011 has shown that focusing on the evolution of the fiscal variables in a given year can lead to an asymmetry in the assessment of compliance with the recommendations. Therefore, since autumn 2014, the Commission has examined whether the fiscal effort over the correction period under scrutiny was delivered on a cumulative basis. In that way, a

⁽¹²⁸⁾ The introduction of the expenditure benchmark in the careful analysis is the main novelty brought about by the agreement endorsed by the ECOFIN Council on 6 December 2016. It aims at simplifying the assessment of compliance with EDP recommendations and increasing the consistency with the preventive arm of the SGP.

⁽¹²⁹⁾ COM(2015) 12: <http://eur-lex.europa.eu/legal-content/EN/TEXT/PDF/?uri=CELEX:52015DC0012&from=en>

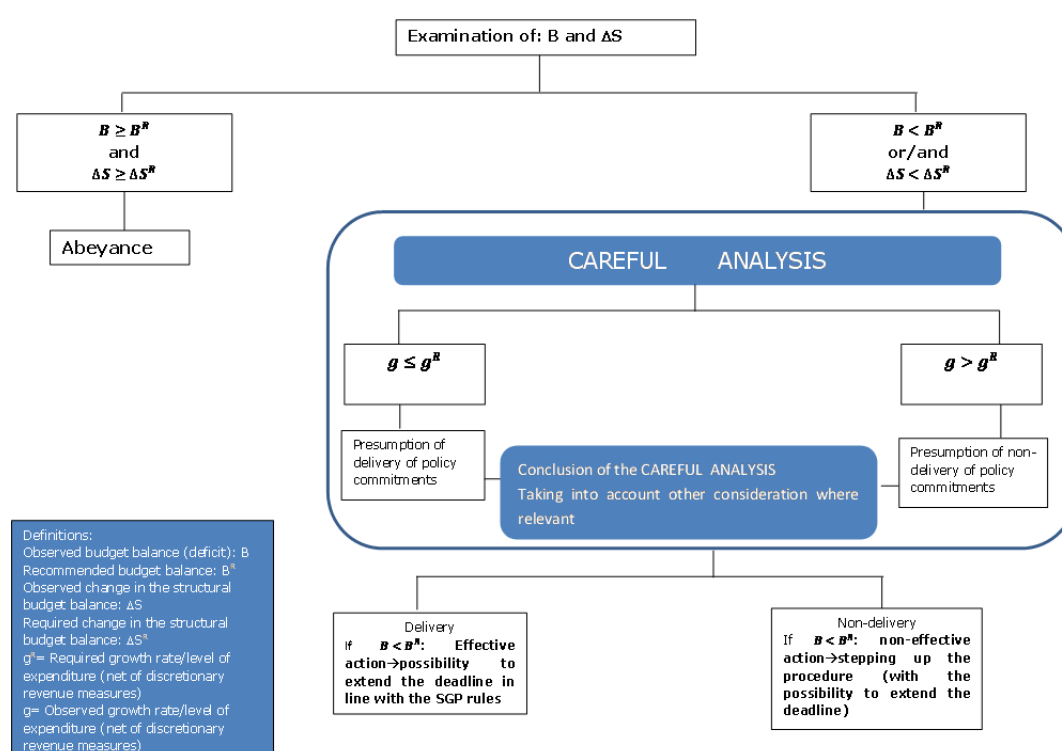
⁽¹³⁰⁾ As endorsed by the ECOFIN Council in June 2014.

⁽¹³¹⁾ E.g. the implementation of structural reforms in the context of the European Semester, such as within the Excessive Imbalance Procedure, as well as structural reforms detailed in the Economic Partnership Programme (see Section 3.1.2.2).

⁽¹³²⁾ 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.

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, in case the nominal deficit falls short of the recommended one thereafter. 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. A numerical example of the assessment of effective action is presented in Annex 9.

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 of 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 in that respect. Specifically, it focuses on aggregate expenditure developments and revenue-increasing (or decreasing) fiscal policy measures, that is, 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 ΔR_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 ΔR_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 uses also qualitative economic judgement in making its final assessment where relevant, in particular of the outcome of the expenditure benchmark, as part of the careful analysis which the Commission uses to determine whether the Member State concerned has delivered or not on its policy commitments. In other words, the careful analysis evaluates whether the Member State concerned has put in place enough actions to comply with the EDP recommendation. 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 determining whether a Member State has put in place enough actions to comply with the EDP recommendation. It is, therefore, the final step in the assessment of effective action that aims at capturing any factor that is relevant to analyse fiscal effort beyond the expenditure benchmark indicator.

With the exclusion of interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure and nationally financed gross fixed capital formation smoothed over a four-year period as well as 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 left out of consideration, since not affecting the expenditure benchmark.

However, there might still be cases where the sole focus on the expenditure benchmark could lead to a biased conclusion. In that sense, other considerations may 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; or 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. Then, the Commission communicates its view that effective action has been taken, and presents the Council with a recommendation for a revised Article 126(7) recommendation. Where this happens, the guidelines set out in Section 2.2.3 should be followed.
- Alternatively, the Commission may conclude that effective action has been taken, but that no revised recommendation should be issued. In 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⁽¹³³⁾) 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 Economic and Financial Committee of the Council, every six months when subject an Article 126(7) recommendation or three months for Article 126(9) notices after the initial report on action taken as outlined in Section 2.3.1. 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⁽¹³⁴⁾ and the tables to be used are shown in Annex 12.

The regular Commission forecast exercises (Box 1.5) provide a natural occasion to check whether Member States (whether subject to the regular reporting or not) are still on track with the correction of their excessive deficit. For euro area Member States, the Two Pack gave the Commission the possibility of issuing an autonomous recommendation to formally warn 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. Box 2.7 provides more details. Where Member States are issued with a Commission autonomous recommendation, the assessment of whether they have complied with it should be taken into account in the assessment of compliance with the Council recommendation under Article 126(7) TFEU or notice under Article 126(9) TFEU as an aggravating or mitigating factor.

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

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

BOX 2.7: ISSUING AN AUTONOMOUS COMMISSION RECOMMENDATION TO EURO AREA MEMBER STATES AT RISK OF NON-COMPLIANCE WITH THEIR EDP DEADLINE

Following the entry into force of Regulation (EU) 473/2013 on 30 May 2013, the Commission may address euro area Member States it considers to be at risk of non-compliance with their EDP deadline with an autonomous recommendation, aiming at warning the Member State concerned of the implicit risks.⁽¹³⁵⁾ 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

⁽¹³³⁾ Notices under Article 126(9) TFEU include a series of deadlines with recommendations attached to them that will govern the pace of the monitoring.

⁽¹³⁴⁾ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:244:0023:0031:EN:PDF>

⁽¹³⁵⁾ That possibility does not apply with regard to Member States under a macroeconomic adjustment programme.

consistent with the deadline for correction of the excessive deficit.

That autonomous recommendation is not meant to replace a stepping up of an EDP; instead its role is to warn Member States that can still meet the deadline for correcting their excessive deficits if the observed risks are catered for on time. The autonomous recommendation can 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.

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

Once issued, the recommendation should be made public and presented to the Economic and Financial Committee and can be presented to the national Parliament of the Member State it is addressed to, at its request. The autonomous recommendation should contain a deadline for the Member State to report back to the Commission on the measures taken – for 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 Economic and Financial Committee. 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.

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.

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 and the imposition of additional sanctions for euro area Member States and in a revised Article 126(7) recommendation for non-euro area Member States. The only possible exception to this is in the case of a severe economic downturn in the euro area or the EU as a whole. The procedure following a lack of effective action by euro area Member States in response to a notice under Article 126(9) 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 (and invite representatives of the European Central Bank, if appropriate) to the Member State

for the purpose of on-site monitoring.⁽¹³⁶⁾ 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 to 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 previous year's GDP, the Commission may recommend that the Council reduce the amount or cancel the 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.

In addition, all Member States, except the United Kingdom, could have a suspension of commitments – or payments – of the European Structural and Investment Funds, following an Article 126(8) decision. For (non-euro area) Member States subject to a second or subsequent Article 126(8) decision, the application of macroeconomic conditionality should involve an increase in suspensions. Box 2.8 explains that macroeconomic conditionality.

Box 2.8: 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,⁽¹³⁷⁾ 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

⁽¹³⁶⁾ In accordance with Article 10a of amended Regulation (EC) 1467/97.

⁽¹³⁷⁾ 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.

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.⁽¹³⁸⁾ 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⁽¹³⁹⁾, the Commission adopted a Communication in July 2014⁽¹⁴⁰⁾ which 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 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.⁽¹⁴¹⁾ 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 of the Regulation provides details on how those conditions should be applied.⁽¹⁴²⁾

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.

⁽¹³⁸⁾ A request to re-programme can only be made between 2015 and 2019.

⁽¹³⁹⁾ Statement by the European Commission on Article 23, OJ C 375, 20.12.2013, p. 2.

⁽¹⁴⁰⁾ Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions; “Guidelines on the application of the measures linking effectiveness of the European Structural and Investment Funds to sound economic governance according to Article 23 of Regulation 1303/2013”, COM (2014) 494 final of 30 July 2014.

⁽¹⁴¹⁾ Annex 6 provides more details on voting arrangements, including RQMV.

⁽¹⁴²⁾ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2013:375:0002:0004:EN:PDF>

2.4.3. Procedures following a lack of effective action in response to a notice under Article 126(9) TFEU: Imposing sanctions to euro area Member States⁽¹⁴³⁾

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 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.

Each year after the imposition of such a fine, the Commission will assess whether the Member State has taken effective action in relation to its Article 126(9) notice and issue a recommendation to the Council to take a decision about effective or a lack of effective action according to the methodology set out in Section 2.3.2. Where the recommendation is for a lack of effective action decision, the Commission will recommend a new decision under Article 126(11) 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⁽¹⁴⁴⁾ 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.⁽¹⁴⁵⁾

⁽¹⁴³⁾ 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.

⁽¹⁴⁴⁾ An excessive deficit may be deficit- and/or debt-based as indicated in Section 2.2.1.

⁽¹⁴⁵⁾ It should be noted that the provision for a transition period for the debt benchmark means that the EDPs that were open in November 2011 should be abrogated on the basis of the deficit criterion only.

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

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

and

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

It should be noted that as abrogation takes place on the basis of achievement of the nominal targets, apart from the special case of pension reforms, the impact of one-off and temporary measures (including financial sector interventions) is not netted out of the figures considered, as it is in assessing effective action based on the calculation of the structural balance 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 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 (on a Commission recommendation) will also abrogate all outstanding sanctions, but any fines imposed will not be reimbursed. The suspensions of commitments or payments due to the macroeconomic conditionality condition of the European Structural and Investment Funds 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 CONTEXT OF BUDGETARY SURVEILLANCE LINKED TO THE STABILITY AND GROWTH PACT (SGP)

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

3.1. THE CYCLE OF INTEGRATED BUDGETARY AND ECONOMIC SURVEILLANCE

Between its adoption in 1997 and the start of the economic crisis in 2008, the SGP was amended once, in 2005. The onset of the crisis prompted an all-encompassing reform of the EU economic governance structure with the institution of the European Semester and the entry into force of the so-called Six Pack and Two Pack legislative packages (as set out in Graph 0.1 in the Introduction Section). Outside of the EU framework, the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), which includes the Fiscal Compact, was signed by 25 of the then 27 EU Member States.⁽¹⁴⁶⁾ The 2005 reform focussed on strengthening the economic rationale of the SGP while remaining strictly within the original framework. The reforms that followed branched out into new directions, increasing the interrelations between fiscal, macroeconomic and structural policy surveillance and completing the cycle of surveillance by reinforcing the links between the preventive and the corrective arms of the Pact and introducing requirements on Member States' national fiscal rules and frameworks that are central to the attainment of European goals.

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

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

The interlinkages between the preventive and the corrective arm of the SGP were further reinforced with the 2011 reform of the SGP – the so-called Six Pack. Compliance with the preventive and corrective arms is now subject to continuous monitoring. The experience of the crisis highlighted the crucial importance of ensuring strong underlying public finances during good economic times. The Commission forecasts (see Box 1.5), which are issued three times a year –winter, spring and autumn–, constitute the key milestones for those regular fiscal assessments. For Member States in the corrective arm, if the Commission assessment concludes on non-compliance with the SGP requirements, this would lead to a stepping up of the EDP together with the issuance of revised recommendations or notice and likely

⁽¹⁴⁶⁾ Croatia joined the EU on 1 July 2013.

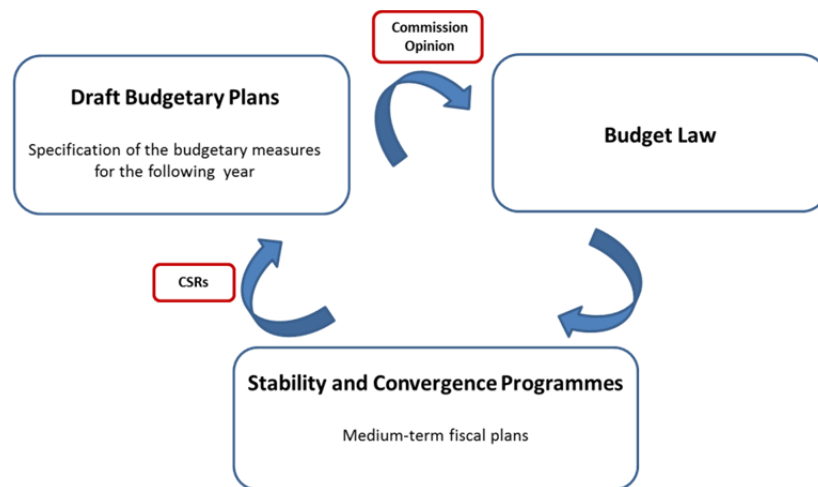
financial sanctions for euro area Member States (Section 2.4). For Member States under the preventive arm, a significant deviation from the adjustment path towards the MTO would trigger ex post a procedure for the correction of the significant deviation (Significant Deviation Procedure, as described in Section 1.4), while a breach of the deficit or debt criteria could lead to an EDP being launched (Section 2.2). Furthermore, Regulation (EU) 1173/2011 *on the effective enforcement of budgetary surveillance in the euro area* provides that for Member States having placed an interest-bearing deposit under the preventive arm, the latter is automatically turned into a non-interest-bearing deposit with the start of an EDP. Non-compliance with the preventive arm is thereby linked to the sanctions system under the corrective arm.

With the entry into force of the Two Pack in May 2013, the regular surveillance processes become formalised for euro area Member States. Regulation (EU) 473/2013 sets a common budgetary timeline, according to which all euro area Member States must prepare and make public their draft budget⁽¹⁴⁷⁾ for the forthcoming year by 15 October. By that date all euro area Member States –except those under a macroeconomic adjustment programme– must transmit a Draft Budgetary Plan (DBP) for the next year to the Commission and the Eurogroup.

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

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

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



⁽¹⁴⁷⁾ For central government and the main parameters for the other subsectors of the general government.

3.1.1.1. The Draft Budgetary Plans for the euro area

With the entry into force of the Regulation (EU) 473/2013 in May 2013, euro area Member States must submit their Draft Budgetary Plans (DBPs) by the 15 October every year. The Code of Conduct on the Two Pack⁽¹⁴⁸⁾ 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 also 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; 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⁽¹⁴⁹⁾ and the timeline set out in the Code of Conduct still apply and the Member State should submit a draft budgetary plan prepared on a no-policy change basis. The incoming government should submit an updated draft budgetary plan to the Commission and to the Eurogroup once it takes office.

The Code of Conduct provisions are meant at preserving 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 the updated draft budgetary plan should as a rule take place at least one month before the draft budget law is planned to be adopted by the national parliament, except where to do so would prove not feasible due to the country-specific parliamentary approval calendar. In the latter case, the submission should still take place in time to allow the Commission to adopt an informed opinion on the DBP and the Eurogroup to hold a proper discussion well before the draft budget law is planned to be adopted by the national parliament.

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

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

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

The content of the DBPs must comply with Regulation (EU) 473/2013 and the Code of Conduct on the Two Pack⁽¹⁵⁰⁾, which sets 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. That standardisation of the format and content of the plans should ensure equality of treatment. The tables to be supplied are replicated in Annex 11. The DBPs should show whether the draft budget is consistent with the SGP.

⁽¹⁴⁸⁾ http://ec.europa.eu/economy_finance/economic_governance/spp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf

⁽¹⁴⁹⁾ In this context, it can be considered a best practice to submit a DBP under the no-policy-change assumptions.

⁽¹⁵⁰⁾ http://ec.europa.eu/economy_finance/economic_governance/spp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf

Economic and budgetary forecasts and plans

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

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

In addition to 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 Country-Specific Recommendations 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 and distributional assessment of the main measures should also be given, where possible. The methodology, economic models and assumptions underpinning the information contained in the draft budgetary plans should be set out.

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

Quality of the data

The figures presented must be based on realistic and cautious macroeconomic forecasts that have been produced or endorsed by 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.

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

3.1.1.3. *Preparing the Commission opinion on the Draft Budgetary Plans*

The Commission must issue an opinion on each DBP as soon as possible after its submission and at the latest by the 30 November. At the outset, it is important to realise that the assessment is done in two stages: (i) taking the DBP targets after recalculating the structural balance based on the commonly agreed methodology⁽¹⁵¹⁾, in order to detect possible deliberate deviations from the requirements, and (ii) taking into account the risks attached to the DBP scenario, as embodied in, for instance, the most recent Commission forecasts.

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

Unlike the Country-Specific Recommendations under the European Semester, the opinions on the DBPs are adopted by the Commission instead of the Council. Once adopted, 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 at the euro area. Furthermore, the Commission should present its opinion to the national parliament of the Member State concerned at its request, after it has been made public. The opinion will serve as an additional element to be taken into account as a relevant factor in any subsequent steps under the SGP, especially where an excessive deficit materialises, following risks identified in the opinion not being addressed by the Member State.

In the case of particularly serious non-compliance with the SGP, an opinion will be adopted requesting submission of a new plan according to the timetable set out in Table 3.1. In such cases, the Commission must consult the Member State within one week of receiving the DBP and will then adopt its opinion requesting a new plan within two weeks of the submission of the DBP. According to the Code of Conduct on the Two Pack, if as a result of the consultation process the 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 and ideally embedded, if feasible, in an updated DBP before the expiry of the two-week deadline for the adoption of an opinion requesting a new DBP.

In general, a revised draft budgetary plan should be submitted as soon as possible and in any event within three weeks of the date of the opinion requesting the revision. Following the submission of the revised plan, the Commission will issue a new opinion within three weeks of its receipt. 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.

⁽¹⁵¹⁾For more details, see “The production function methodology for calculating potential growth rates and output gaps”, European Economy, Economic Papers No. 535, November 2014. 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.

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>	Commission	Adopts an opinion on each DBP
<i>If Commission detects particularly serious non-compliance with SGP obligations in a DBP</i>		
<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 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 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.

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

3.1.2.1. The main steps of the European Semester

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

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

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

The March European Council reports on its conclusions on the discussion of the AGS and issues general policy guidance for Member States. Following the adoption of the European Council conclusions, Member States submit their SCPs in April, preferably by mid-April and not later than 30 April to the Commission and the Council. They outline the public finance plans of Member States⁽¹⁵²⁾ 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 SCPs and NRPs the Commission proposes country-specific recommendations in the relevant policy areas. The Commission proposal includes its opinion for relevant Member States (all except Member States subject to a macroeconomic adjustment programme) on their Stability or Convergence Programme.

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

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

⁽¹⁵²⁾ The SCPs are also the vehicle through which Member States can apply for the use of the structural reform clause or the investment clause under the preventive arm of the SGP (see Annex 3).

BOX 3.1: EURO AREA MEMBER STATES EXPERIENCING FINANCIAL DIFFICULTIES – A LIGHTENING OF THE BUDGETARY SURVEILLANCE OBLIGATIONS UNDER THE TWO PACK FOR COUNTRIES UNDER A MACROECONOMIC ADJUSTMENT PROGRAMME

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

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

- exempt from submitting a Stability Programme, as the content that would form the Stability Programme should be integrated in the macroeconomic adjustment programme. In addition, such Member States are exempt from the general monitoring and assessments under the European Semester;
- exempt from submitting the reports on action taken for the first assessment after the issuance of the Article 126(7) recommendations or notice under Article 126(9) 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 Draft Budgetary Plans in the autumn.

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

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

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

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

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

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

The EPP will be submitted at the time of the report on action taken, after the opening of an EDP. In 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 EPP should be a one-off document detailing the policy priorities and the fiscal structural strategy over time. As such, after its first assessment, its implementation should be monitored through the European Semester framework.

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

3.2. NATIONAL BUDGETARY PROCESSES AND THE SGP

While the European dimension of budgetary policy is set through overarching fiscal rules and associated sanctions, the detailed contours and implementation of budgetary choices remain the competence of the Member States. However, the Six-pack set of reforms has brought about a shift in the approach by which Member States conduct fiscal policy domestically. Starting in 2011 with the directive on national budgetary frameworks,⁽¹⁵³⁾ a series of legislative acts has set seminal requirements on Member States' budgetary policy arrangements. Those reforms recognise the major impact that national arrangements – including fiscal rules and budgetary actors and processes– can have on the ability of Member States to fulfil their obligations with respect to the SGP and deliver prudent and appropriate fiscal policy over the years.

Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States set out minimum standards that Member States have to comply with in terms of their national budgetary framework, which is defined as comprising the arrangements, procedures, rules and institutions that

⁽¹⁵³⁾ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32011L0085:EN:NOT>

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

By specifying that compliance with national fiscal rules should be overseen by an independent body or one with functional autonomy with respect to the fiscal authorities, the directive was the first piece of Union legislation giving a role to independent bodies in fiscal policy matters. Following on the heels of the directive, the Treaty for Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) committed those of its signatories that are bound by the Fiscal Compact chapter⁽¹⁵⁴⁾ 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 signatories bound by the Fiscal Compact to incorporating the medium-term budgetary objective (MTO) and the adjustment path towards it into national law through “provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the budgetary process.” In addition, they should also put in place correction mechanisms to be triggered automatically in the event of significant deviations from the MTO or the adjustment path towards it, which should include an obligation for the 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 Contracting Parties to integrate the requirements of the preventive arm of the SGP in their national legislation. The TSCG sets a deadline of 31 December 2013 for this to occur. 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.⁽¹⁵⁵⁾⁽¹⁵⁶⁾

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

⁽¹⁵⁴⁾ All 19 euro area Member States and 3 non-euro area Member States (Bulgaria, Denmark and Romania).

⁽¹⁵⁵⁾ https://ec.europa.eu/info/sites/info/files/c20171201_en.pdf

⁽¹⁵⁶⁾ The TSCG foresees that, by 1st 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 this end.

expenditure benchmark and that a temporary deviation from the MTO or the adjustment path towards it can be permitted in exceptional circumstances (known as the escape clause, as defined in the SGP). Importantly, it goes beyond the SGP by stipulating a tighter lower bound of -0.5% of GDP –compared to -1% of GDP in the SGP for euro area Member States– for all Contracting Parties except those with debt significantly below 60% of GDP and where risks in terms of long-term sustainability of public finances are low, for which the lower bound is set at -1% of GDP. Given the methodology to set the minimum MTO (as set out in Section 1.2.1.1), there should be no contradiction between the SGP and the TSCG requirements in most cases.

Under the TSCG the Commission was to propose “common principles” underlying the design of the requested corrective mechanisms. The Commission’s Communication on *Common principles for the national correction mechanisms* was published on 20 June 2012⁽¹⁵⁷⁾ and the principles it presents are given in Box 3.2. In addition, the TSCG called for independent bodies to be put in place to monitor compliance with the national balanced-budget rules incorporating the MTO requirement and the operation of the related national correction mechanism. That requirement has also been incorporated into Union law via the Two Pack and Section 3.2.2 provides more details on the role and structure of such bodies.

Box 3.2: COMMON PRINCIPLES FOR THE NATIONAL CORRECTION MECHANISMS

The common principles presented in the Commission’s Communication of 20 June 2012 are:

- (1) Legal status: The correction mechanism shall be enshrined in national law through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes. The mechanism shall fully respect the prerogatives of national parliaments.
- (2) Consistency with EU framework: National correction mechanisms shall rely closely on the concepts and rules of the European fiscal framework. This applies in particular to the notion of a ‘significant deviation’ and the definition of possible escape clauses. The correction, in terms of size and timeline, shall be made consistent with possible recommendations addressed to the Member State concerned under the Stability and Growth Pact.
- (3) Activation: The activation of the correction mechanism shall occur in well-defined circumstances characterising a significant deviation from the medium-term objective (MTO) or the adjustment path towards it. The activation triggers may comprise EU-driven or country-specific criteria, to the extent that they meet the above condition. Subject to the same condition, both ex ante mechanisms that set budgetary objectives preventing the materialisation of deviations and ex post mechanisms that trigger corrections in reaction to prior deviations, may fulfil the requirements.
- (4) Nature of the correction: The size and timeline of the correction shall be framed by predetermined rules. Larger deviations from the medium-term objective or the adjustment path towards it shall lead to larger corrections. Restoring the structural balance at or above the MTO within the planned deadline and maintaining it there afterwards, shall provide the reference point for the correction mechanism. The correction mechanism shall ensure adherence to critical fiscal targets as set before the occurrence of the significant deviation, thereby preventing any lasting departure from overall fiscal objectives as planned before the occurrence of the significant deviation. At the onset of the correction Contracting Parties shall adopt a corrective plan that shall be binding over the budgets covered by the correction period.
- (5) Operational instruments: The correction mechanism may give a prominent operational role to rules on public expenditure and discretionary tax measures, including in activating the mechanism and implementing the correction, to the extent that these rules are consistent with attainment of the MTO and the adjustment path towards it. The design of the correction mechanism shall consider provisions as regards, in the event of activation, the coordination

⁽¹⁵⁷⁾ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0342:FIN:EN:PDF>

of fiscal adjustments across some or all sub-sectors of general government

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

(7) Independent bodies or bodies with functional autonomy acting as monitoring institutions: They shall support the credibility and transparency of the correction mechanism. These institutions would provide public assessments over: the occurrence of circumstances warranting the activation of the correction mechanism; of whether the correction is proceeding in accordance with national rules and plans; and over the occurrence of circumstances for triggering, extending and exiting escape clauses. The Contracting Party concerned shall be obliged to comply with, or alternatively explain publicly why they are not following the assessments of these bodies. The design of the above bodies shall take into account the already existing institutional setting and the country-specific administrative structure. National legal provisions ensuring a high degree of functional autonomy shall underpin the above bodies, including: i) a statutory regime grounded in law; ii) freedom from interference, whereby the above bodies shall not take instructions, and shall be in a capacity to communicate publicly in a timely manner; iii) nomination procedures based on experience and competence; iv) adequacy of resources and appropriate access to information to carry out the given mandate.

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

3.2.2.1. The mandates of the independent bodies

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

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

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

The Two Pack requires that the macroeconomic forecasts underlying the national medium-term fiscal plans and the draft budgets be produced or endorsed by independent bodies. Member States should indicate in 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, although they are free to choose neither of those two options. Given the link between the national medium-term fiscal plans and the Stability Programmes⁽¹⁵⁸⁾ and between the draft budgets and the draft budgetary plans, the requirements relating to the involvement of independent bodies in the preparation of the forecasts effectively also translate to the Stability Programmes and DBPs.

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⁽¹⁵⁹⁾ 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 the macroeconomic forecasts by the independent body, such as access rights to relevant budgetary information, including budgetary execution data. Additionally, the national legislation or the internal procedures of the Ministry of Finance should define rules governing the handling of forecasts received from the independent body.

Analogously, for the macroeconomic forecasts produced by public sector entities and submitted for endorsement to the independent body, Member States should lay down implementing aspects of the endorsement process (including deadlines for action and the consequences arising from the forecast-related decisions of the independent body), without prejudice to the independent assessment of the endorsing body. The independent body should make clear whether 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.

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.⁽¹⁶⁰⁾

⁽¹⁵⁸⁾ In fact, national medium-term fiscal plans and stability programmes may be the same document.

⁽¹⁵⁹⁾ http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf

⁽¹⁶⁰⁾ 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 LEGAL TEXTS

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

Regulation on the preventive arm of the SGP

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

Original from 1997:

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

Consolidated following Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies

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

Regulation on the corrective arm of the SGP

Council Regulation (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 (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure

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

Other texts linked to the SGP or its application

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

[http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997Y0802\(01\):EN:HTML](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 Pact0

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 15 May 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

<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 29 November 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 29 November 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

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, 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 30 September 2016

http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf

ANNEX 2

ANNUAL UPDATE OF THE MINIMUM BENCHMARKS

The preventive arm of the Stability and Growth Pact requires that Member States achieve and maintain their medium-term budgetary objectives (MTO) to ensure, inter alia, a sufficient safety margin against the risk of breaching the 3% of GDP reference value of the Treaty. That sufficient margin is a threshold value for the structural government deficit, called the minimum benchmark (MB), which ensures the respect of the 3% reference value under normal cyclical conditions. This is calculated by adjusting the 3% of GDP deficit threshold for the effect of a normal cyclical fluctuation (encapsulated by the representative output gap). The minimum benchmark thus provides a lower bound for the determination of the MTOs.

Formula: The standard formula for the computation of the minimum benchmark is

$$MB = -3 - \varepsilon * ROG$$

where the two elements necessary for the calculation are the semi-elasticity of the budget to the output gap - ε - and the representative output gap - ROG.

The representative output gap is a country-specific measure of cyclical conditions Member States typically experience. It reflects the fact that different countries typically experience different magnitudes of economic cycles, and this has an impact on the cyclical fluctuation of their public finances. Countries with larger cycles and therefore bigger negative values require larger safety margin for the MTO to ensure compliance with the 3% deficit limit under a normal economic cycle. The representative output gap is calculated in the following way, containing a country-specific and a cross-country component:

$$ROG = \frac{N_i}{(N_t + N_i)} P_{5\%}(\text{country}) + \frac{N_t}{(N_t + N_i)} P_{5\%}(EU28)$$

where $P_{5\%}(\text{country})$ represents the 5th percentile of the distribution of the country-specific output gap series and $P_{5\%}(EU28)$ the 5th percentile of output gap data for all countries, after the removal of outliers. N_i and N_t stand for the number of country-specific and common annual observations available, respectively over a period of 25 years. N_t is set at 25.

The logic of that approach is to use the simplest and most direct statistical indicator which captures the idea of the representative output gap, i.e. a particularly low value of the output gap likely to be observed with a probability of 5%. The percentile is moreover computed after outlier values are deleted.⁽¹⁶¹⁾

It should be noted that the relative weights of the common and country-specific component in equation 2 above are different across countries, especially for the recently acceded Member States due to the limited availability of data before 1995. However, the weights will automatically converge to the same value when the length of the time series increases over time reaching and exceeding 25 years.

In light of discussions in the committees, the Commission has committed to update the minimum benchmark annually ⁽¹⁶²⁾ as the minimum benchmark has become critical in the application of the flexibility clauses. This was decided also as part of the effort to increase transparency and predictability. Table A2.1 shows the most recent update, based on the Commission's 2017 autumn forecast.

⁽¹⁶¹⁾ Outliers are defined as observations of the distribution for the entire sample –including all Member States– below, and above, respectively, the 2.5% and the 97.5% percentiles. Exceptionally, the country-specific series have also been trimmed of their smaller values between 2009 and 2010, as these do not reflect normal conditions.

⁽¹⁶²⁾ Even if the minimum benchmarks are updated yearly, the minimum MTOs remain frozen for three years.

Table A2.1: **Basic assumptions**

Country	Current Minimum Benchmark (for 2018)	New Minimum Benchmark (for 2019)
BE	-1.4	-1.4
BG	-1.9	-1.9
CZ	-1.6	-1.5
DK	-0.8	-0.9
DE	-1.4	-1.3
EE	-1.4	-0.8
IE	-1.0	-1.0
EL	-2.1	-2.0
ES	-1.1	-1.0
FR	-1.1	-1.0
HR	-1.3	-1.1
IT	-1.3	-0.8
CY	-1.3	-0.8
LV	-1.7	-1.6
LT	-1.4	-1.3
LU	-1.4	-1.2
HU	-1.2	-1.1
MT	-1.7	-1.5
NL	-1.0	-0.8
AT	-1.6	-1.5
PL	-1.0	-0.8
PT	-1.1	-1.0
RO	-1.6	-1.5
SI	-1.0	-0.9
SK	-1.6	-1.5
FI	-0.6	-0.5
SE	-0.9	-0.8
UK	-1.0	-0.8

ANNEX 3

TABLES TO BE SUPPLIED IN THE STABILITY AND CONVERGENCE PROGRAMMES

Provision of data on variables in bold characters is a requirement.

Provision of data on other variables is optional but highly desirable.

The tables should be submitted to the Commission by means of the dedicated web application.

Table 1a: Macroeconomic prospects

	ESA Code	Year X-1	Year X-1	Year X	Year X+1	Year X+2	Year X+3
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g						
2. Nominal GDP	B1*g						
Components of real GDP							
3. Private final consumption expenditure	P.3						
4. Government final consumption expenditure	P.3						
5. Gross fixed capital formation	P.51g						
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53						
7. Exports of goods and services	P.6						
8. Imports of goods and services	P.7						
Contributions to real GDP growth							
9. Final domestic demand		-					
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-					
11. External balance of goods and services	B.11	-					

Table 1b: Price developments

	ESA Code	Year X-1	Year X-1	Year X	Year X+1	Year X+2	Year X+3
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator							
2. Private consumption deflator							
3. HICP⁽¹⁾							
4. Government consumption deflator							
5. Investment deflator							

6. Export price deflator (goods and services)							
7. Import price deflator (goods and services)							

(1) Optional for stability programmes.

Table 1c: Labour market developments

	ESA Code	Year X-1	Year X-1	Year X	Year X+1	Year X+2	Year X+3
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons⁽¹⁾							
2. Employment, hours worked ⁽²⁾							
3. Unemployment rate (%)⁽³⁾							
4. Labour productivity, persons⁽⁴⁾							
5. Labour productivity, hours worked ⁽⁵⁾							
6. Compensation of employees	D.1						
7. Compensation per employee					optional	optional	optional

(1) Occupied population, domestic concept national accounts definition.

(2) National accounts definition. Please, provide the series in terms of average annual hours worked per person employed. This series is needed for internal calculations.

(3) Harmonised definition, Eurostat; levels.

(4) Real GDP per person employed.

(5) Real GDP per hour worked.

Table 1d: Sectoral balances

% of GDP	ESA Code	Year X-1	Year X	Year X+1	Year X+2	Year X+3
1. Net lending/borrowing vis-à-vis the rest of the world	B.9					
of which:						
–Balance on goods and services						
–Balance of primary incomes and transfers						
–Capital account						
2. Net lending/borrowing of the non-government sector	B.9					
3. Net lending/borrowing of general government	B.9					
4. Statistical discrepancy						

Table 2a: General government budgetary prospects

	ESA Code	Year X-1	Year X-1	Year X	Year X+1	Year X+2	Year X+3
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (+) / net borrowing (-) (B.9) by sub-sector							
1.General government	S.13						
1a.Central government	S.1311						
1b.State government	S.1312						
1c.Local government	S.1313						
1d.Social security funds	S.1314						
General government (S13)							
2.Total revenue	TR						
3.Total expenditure	TE ⁽¹⁾						
4.Net lending/borrowing	B.9						
5.Interest expenditure	D.41						
6.Primary balance⁽²⁾	B.9+D.4 1						
7.One-off and other temporary measures⁽³⁾							
Selected components of revenue							
8.Taxes on production and imports	D.2					optional	optional
9.Current taxes on income, wealth, etc	D.5					optional	optional
10.Capital taxes	D.91					optional	optional
11.Social contributions	D.61					optional	optional
12.Property income	D.4					optional	optional
13.Other⁽⁴⁾						optional	optional
14=2.Total revenue	TR						
p.m.: Tax burden (D.2+D.5+D.61+D.91–D.995)⁽⁵⁾							
Selected components of expenditure							
15.Compensation of employees + intermediate consumption	D.1+P.2						
15a.Compensation of employees	D.1						
15b.Intermediate consumption	P.2						

16.Social payments (16=16a+16b)							
of which Unemployment benefits⁽⁶⁾							
16a.Social transfers in kind – purchased market production	D.632						
16b.Social benefits other than social transfers in kind	D.62						
17=5.Interest expenditure	D.41						
18.Subsidies	D.3						
19.Gross fixed capital formation	P.51g						
20.Capital transfers	D.9						
21.Other⁽⁷⁾							
22=3.Total expenditure	TE ⁽¹⁾						
p.m.: Governments final consumption expenditure (nominal)	P.3						

⁽¹⁾TR–TE=B.9

⁽²⁾ The primary balance is calculated as B.9 (item 4) plus D.41 (item 5).

⁽³⁾ A plus sign means deficit-reducing one-off measures.

⁽⁴⁾ P.11+P.12+P.131+D.39rec+D.7rec+D.9rec (other than D.91).

⁽⁵⁾ Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

⁽⁶⁾ Includes social benefits other than social transfers in kind (D.62) and social transfers in kind via market produces (D.632) related to unemployment benefits.

⁽⁷⁾ D.29pay+D4pay (other than D.41pay) + D.5pay+D.7pay+P.52+P.53+NP+D.8.

Table 2b: No-policy change projections⁽¹⁾

	Year X–1	Year X–1	Year X	Year X+1	Year X+2	Year X+3
	Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
1.Total revenue at unchanged policies						
2.Total expenditure at unchanged policies						

⁽¹⁾ The projections shall start at the time when the Stability or Convergence Programme is drafted (please indicate the cut-off date) and show revenue and expenditure trends under a “no-policy change” assumption. Therefore, figures for X–1 should correspond to actual data for revenue and expenditure.

Table 2c: Amounts to be excluded from the expenditure benchmark

	Year X–1	Year X–1	Year X	Year X+1	Year X+2	Year X+3
	Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
1.Expenditure on EU programmes fully matched by EU funds revenue						
1a.of which investments fully matched by EU funds revenue						
2.Cyclical unemployment benefit						

expenditure(1)						
3.Effet of discretionary revenue measures(2)						
4.Revenue increases mandated by law						

(1) Please detail the methodology used to obtain the cyclical component of unemployment benefit expenditure. It should build on unemployment benefit expenditure as defined in COFOG under the code 10.5.

(2) Revenue increases mandated by law should not be included in the effect of discretionary revenue measures: data reported in rows 3 and 4 should be mutually exclusive.

Table 3: General government expenditure by function

% of GDP	COFOG Code	Year X-2	Year X+3
1.General public services	1		
2.Defence	2		
3.Public order and safety	3		
4.Economic affairs	4		
5.Environmental protection	5		
6.Housing and community amenities	6		
7.Health	7		
8.Recreation, culture and religion	8		
9.Education	9		
10.Social protection	10		
11.Total expenditure (=item 3=22 in Table 2a	TE		

Table 4: General government debt developments

% of GDP	ESA Code	Year X-1	Year X	Year X+1	Year X+2	Year X+3
		% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
1.Gross debt⁽¹⁾						
2.Change in gross debt ratio						
Contributions to changes in gross debt						
3. Primary balance⁽²⁾	B.9+D.41					
4.Interest expenditure⁽³⁾	D.41					
5.Stock-flow adjustment						
<i>of which:</i>						
–Differences between cash and accruals ⁽⁴⁾						
–Net accumulation of financial assets ⁽⁵⁾						
<i>of which:</i>						
–privatisation proceeds						
–Valuation effects and other ⁽⁶⁾						
p.m.: Implicit interest rate on debt⁽⁷⁾						
Other relevant variables						
6.Liquid financial assets ⁽⁸⁾						

7.Net financial debt (7=1-6)						
8.Debt amortisation (existing bonds) since the end of the previous year						
9.Percentage of debt denominated in foreign currency						
10.Average maturity						

(1) As defined in amended Regulation 479/2009.

(2) Cf. item 6 in Table 2a.

(3) Cf. item 5=17 in Table 2a.

(4) The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

(5) Currency and deposits, government debt securities, government controlled enterprises and the difference between listed and unlisted shares could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

(6) Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

(7) Proxied by interest expenditure divided by the debt level of the previous year.

(8) Liquid assets are here defined as stocks of AF.1, AF.2, AF.3 (consolidated for general government, i.e. netting out financial positions between government entities), AF.511, AF.52 (only if listed on stock exchange).

Table 5: Cyclical developments

% of GDP	ESA Code	Year X-1	Year X	Year X+1	Year X+2	Year X+3
		% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
1.Real GDP growth (%)						
2.Net lending of general government	B.9					
3.Interest expenditure	D.41					
4.one-off and other temporary measures⁽¹⁾						
5.Potential GDP growth (%)						
contributions:						
–labour						
–capital						
–total factor productivity						
6.Output gap						
7.Cyclical budgetary component						
8.Cyclically-adjusted balance (2 – 7)						
9.Cyclically-adjusted primary balance (8 + 3)						
10.Structural balance (8 – 4)						

(1) A plus sign means deficit-reducing one-off measures.

Table 6: Divergence from previous update

	ESA Code	Year X-1	Year X-1	Year X	Year X+1	Year X+2	Year X+3
Real GDP growth (%)							
Previous update							
Current update							
Difference							
General government net lending (% of GDP)	B.9						
Previous update							
Current update							

Difference							
General government gross debt (% of GDP)							
Previous update							
Current update							
Difference							

Table 7: Long-term sustainability of public finances

% of GDP	2007	2010	2020	2030	2040	2050	2060
Total expenditure							
Of which: age-related expenditures							
Pension expenditure							
Social security pension							
Old-age and early pensions							
Other pensions (disability, survivors)							
Occupational pensions (if in general government)							
Health care							
Long-term care							
Educational expenditure							
Other age-related expenditures							
Interest expenditure							
Total revenue							
Of which: property income							
<i>Of which:</i> from pensions contributions (or social contributions if appropriate)							
Pension reserve fund assets							
<i>Of which:</i> consolidated public pension fund assets (assets other than government liabilities)							
Systemic pension reforms(1)							
Social contributions diverted to mandatory private scheme(2)							
Pension expenditure paid by mandatory private scheme(3)							
Assumptions							
Labour productivity growth							
Real GDP growth							
Participation rate males (aged 20–64)							
Participation rates females (aged 20–64)							
Total participation rates (aged 20–64)							

Unemployment rate							
Population aged 65+ over total population							

⁽¹⁾ Systemic pension reforms refer to pension reforms that introduce a multi-pillar system that includes a mandatory fully funded pillar.

⁽²⁾ Social contributions or other revenue received by the mandatory fully funded pillar to cover for the pension obligations it acquired in conjunction with the systemic reform.

⁽³⁾ Pension expenditure or other social benefits paid by the mandatory fully funded pillar linked to the pension obligations it acquired in conjunction with the systemic pension reform.

Table 7a: Contingent liabilities

% of GDP	Year X-1	Year X
Public guarantees		Optional
<i>Of which: linked to the financial sector</i>		Optional

Table 8: Basic assumptions

	Year X-1	Year X-1	Year X-1	Year X-1	Year X-1
Short-term interest rate(1) (annual average)					
Long-term interest rate (annual average)					
USD/€ exchange rate (annual average) (euro area and ERM II countries)					
Nominal effective exchange rate (for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)					
World excluding EU, GDP growth					
EU GDP growth					
Growth of relevant foreign markets					
World import volumes, excluding EU					
Oil prices (Brent, USD/barrel)					

⁽¹⁾ If necessary, purely technical assumptions.

ADDITIONAL TABLE FOR STABILITY AND CONVERGENCE PROGRAMMES OF MEMBER STATES APPLYING FOR USE OF THE STRUCTURAL REFORM CLAUSE

Table: Structural reforms (table to be included in both SCP and NRP) – To be completed for each structural reform under consideration

Description of the reform (1)	Methodological elements		Quantitative elements					In cases of ex ante implementation		
	Relevant features of the model used/estimation technique (2)	Main macroeconomic assumptions/simulation assumptions (3)	Main outcome of macroeconomic simulations (4)					Other impacts/ indicators (7)	Timeline for adoption and implementation of measures (8)	Institutional process for approval of measures (9)
			Description (5)	Yearly and cumulated effect on GDP and other main macroeconomic variables (6)						
				Year X+5	Year X+10	Year X+15	Year X+20	Year X+25*		
			GDP							
			Gross capital formation							
			Employment							
			Direct fiscal impact upon primary balance (10)							
			Total impact upon primary balance (11)							

*The impact at X+25 is akin to the final impact in a steady-state economic environment.

(1) This column should contain “Measure 1”, “Measure 2” etc and short titles e.g. labour market reform.

(2) This column should include all relevant information on the analytical and methodological approach used in the empirical exercise. This would include: (a) the type of the model used/estimation technique (e.g. econometric estimations or simulation based assessments with DSGE/dynamic CGE/static CGE models, etc.); (b) data

sources and the frequency of macroeconomic data used in the empirical exercise; (c) if available, the list of references related to the main methodological paper(s) that describes the structure of the country-specific model underlying the empirical exercise.

(3) This column should encompass the main macroeconomic and simulation assumptions underlying the estimation including transmission channels and elasticities.

(4) This column summarises the main macroeconomic variables involved as well as the quantitative results of the macroeconomic simulations exercise.

(5) Specifically, this column contains the list of the macroeconomic variables which are assumed to be affected by the enacted or planned structural reforms presented in the programmes. The list reported in the reporting table is illustrative (but not exhaustive) and can be changed and/or broadened according to the type of reforms implemented at national level.

(6) This column reports the quantitative impact of the structural reforms expressed as the yearly and/or cumulated effect on GDP and the other main macroeconomic variables involved in the simulation as well as the policy simulation horizon. The macroeconomic impact of structural reforms needs to take the form of a number expressing the difference (in percentage points) with respect to the reference scenario, i.e. the scenario that does not include the structural measures).

(7) This column shall contain other relevant indicators that can also demonstrate economic impacts, for example resource efficiency indicators. This can also include information on the expected direct results from the measure (e.g. how many people are expected to be supported by a new ALMP measures; or which increase in the proportion of unemployed will be covered by an increase ALMP budget).

(8) This column should set out the timeline for the adoption and implementation of any reform measures which justify an application for use of the structural reform clause on an ex ante implementation basis as detailed in the dedicated structural reform plan adopted by Government.

(9) This column should set out the institutional plans and processes for the implementation of reform measures which justify an application for use of the structural reform clause on an ex ante implementation basis

(10) This row should contain the direct budgetary impact (budgetary savings minus budgetary costs) of reform measures, excluding any impact through associated changes to output. The effects should be shown as a percentage of GDP.

(11) This row should contain the total budgetary impact of reform measures, including both direct fiscal effects and any indirect effects through associated changes to output. The effects should be shown as a percentage of GDP.

ANNEX 4

THE MEDIUM-TERM REFERENCE RATE OF POTENTIAL GROWTH AND THE CONVERGENCE MARGIN FOR THE ASSESSMENT OF 2018 BASED ON SPRING 2017 COMMISSION FORECAST

	2018 ⁽¹⁶³⁾				
	Medium-term rate of potential GDP growth	Convergence margin	Reference rate (real)	GDP deflator (%change)	Reference rate (nominal)
BE	1.2	1.2	0.0	1.6	1.6
BG	2.2	-1.7	3.9	1.5	5.5
CZ	1.8	-2.7	4.5	1.7	6.3
DK	1.3	-0.2	1.5	1.7	3.2
DE	1.5	-2.5	4.0	1.6	5.6
EE	2.2	-0.5	2.7	3.3	6.1
IE	3.4	2.3	1.1	1.3	2.4
EL	n.r.	n.r.	n.r.	n.r.	n.r.
ES	n.r.	n.r.	n.r.	n.r.	n.r.
FR	1.1	1.1	-0.1	1.3	1.2
HR	0.5	-0.2	0.7	1.6	2.4
IT	-0.1	1.3	-1.4	1.2	-0.2
CY	-0.1	0.6	-0.6	0.9	0.3
LV	2.5	-0.7	3.2	2.7	6.0
LT	2.0	-1.8	3.8	2.5	6.4
LU	3.4	-2.1	5.5	2.3	7.9
HU	1.8	2.2	-0.4	3.3	2.8
MT	4.7	-1.1	5.8	1.8	7.7
NL	1.1	-1.7	2.7	1.2	4.0
AT	1.3	0.5	0.8	1.5	2.2
PL	2.9	1.2	1.7	2.0	3.7
PT	0.2	1.5	-1.3	1.4	0.1
RO	2.9	1.5	1.4	2.8	4.3
SI	1.2	2.4	-1.2	1.8	0.6
SK	2.6	1.2	1.3	1.5	2.9
FI	0.4	0.1	0.3	1.2	1.6
SE	2.2	-2.8	5.0	2.0	7.1
UK	1.4	1.5	-0.1	1.9	1.8

¹⁶³ Note that the numbers in the table are for information only, as per spring 2017.

ANNEX 5

CALCULATING THE MINIMUM LINEAR STRUCTURAL ADJUSTMENT (MLSA) FOR THE APPLICATION OF THE DEBT CRITERION DURING THE TRANSITION PERIOD

Member States that were in EDP on the date that the Six Pack amendments to the SGP were adopted (8 November 2011) are subject to transitional arrangements –concerning the debt rule– for the three years following the correction of their excessive deficit, in order to ensure that they have time to adapt their structural adjustments to the level needed to comply with the debt reduction benchmark. During those three years, compliance with the debt criterion is judged according to whether the Member State makes sufficient progress towards compliance. The concept of “sufficient progress towards compliance” is set out in the Code of Conduct on the SGP. It is defined as the Minimum Linear Structural Adjustment (MLSA) ensuring that –if followed– Member States will comply with the debt rule at the end of the transition period.

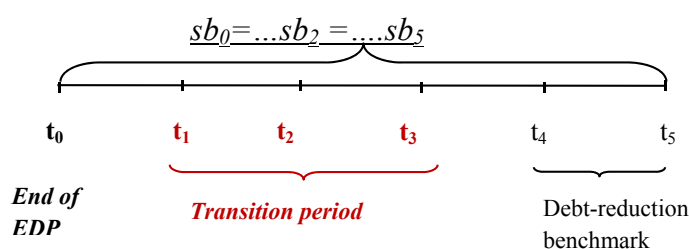
COMPUTATION OF THE MLSA

Two scenarios are considered for a Member State correcting its excessive deficit in year t_0 : a baseline scenario based on no adjustment and a counterfactual scenario based on a constant (linear) adjustment adj implemented for the three years of the transition period.

Baseline scenario

If no adjustment is implemented: the structural balance (sb) remains constant over the period⁽¹⁶⁴⁾ shown in Graph A5.1 below. This implies that during the transition period, which covers year t_1 to year t_3 , the deficit: $bal_i^* = sb_0 + o_i + cb_i$ with $i=1, \dots, 5$, evolves according to the cyclical balance (the cyclical components of the general government balance cb) and the one-off measures (o), while the debt-to-GDP ratio: $b_i^* = \frac{b_{i-1}}{1+g_i} - bal_i^* + sfa_i$ with $i=1, \dots, 5$, evolves according to growth (g), the cyclical balance and the stock-flow adjustments (sfa).

Graph A5.1: **Baseline scenario**

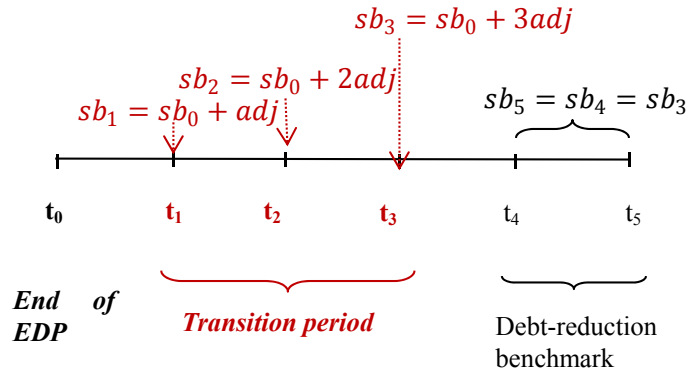


⁽¹⁶⁴⁾ Years t_4 and t_5 are taken into account as relevant for the forward-looking debt benchmark.

Counterfactual scenario

A constant (linear) adjustment (adj) is implemented during the transition period, while keeping the structural balance constant after it.

Graph A5.2: Counterfactual scenario



Thus, the trajectories for debt: $b_i = \frac{b_{i-1}}{1+g_i} - bal_i + sfa_i$ and deficit: $bal_i = sb_0 + i \cdot adj + o_i + cb_i$ with $i=1, \dots, 5$, change accordingly under this scenario. In particular, for year t_1 - t_5 the debt becomes:

✓ in year t_1 : $b_1 = b_1^* - adj \times e_1$

as $b_1^* - b_1 = \left(\frac{b_0}{1+g_1} - sb_0 - cb_1 - o_1 + sfa_1 \right) - \left(\frac{b_0}{1+g_1} - (sb_0 + adj) - cb_1 - o_1 + sfa_1 \right) = adj = adj \times e_1$ where $e_1 = 1$

✓ in year t_2 : $b_2 = b_2^* - adj \times e_2$

As $b_2^* - b_2 = \left(\frac{b_1^*}{1+g_2} - sb_0 - cb_2 - o_2 + sfa_2 \right) - \left(\frac{b_1}{1+g_2} - (sb_0 + 2adj) - cb_2 - o_2 + sfa_2 \right) = 2adj + \frac{b_1^* - b_1}{1+g_2} = adj \times e_2$

and, following the same logic:

✓ in year t_3 : $b_3 = b_3^* - adj \times e_3$

as $b_3^* - b_3 = 3adj + \frac{b_2^* - b_2}{1+g_3} = adj \times e_3$

✓ in year t_4 : $b_4 = b_4^* - adj \times e_4$

as $b_4^* - b_4 = 3adj + \frac{b_3^* - b_3}{1+g_4} = adj \times e_4$

✓ in year t_5 : $b_5 = b_5^* - adj \times e_5$

as $b_5^* - b_5 = 3adj + \frac{b_4^* - b_4}{1+g_5} = adj \times e_5$

with the sequence e defined as follows:

$$\begin{cases} e_0 = 0 \\ e_i = i + \frac{e_{i-1}}{1 + g_i} \text{ if } i \in [1; 3] \\ e_i = 3 + \frac{e_{i-1}}{1 + g_i} \text{ if } i \in [4; 5] \end{cases}$$

In order to identify the constant (linear) annual structural adjustment (*adj*) to be implemented during the transition period, the following equation has to be solved:

$$G_3(adj) = \min(b_3 - bb_3; b_5 - bb_5; b_3^{3\text{-year-adjusted}} - bb_3) = 0 \quad (1)$$

which implies finding that minimum adjustment that assures, at the end of the transition period, the respect with at least one of the configurations of debt benchmarks based on the counterfactual scenario. This is done in three steps:

1. calculate the adjustment (*BLadj*) allowing closing the gap to the backward-looking debt benchmark:
 $bb_3 = 60\% + 0.95/3 (b_2 - 60\%) + 0.95^2/3 (b_1 - 60\%) + 0.95^3/3 (b_0 - 60\%)$

$$b_3 = bb_3$$

$$\begin{aligned} \Leftrightarrow b_3^* - BLadj \times e_3 \\ = 60 + \frac{0.95^3}{3} (b_0 - 60) + \frac{0.95^2}{3} (b_1^* - BLadj \times e_1 - 60) + \frac{0.95}{3} (b_2^* - BLadj \times e_2 \\ - 60) \end{aligned}$$

$$\Leftrightarrow BLadj = \frac{b_3^* - bb_3^*}{e_3 - \frac{0.95^3}{3} e_0 - \frac{0.95^2}{3} e_1 - \frac{0.95}{3} e_2}$$

where $b_3^* - bb_3^*$ is the gap to the backward-looking element of the debt reduction benchmark at the end of the transition period in the baseline scenario.

2. calculate the adjustment (*CYCLadj*) allowing closing the gap between the cyclically adjusted debt⁽¹⁶⁵⁾, at the end of the transition period, and the backward-looking debt ratio:

$$b_3^{3\text{-year-adjusted}} = bb_3$$

$$\Leftrightarrow CYCLadj = \frac{ab_3^* \mp \beta - bb_3^*}{\alpha e_3 - \frac{0.95^3}{3} e_0 - \frac{0.95^2}{3} e_1 - \frac{0.95}{3} e_2}$$

3. calculate the adjustment (*FLadj*) allowing closing the gap to the forward-looking debt benchmark:
 $bb_5 = 60\% + 0.95/3 (b_4 - 60\%) + 0.95^2/3 (b_3 - 60\%) + 0.95^3/3 (b_2 - 60\%)$

$$b_5 = bb_5$$

⁽¹⁶⁵⁾ $b_3^{3\text{-year-adjusted}} = \frac{\prod_{i=1}^3 (1+g_i)}{\prod_{i=1}^3 (1+g_i^{pot})(1+p_i)} \times b_3 + \frac{\sum_{i=1}^3 c b_i \prod_{j=1}^i (1+g_j)}{\prod_{i=1}^3 (1+g_i^{pot})(1+p_i)} = \alpha \cdot b_3 + \beta$ where *g* represents the nominal growth *g*^{pot} the potential growth and *p* the GDP deflator growth.

$$\Leftrightarrow FLadj = \frac{b_5^* - bb_5^*}{e_5 - \frac{0.95^3}{3}e_2 - \frac{0.95^2}{3}e_3 - \frac{0.95}{3}e_4}$$

Finally, the Minimum Linear Structural Adjustment needed to ensure compliance with the debt criterion at the end of the transition period results from:

$$MLSA = \min(BLadj ; FLadj ; CYCLadj)$$

If the adjustment really implemented by the country under analysis in the first year (or second year) of the transition period, differs from the MLSA, one needs to follow the same logic, as presented above, and find the linear constant structural adjustment for the two (one) remaining years of the transition period assuring the respect of the debt rule at the end of the transition period. This implies to consider as a starting point a structural balance corresponding to year t2 (year t3) and a transition period lasting only two years (1 year).

ANNEX 6

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 voting on in line with 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.

ANNEX 7

THE FISCAL COMPACT

ARTICLE 3

1. The Contracting Parties shall apply the rules set out in this paragraph in addition and without prejudice to their obligations under European Union law:

(a) the budgetary position of the general government of a Contracting Party shall be balanced or in surplus;

(b) the rule under point (a) shall be deemed to be respected if the annual structural balance of the general government is at its country-specific medium-term objective, as defined in the revised Stability and Growth Pact, with a lower limit of a structural deficit of 0,5 % of the gross domestic product at market prices. The Contracting Parties shall ensure rapid convergence towards their respective medium-term objective. The time-frame for such convergence will be proposed by the European Commission taking into consideration country-specific sustainability risks. Progress towards, and respect of, the medium-term objective shall be evaluated on the basis of an overall assessment with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures, in line with the revised Stability and Growth Pact;

(c) the Contracting Parties may temporarily deviate from their respective medium-term objective or the adjustment path towards it only in exceptional circumstances, as defined in point (b) of paragraph 3;

(d) where the ratio of the general government debt to gross domestic product at market prices is significantly below 60 % and where risks in terms of long-term sustainability of public finances are low, the lower limit of the medium-term objective specified under point (b) can reach a structural deficit of at most 1,0 % of the gross domestic product at market prices;

(e) in the event of significant observed deviations from the medium-term objective or the adjustment path towards it, a correction mechanism shall be triggered automatically. The mechanism shall include the obligation of the Contracting Party concerned to implement measures to correct the deviations over a defined period of time.

2. The rules set out in paragraph 1 shall take effect in the national law of the Contracting Parties at the latest one year after the entry into force of this Treaty through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes. The Contracting Parties shall put in place at national level the correction mechanism referred to in paragraph 1(e) on the basis of common principles to be proposed by the European Commission, concerning in particular the nature, size and time-frame of the corrective action to be undertaken, also in the case of exceptional circumstances, and the role and independence of the institutions responsible at national level for monitoring compliance with the rules set out in paragraph 1. Such correction mechanism shall fully respect the prerogatives of national Parliaments.

3. For the purposes of this Article, the definitions set out in Article 2 of the Protocol (No 12) on the excessive deficit procedure, annexed to the European Union Treaties, shall apply.

The following definitions shall also apply for the purposes of this Article:

(a) “annual structural balance of the general government” refers to the annual cyclically-adjusted balance net of one-off and temporary measures;

(b) “exceptional circumstances” refers to the case of an unusual event outside the control of the Contracting Party concerned which has a major impact on the financial position of the general government or to periods of severe economic downturn as set out in the revised Stability and Growth

Pact, provided that the temporary deviation of the Contracting Party concerned does not endanger fiscal sustainability in the medium-term.

ARTICLE 4

When the ratio of a Contracting Party's general government debt to gross domestic product exceeds the 60 % reference value referred to in Article 1 of the Protocol (No 12) on the excessive deficit procedure, annexed to the European Union Treaties, that Contracting Party shall reduce it at an average rate of one twentieth per year as a benchmark, as provided for in Article 2 of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, as amended by Council Regulation (EU) No 1177/2011 of 8 November 2011. The existence of an excessive deficit due to the breach of the debt criterion will be decided in accordance with the procedure set out in Article 126 of the Treaty on the Functioning of the European Union.

ARTICLE 5

1. A Contracting Party that is subject to an excessive deficit procedure under the Treaties on which the European Union is founded shall put in place a budgetary and economic partnership programme including a detailed description of the structural reforms which must be put in place and implemented to ensure an effective and durable correction of its excessive deficit. The content and format of such programmes shall be defined in European Union law. Their submission to the Council of the European Union and to the European Commission for endorsement and their monitoring will take place within the context of the existing surveillance procedures under the Stability and Growth Pact.

2. The implementation of the budgetary and economic partnership programme, and the yearly budgetary plans consistent with it, will be monitored by the Council of the European Union and by the European Commission.

ARTICLE 6

With a view to better coordinating the planning of their national debt issuance, the Contracting Parties shall report ex ante on their public debt issuance plans to the Council of the European Union and to the European Commission.

ARTICLE 7

While fully respecting the procedural requirements of the Treaties on which the European Union is founded, the Contracting Parties whose currency is the euro commit to supporting the proposals or recommendations submitted by the European Commission where it considers that a Member State of the European Union whose currency is the euro is in breach of the deficit criterion in the framework of an excessive deficit procedure. This obligation shall not apply where it is established among the Contracting Parties whose currency is the euro that a qualified majority of them, calculated by analogy with the relevant provisions of the Treaties on which the European Union is founded, without taking into account the position of the Contracting Party concerned, is opposed to the decision proposed or recommended.

ARTICLE 8

1. The European Commission is invited to present in due time to the Contracting Parties a report on the provisions adopted by each of them in compliance with Article 3(2). If the European Commission, after having given the Contracting Party concerned the opportunity to submit its observations, concludes in its report that such Contracting Party has failed to comply with Article 3(2), the matter will be brought to the Court of Justice of the European Union by one or more Contracting Parties. Where a Contracting Party considers, independently of the Commission's report, that another Contracting Party has failed to comply

with Article 3(2), it may also bring the matter to the Court of Justice. In both cases, the judgment of the Court of Justice shall be binding on the parties to the proceedings, which shall take the necessary measures to comply with the judgment within a period to be decided by the Court of Justice.

2. Where, on the basis of its own assessment or that of the European Commission, a Contracting Party considers that another Contracting Party has not taken the necessary measures to comply with the judgment of the Court of Justice referred to in paragraph 1, it may bring the case before the Court of Justice and request the imposition of financial sanctions following criteria established by the European Commission in the framework of Article 260 of the Treaty on the Functioning of the European Union. If the Court of Justice finds that the Contracting Party concerned has not complied with its judgment, it may impose on it a lump sum or a penalty payment appropriate in the circumstances and that shall not exceed 0,1 % of its gross domestic product. The amounts imposed on a Contracting Party whose currency is the euro shall be payable to the European Stability Mechanism. In other cases, payments shall be made to the general budget of the European Union.

3. This Article constitutes a special agreement between the Contracting Parties within the meaning of Article 273 of the Treaty on the Functioning of the European Union.

ANNEX 8

A NUMERICAL EXAMPLE OF THE EXPENDITURE BENCHMARK

This section presents a calculation of the expenditure benchmark, in line with the methodology outlined in Box 1.11 in Section 1.3.2.6. The Table A8.1 at the end of this annex presents the data used for the calculation of the expenditure benchmark, expressed in nominal terms, for an indicative country and the further adjustments used for the overall assessment.

Expenditure benchmark calculations

As Box 1.11 sets out, the first data that enters the calculation is the government expenditure aggregate given in line 1. Interest expenditure (line 2), government expenditure on EU programmes fully matched by EU funds revenue (line 3), gross fixed capital formation for the year in question netted out of the EU funds revenues spent in investment projects (line 7), cyclical unemployment benefit expenditure (line 9) and one-off measures on the expenditure side of the budget are all subtracted from the government expenditure aggregate, while the average annual gross fixed capital formation for years t-3 to t (line 8), netted out yearly of the EU funds revenues spent in investment projects, is added. The table shows how the average is computed from the nominal figures for the four years in question, using the information from lines 4 to 7. The modified expenditure aggregate is then given in line 17. This is then corrected for discretionary revenue measures (given in line 11) and revenue measures mandated by law (12).

The change in the net nominal expenditure is then computed in line 19 using the formula from Box 1.11. Note that in doing this, the corrected expenditure aggregate net of revenue measures in year t (line 18) is compared to the corrected expenditure for year t-1 that is not net of revenue measures (line 17). This is because the revenue measures from lines 11 and 12 are given on an incremental basis over the previous year.

In the example given in the table below, the country has an MTO of -0.45% of GDP for the entire period concerned and a structural balance of -1.1% in year t-1 and -0.6% in year t. Line 22 gives the reference rate for the country in question depending chiefly on whether it is at its MTO or not. The reference rate is then converted to nominal terms using the deflator in line 23, as from Commission's spring forecast of the previous year. The reference rate in nominal terms is given in line 24 according to the formula: $(1+\text{real}) \cdot (1+\text{deflator}) - 1 = \text{nominal}$, which is to be used to judge compliance with the expenditure benchmark.

If one aims at verifying compliance with the expenditure benchmark for instance for year t+1, the first stage is to determine the initial position of this Member State at the start of the year (which implies comparing the structural balance in year t with the country's MTO). This implies that at the start of year t+1, the country in question is assessed to be at its MTO due to the 0.25% of GDP margin of tolerance (-0.6 vs. MTO = -0.45).

If line 19 is at or below the level given in line 24, the country is compliant with the expenditure benchmark for a given year. Otherwise it is not compliant. Line 25 calculates the excess of the growth in expenditure over the reference rate, and converts into the national currency using the figure for the net expenditure aggregate. Using the figure for nominal GDP given in line 26, this difference of net expenditure growth relative to the reference rate is given as a share of GDP in line 27.

The figure in line 27 gives the excess (if it is negative) of net expenditure growth over the reference rate to be used to assess whether the deviation is significant or not. If the deviation exceeds 0.5, it is judged to be significant. As the significance of deviation is judged both in each year and over two years, line 28 gives the average over two years. If this is over 0.25, the deviation is judged to be significant over two years.

Expenditure benchmark calculations within the overall assessment

A further correction (in grey at the bottom of the table), at the time of the overall assessment, consists in netting out also the one-off measures referring to both sides of the budget. This adjustment affects the deviation via the total discretionary revenue measures, because of the role of the one-offs on the revenue side⁽¹⁶⁶⁾ (line 29), and the corrected expenditure aggregate, because of the role of the one-offs on the expenditure side⁽¹⁶⁷⁾ (30). As a result, the change in the net nominal expenditure aggregate (line 32), its deviation from the reference rate (in nominal and in % of GDP: lines 33 and 34 respectively) and the average deviation (line 35) are then affected.

⁽¹⁶⁶⁾ When netting out the one-off measures on the revenue side of the budget, their recording in the AMECO database should be taken into account. In AMECO, one-off measures are recorded in levels while the total amount of discretionary revenue measures is reported on an incremental basis. When computing the Total discretionary measures net of one-offs for a given year t , we have to proceed by summing up first the discretionary measures referred to that year and then subtract the incremental contribution of the one-offs, obtained as the difference of the one-offs over two consecutive years (t and $t-1$):

Total discretionary measures net of one-offs _{t} = Discretionary measures current revenue _{t} + Discretionary measures capital transfers received - (One-offs on the revenue side _{t} - One-offs on the revenue side _{$t-1$}).

⁽¹⁶⁷⁾ In the AMECO database, one-off expenditure measures are recorded with a positive sign when they imply expenditure decreases. This means that in order to net out the one-offs from the expenditure aggregate, these have to be added.

Table A8.1: A numerical example of the expenditure benchmark

	t-1	t	t+1
1 General government expenditure	173.5	175.1	177.4
2 Interest expenditure	8.1	7.9	7.8
3 Government expenditure on EU programmes fully matched by EU funds revenue	0.2	0.2	0.2
<i>Gross fixed capital formation t</i>	9.7	9.9	10.1
4 <i>Gross fixed capital formation t-3 net of EU funds revenues spent in investment projects</i>	9.2	9.2	9.7
5 <i>Gross fixed capital formation t-2 net of EU funds revenues spent in investment projects</i>	9.2	9.7	9.7
6 <i>Gross fixed capital formation t-1 net of EU funds revenues spent in investment projects</i>	9.7	9.7	9.9
7 Gross fixed capital formation t net of EU funds revenues spent in investment projects	9.7	9.9	10.1
8 Annual average gross fixed capital formation t-3 to t	9.5	9.6	9.9
9 Cyclical unemployment expenditure	0.3	0.5	0.4
10 One-offs on expenditure side	5.1	-2.1	-0.7
11 <i>Discretionary measures current revenue</i>	0.6	0.2	-1.9
12 <i>Discretionary measures capital transfers received</i>	0.0	0.0	0.0
13 <i>One-offs on the revenue side</i>	0.3	0	0
14 Total discretionary revenue measures = (11)+(12)	0.6	0.2	-1.9
15 Revenue measures mandated by law	0	0	0
17 Corrected expenditure aggregate (nominal) = (1)-(2)-(3)-(7)+(8)-(9)	164.7	166.2	168.7
18 Corrected expenditure aggregate net of (14) and (16) (nominal) = (17)-(14)-(16)	164.0	166.0	170.6
19 Net public expenditure annual growth in % (nominal)	5.8	0.8	2.7
20 MTO	-0.45	-0.45	-0.45
21 Structural balance frozen to identify the initial position toward the MTO	-0.4	-0.6	n.a.
22.a Applicable benchmark rate if already at MTO (i.e. if $SB_{t-1} = MTO$) ~	1.9	1.6	2.0
22.b Convergence margin *	1.2	-0.1	0.3
22 Reference rate to be applied (real) = (22.b)/(22.a)	0.7	1.8	1.7
23 GDP deflator (% change)	1.7	1.6	1.5
24 Reference rate to be applied (nominal) = $[(1+(22)/100)]^t [1+(23)/100]^{t-1} * 100$	2.4	3.4	3.2
25 Deviation in year t (in national currency) if negative, it is an excess over the benchmark = $[(24)-(19)] * (17 \text{ from the previous year}) / 100$	-5.2	4.3	0.9
26 GDP (nominal)	329.3	337.2	347.7
27 Deviation in year t (in % GDP) if negative, it is an excess over the benchmark = (25)/(26)*100	-1.6	1.3	0.3
28 Average deviation in t-1 and t (in % GDP)		-0.2	0.8
Overall assessment further adjustments			
29 Total discretionary revenue measures net of one-offs = (11)+(12)-(13)+(13 referred to the previous year)	1.0	0.5	-1.9
30 Corrected expenditure aggregate (nominal) net of one-offs = (1)-(2)-(3)-(7)+(8)-(9)+(10)	169.8	164.1	168.0
31 Corrected expenditure aggregate net of one-offs (nominal) = (30)-(29)-(16)	168.7	163.6	169.9
32 Net public expenditure annual growth in % (nominal) net of one-offs	9.4	-3.0	3.9
33 Deviation in year t (in national currency) net of one-offs = $[(24)-(32)] * (30 \text{ from the previous year}) / 100$ (if negative, it is an excess over the benchmark)	-10.9	11.0	-1.0
34 Deviation net of one-offs in year t (in % GDP) if negative, it is an excess over the benchmark = (33)/(26)*100	-3.3	3.2	-0.3
35 Average deviation net of one-offs in t-1 and t (in % GDP)		0.0	1.5

~ It corresponds to the 10-year average potential growth on the basis of the Commission spring forecast of year t-1, when the requirement is set.
* See Box 1.10 for details on calculation.

ANNEX 9

A NUMERICAL EXAMPLE OF AN ASSESSMENT OF EFFECTIVE ACTION TO AN ARTICLE 126(7) RECOMMENDATION OR ARTICLE 126(9) NOTICE

This annex presents an example of an assessment of effective action following an Article 126(7) recommendation or notice under Article 126(9).

SETTING THE EDP TARGETS

The baseline, no-policy change scenario

Defining the EDP scenario –that is, the EDP targets and the underlying assumptions– always starts by looking at what would happen if no further fiscal policy measures were taken. This is known as the baseline, no-policy change scenario.

The baseline scenario is actually the Commission’s most recent forecast available at the time of recommendation. Typically, it shows that the headline deficit breached the 3% of GDP limit in the previous year, which triggers the opening of an EDP. In some cases, the Commission’s forecast horizon (which typically covers years T and T+1, and T+2 in the case of the autumn forecast) is extended in an ad hoc way, if a longer correction period is being contemplated.

In the example shown in Table A9.1, the headline deficit reached 4% of GDP in year T-1, based on notified data. The deficit is forecast to stay at 4% in years T and T+1, meaning that it would remain above 3% of GDP if no further measures were taken. By further measures we mean any measures that would come on top of those included in the Commission’s no-policy change forecast.

Table A9.1: **The baseline, no-police change scenario**

	Year t-1	Year t	Year t+1
	Outturn	Forecast	
GDP growth (constant prices – in %)		1.5	1.5
GDP growth (current prices – in %)		3.5	3.5
Potential GDP growth (constant prices – in %)		1.0	1.0
Output gap (in % of potential GDP)	-3.0	-2.5	-2.0
General government balance (in % of GDP)	-4.0	-4.0	-4.0
Structural balance (in % of potential GDP)	-2.5	-2.7	-3.0
Change in structural balance (in % of potential GDP)		-0.2	-0.2

Note: Annual changes in the structural balance may not match annual levels due to rounding.

The headline deficit path is also dependent on the forecast macroeconomic outlook. Here we expect real GDP to grow by 1.5% in years T and T+1 and inflation to be 2% in both years.

With growth forecast above potential, the output gap is narrowing over the forecast horizon.

For the sake of simplicity, we assume that there are no one-off measures taken by the Member State, implying that all measures are of a permanent nature.

On this basis, and using the commonly agreed methodology for the cyclically-adjusted balance, the structural balance is estimated to deteriorate by 0.2% of potential GDP in both year T and year T+1.

The EDP scenario

The EDP scenario is composed of headline deficit targets and required annual improvements in the structural balance which – if followed – allow bringing the headline deficit below 3% of GDP by a given deadline while ensuring that an appropriate fiscal effort is pursued.

The EDP scenario is built in an iterative way. Specifically, starting from the baseline, no-policy change scenario, we look at whether a one-year deadline seems reasonable in terms of the underlying fiscal effort and the impact on the macroeconomic outlook. If this seems unrealistic, for example because it would imply too high of a fiscal effort and/or because it would have too negative impact on GDP growth, there may be a case for a two-year deadline. And so on.

Table A9.2: **The EDP scenario**

	Year t-1	Year t	Year t+1
	Outturn	Forecast	
GDP growth (constant prices – in %)		0.8	0.7
GDP growth (current prices – in %)		2.8	2.7
Potential GDP growth (constant prices – in %)		1.0	1.0
Output gap (in % of potential GDP)	-3.0	-3.2	-3.4
General government balance (in % of GDP)	-4.0	-3.4	-2.7
Structural balance (in % of potential GDP)	-2.5	-1.8	-1.0
Change in structural balance (in % of potential GDP)		0.7	0.8

Note: Annual changes in the structural balance may not match annual levels due to rounding.

In the example, the EDP scenario as shown in Table A9.2 is such that it brings the headline deficit to 3.4% of GDP in year T and 2.7%, i.e. below the 3% limit, in year T+1. The corresponding improvements in the structural balance are 0.7% of (potential) GDP in year T and 0.8% in year T+1.

The EDP targets are defined in terms of the expenditure benchmark, that is, the maximum allowable growth rate of expenditure consistent with, and conducive to, the fulfilment of the targets for the headline deficit and the underlying improvement in the structural balance. The expenditure benchmark is net of the possible fiscal policy (discretionary) measures assumed 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 4 four-year period. Any possible one-off measures, whether on the expenditure or on the revenue side, are also excluded.

In the example as shown in Table A9.3, in the EDP scenario total government expenditure is projected to reach 51.3 billion of national currency in year T and 52.5 billion in year T+1, from 50 billion in year T-1. The modified expenditure aggregate is 47.8 billion in year T and 49.0 billion in year T+1. The latter is then corrected for the non-one-off discretionary revenue measures assumed in the EDP scenario, which gives the expenditure benchmark (1.2% in year T, 1.4% in year T+1).

Table A9.3: **The expenditure benchmark as per the EDP scenario**

	Year t-1	Year t	Year t+1
<i>in billions of national currency</i>	Outturn	Forecast	
1 General government expenditure	50.0	51.3	52.5
2 Interest expenditure	3.0	3.0	3.0
3 Expenditure on EU programmes fully matched by EU funds revenue	0.1	0.1	0.2
4 Gross fixed capital formation t net of EU funds revenue spent in investment projects	2.8	3.0	2.9
5 Annual average gross fixed capital formation t-3 to t net of EU funds revenue spent in investment projects	2.9	2.9	2.9
6 Cyclical unemployment expenditure	0.2	0.2	0.2
7 One-off expenditure measures	0.0	0.0	0.0

8	Corrected expenditure aggregate = $(1)-(2)-(3)-((4)-(5))-(6)+(7)$	46.8	47.8	49.0
9	Non-one-off revenue measures		0.5	0.6
10	Expenditure benchmark (in %) = $[(8)_t-(9)_t]/(8)_{t-1}] * 100$		1.2	1.4

ASSESSING EFFECTIVE ACTION

A decision tree sets out the order of logical and procedural steps for the assessment of effective action under the EDP (see Graph 2.3 in Section 2.3.2.1). First, the headline balance and the change in the structural balance are assessed. When a Member State achieves both its headline deficit target and the recommended improvement in the structural balance, the Member State is considered to have acted in compliance with the recommendation and the EDP is held in abeyance – meaning it is put on hold until the excessive deficit is eventually corrected, as long as it continues to comply with the headline and structural targets. When this is not achieved, the Commission engages in a more detailed examination, known as the careful analysis, primarily based on an assessment of compliance with the expenditure benchmark.

In the example as shown in Table A9.4, the headline deficit is above the EDP targets (3.7% of GDP in year T and 3.4% in year T+1 versus 3.4% and 2.7%, respectively). A careful analysis is therefore needed to see whether the breach is due to the macroeconomic situation turning worse than forecast in the EDP scenario or to the Member State not delivering on its policy commitments. In the example, the growth rates of the modified expenditure aggregate net of non-off discretionary revenue measures (1.0% in year T and 1.3% in year T+1) are below the recommended growth rates (1.2% and 1.4%, respectively), which means that the expenditure benchmark is met and there is a presumption that the Member State has delivered on its policy commitments.

Table A9.4: **Most recent forecast/outturn data available at the time of assessment**

	Year t-1	Year t	Year t+1
	Outturn	Forecast/outturn	
GDP growth (constant prices - in %)		-0.1	-0.2
GDP growth (current prices - in %)		1.9	1.7
Potential GDP growth (constant prices - in %)		1.0	1.0
Output gap (in % of potential GDP)	-3.0	-4.0	-5.2
General government balance (in % of GDP)	-4.0	-3.7	-3.4
Structural balance (in % of potential GDP)	-2.5	-1.7	-0.8
Change in structural balance (in % of potential GDP)		0.8	0.9
Corrected expenditure aggregate net of non-one-off revenue measures (in %)		1.0	1.3

Table A9.5: Calculating the growth rate of expenditure at the time of assessment

	Year t-1	Year t	Year t+1
<i>in billions of national currency</i>	Outturn	Forecast/outturn	
1 General government expenditure	50.0	51.0	51.9
2 Interest expenditure	3.0	3.0	3.0
3 Expenditure on EU programmes fully matched by EU funds revenue	0.1	0.2	0.2
4 Gross fixed capital formation t net of EU funds revenue spent in investment projects	2.8	2.8	2.7
5 Annual average gross fixed capital formation t-3 to t net of EU funds revenue spent in investment projects	2.9	2.8	2.8
6 Cyclical unemployment expenditure	0.2	0.3	0.4
7 One-off expenditure measures	0.0	0.0	0.1
8 Corrected expenditure aggregate = (1)-(2)-(3)-((4)-(5))-(6)+(7)	46.8	47.5	48.5
9 Non-one-off revenue measures		0.3	0.4
10 Corrected expenditure aggregate net of non-one-off revenue measures (in %) = <i>$[(8)-(9))/(8)_{t-1}] * 100$</i>		1.0	1.3

ANNEX 10

PARAMETERS UNDERLYING THE COMMISSION'S CYCLICAL ADJUSTMENT METHODOLOGY

The cyclically-adjusted budget balance (CAB) corresponds to the deficit/surplus-to-GDP ratio that would prevail if the economy was running at potential. It is computed as the difference between the actual balance-to-GDP ratio and an estimated cyclical component. In algebraic terms:

$$CAB_t = \frac{(R_t - G_t)}{Y_t} - \varepsilon \cdot OG_t \quad (1)$$

where R and G stand for the nominal government revenue and expenditure respectively and Y for nominal GDP. The nominal budget balance B is defined as the difference between the nominal government revenue and expenditure. The cyclical component of the budget balance is the product of a cyclical adjustment parameter (ε) and the output gap (OG). ε is often called semi-elasticity, which captures the reaction of the budget balance, as a percentage of GDP, to the output gap. This cyclical component is subtracted from the actual budget as a percentage of GDP (also called 'headline budget balance' in the fiscal literature) to obtain the CAB. It has the merit to be easily calculated and be clearly communicable to policymakers.

The cyclical adjustment parameter, i.e. the budgetary semi-elasticity is computed based on the weighting parameters⁽¹⁶⁸⁾ and the recently revised individual elasticities of revenue and spending⁽¹⁶⁹⁾. As shown by Table A10.1, budgetary semi-elasticities are computed by weighting individual elasticities by the corresponding share of the individual revenue (expenditure) category in total revenue (expenditure) and by the corresponding revenue (expenditure) weight (in percentage of GDP).

$$\varepsilon = \varepsilon_R - \varepsilon_G = (\eta_R - 1) \frac{R}{Y} - (\eta_G - 1) \frac{G}{Y} = \left(\sum_{i=1}^5 \eta_{R_i} \frac{R_i}{R} - 1 \right) \frac{R}{Y} - \left(\eta_{G_U} \frac{G_U}{G} - 1 \right) \frac{G}{Y} \quad (2)$$

where η_R and η_G denote respectively the elasticity of (total) revenue and expenditure with respect to the output gap. $(\eta_R - 1)$ and $(\eta_G - 1)$ correspond to the elasticity of the revenue-to-GDP ratio and the elasticity of the expenditure-to-GDP ratio respectively. Individual revenue/spending elasticities with respect to the output gap are computed using a two-step procedure (see Table A10.2): (i) the elasticity of the revenue/expenditure item with respect to its base $\varepsilon_{base/OG}$, and (ii) the elasticity of the base with respect to output $\varepsilon_{R/OG}$.

$$\varepsilon_{R/OG} = \varepsilon_{R/base} \cdot \varepsilon_{base/OG} \quad (3)$$

⁽¹⁶⁸⁾ For more details, see G. Mourre, G-M. Isbasoiu, D. Paternoster and M. Salto, "The cyclically-adjusted budget balance used in the EU fiscal framework: a revised computation", European Economy. Economic Papers, March 2013.

⁽¹⁶⁹⁾ For more details, see G. Mourre, C. Astarita and S. Princen, "Adjusting the budget balance for the business cycle: the EU methodology", European Economy. Economic Papers, November 2014 and Price, R. W, Dang T. and Guillemette Y. (2014), "New tax and expenditure elasticity estimates for EU budget surveillance", OECD Economics Department Working Paper No. 1174.

	Elasticity of:				Weights (% of GDP) of:		Semi-elasticity for:		
	Revenue level	Expenditure level	Revenue-to-GDP ratio	Expenditure-to-GDP ratio	Total revenue	Total expenditure	Revenue	Expenditure	Budget balance
	(a)	(b)	c = a-1	d = b-1	(e)	(f)	g = c*e	h = d*f	i = g-h
BE	1.03	-0.17	0.03	-1.17	49.05	50.70	0.015	-0.591	0.605
BG	0.78	-0.03	-0.22	-1.03	37.75	38.10	-0.084	-0.391	0.308
CZ	0.97	-0.02	-0.03	-1.02	39.91	43.77	-0.012	-0.446	0.433
DK	1.00	-0.14	0.00	-1.14	55.75	54.34	-0.001	-0.620	0.619
DE	0.98	-0.21	-0.02	-1.21	44.00	46.45	-0.009	-0.560	0.551
EE	1.10	-0.10	0.10	-1.10	37.63	36.99	0.037	-0.406	0.443
IE	1.05	-0.24	0.05	-1.24	35.20	41.14	0.019	-0.508	0.528
EL	0.94	-0.05	-0.06	-1.05	39.93	48.06	-0.023	-0.506	0.483
ES	1.03	-0.28	0.03	-1.28	38.14	41.13	0.011	-0.528	0.539
FR	1.00	-0.11	0.00	-1.11	49.90	54.11	0.002	-0.601	0.603
HR	0.97	-0.02	-0.03	-1.02	40.48	46.96	-0.011	-0.479	0.467
IT	1.08	-0.03	0.08	-1.03	45.14	48.77	0.038	-0.501	0.539
CY	1.18	-0.04	0.18	-1.04	40.27	43.47	0.071	-0.452	0.523
LV	0.92	-0.07	-0.08	-1.07	35.08	38.26	-0.028	-0.408	0.380
LT	1.07	-0.08	0.07	-1.08	32.92	36.13	0.022	-0.391	0.413
LU	1.01	-0.08	0.01	-1.08	41.87	41.09	0.003	-0.442	0.445
HU	0.96	-0.01	-0.04	-1.01	44.97	50.33	-0.019	-0.511	0.492
MT	1.02	-0.03	0.02	-1.03	39.48	43.74	0.007	-0.449	0.456
NL	1.15	-0.22	0.15	-1.22	45.25	47.37	0.066	-0.579	0.646
AT	1.02	-0.12	0.02	-1.12	48.49	50.77	0.012	-0.569	0.580
PL	1.07	-0.13	0.07	-1.13	38.78	43.79	0.027	-0.494	0.521
PT	0.95	-0.13	-0.05	-1.13	41.08	46.42	-0.019	-0.525	0.506
RO	0.86	-0.04	-0.14	-1.04	32.97	36.78	-0.045	-0.384	0.339
SI	0.99	-0.04	-0.01	-1.04	43.46	46.49	-0.006	-0.483	0.477
SK	0.99	-0.03	-0.01	-1.03	34.23	38.62	-0.005	-0.398	0.393
FI	0.94	-0.18	-0.06	-1.18	53.13	51.08	-0.030	-0.604	0.574
SE	0.96	-0.15	-0.04	-1.15	53.99	53.13	-0.020	-0.609	0.590
UK	1.30	-0.03	0.30	-1.03	40.36	45.60	0.120	-0.471	0.591

Table A10.1: Decomposition of the semi-elasticity of budget balance to output gap

Note: The total revenue and expenditure as a percentage of GDP (columns e and f) correspond to the 'Excessive Deficit Procedure' definition, as explained in more detail in Mourre et al.(2013).

Personal income tax			Corporate income tax			Social security contributions			Indirect taxes			Unemployment-related expenditure			
Revenue-to-base elasticity	Base-to-output gap elasticity	Revenue-to-output gap elasticity	Revenue-to-base elasticity	Base-to-output gap elasticity	Revenue-to-output gap elasticity	Revenue-to-base elasticity	Base-to-output gap elasticity	Revenue-to-output gap elasticity	Revenue-to-base elasticity	Base-to-output gap elasticity	Revenue-to-output gap elasticity	Expenditure-to-base elasticity	Base-to-output gap elasticity	Expenditure-to-output gap elasticity	
<i>j</i>	<i>k</i>	= <i>j * k</i>	<i>l</i>	<i>m</i>	= <i>l * m</i>	<i>n</i>	<i>o</i>	= <i>n * o</i>	<i>p</i>	<i>q</i>	= <i>p * q</i>	<i>r</i>	<i>s</i>	= <i>r * s</i>	
BE	1.62	0.81	1.31	1.62	1.53	2.48	1.15	0.61	0.71	1.00	1.00	1.00	1.00	-3.70	-3.70
BG	1.11	1.04	1.15	1.81	1.18	2.13	0.93	0.66	0.61	1.00	1.00	1.00	1.00	-3.91	-3.91
CZ	2.23	0.74	1.65	1.23	1.45	1.78	0.99	0.87	0.86	1.00	1.00	1.00	1.00	-2.45	-2.45
DK	1.43	0.70	1.00	2.07	1.52	3.15	0.70	0.59	0.41	1.00	1.00	1.00	1.00	-4.97	-4.97
DE	1.88	1.00	1.87	1.59	1.20	1.91	0.86	0.70	0.60	1.00	1.00	1.00	1.00	-3.30	-3.30
EE	1.46	1.08	1.58	1.81	0.99	1.78	1.36	1.03	1.40	1.00	1.00	1.00	1.00	-5.18	-5.18
IE	2.04	0.77	1.58	1.00	1.26	1.25	1.51	0.69	1.04	1.00	1.00	1.00	1.00	-5.45	-5.45
EL	2.21	1.00	2.22	1.81	1.05	1.90	0.84	0.69	0.58	1.00	1.00	1.00	1.00	-3.15	-3.15
ES	1.88	0.98	1.84	1.32	1.18	1.56	0.82	0.88	0.72	1.00	1.00	1.00	1.00	-5.83	-5.83
FR	1.68	1.11	1.86	2.03	1.36	2.76	0.95	0.66	0.63	1.00	1.00	1.00	1.00	-3.23	-3.23
HR	1.75	0.98	1.71	1.81	1.27	2.29	1.00	0.71	0.70	1.00	1.00	1.00	1.00	-2.39	-2.39
IT	1.85	0.79	1.46	2.09	1.47	3.07	0.97	0.60	0.58	1.10	1.00	1.10	1.00	-2.29	-2.29
CY	2.25	1.01	2.28	1.93	1.17	2.26	1.00	0.91	0.91	1.00	1.00	1.00	1.00	-3.08	-3.08
LV	1.31	1.14	1.50	1.89	1.05	1.99	1.00	0.81	0.81	1.00	1.00	1.00	1.00	-3.94	-3.94
LT	1.46	1.23	1.79	1.68	0.99	1.67	1.00	1.04	1.04	1.00	1.00	1.00	1.00	-5.60	-5.60
LU	2.24	0.60	1.34	1.81	1.30	2.36	0.89	0.44	0.39	1.00	1.00	1.00	1.00	-3.06	-3.06
HU	1.80	0.96	1.73	1.81	1.22	2.21	0.99	0.77	0.76	1.00	1.00	1.00	1.00	-1.25	-1.25
MT	2.11	0.98	2.07	1.81	1.17	2.11	0.92	0.76	0.71	1.00	1.00	1.00	1.00	-1.96	-1.96
NL	2.00	1.19	2.37	2.81	1.11	3.13	0.86	0.73	0.62	1.00	1.00	1.00	1.00	-5.76	-5.76
AT	1.97	0.84	1.66	1.90	1.44	2.74	0.92	0.70	0.65	1.00	1.00	1.00	1.00	-4.71	-4.71
PL	1.93	0.98	1.88	2.30	1.27	2.92	0.97	0.99	0.97	1.00	1.00	1.00	1.00	-6.18	-6.18
PT	2.15	0.91	1.97	1.07	1.24	1.33	1.00	0.79	0.79	1.00	1.00	1.00	1.00	-6.04	-6.04
RO	1.36	0.95	1.29	1.81	1.11	2.02	0.99	0.62	0.62	1.00	1.00	1.00	1.00	-3.91	-3.91
SI	2.14	0.76	1.63	2.72	1.38	3.76	1.00	0.66	0.66	1.00	1.00	1.00	1.00	-2.81	-2.81
SK	2.43	0.79	1.93	1.24	1.28	1.58	1.19	0.75	0.89	1.00	1.00	1.00	1.00	-2.98	-2.98
FI	1.48	0.95	1.41	1.63	1.25	2.03	1.00	0.77	0.77	1.00	1.00	1.00	1.00	-3.66	-3.66
SE	1.42	0.93	1.32	1.19	1.30	1.56	0.95	0.75	0.71	1.00	1.00	1.00	1.00	-4.42	-4.42
UK	1.49	1.12	1.68	2.89	1.35	3.92	1.20	0.50	0.60	1.00	1.00	1.00	1.00	-4.21	-4.21

Table A10.2: Revenue (expenditure)-to-base and base-to-output gap elasticities of individual revenue and expenditure categories

ANNEX 11

MODEL STRUCTURE AND TABLES TO BE CONTAINED IN DRAFT BUDGETARY PLANS

A. MODEL STRUCTURE FOR DRAFT BUDGETARY PLANS

Macroeconomic Forecasts.

Budgetary targets.

Expenditure and revenue projections under the no-policy change scenario.

Expenditure and revenue targets. General government expenditure by function.

Discretionary measures included in the draft budget.

Possible links between the draft budgetary plan and the targets set by the Union's Strategy for growth and jobs and CSRs.

Comparison with latest Stability Programme.

Distributional impact of the main expenditure and revenue measures.

Annex: Methodological aspects, including the estimated impact of aggregated budgetary measures on economic growth.

B. TABLES TO BE CONTAINED IN DRAFT BUDGETARY PLANS ⁽¹⁷⁰⁾

1. Macroeconomic forecasts

Table 0.i): **Basic assumptions**

	Year	Year	Year
	t-1	t	t+1
Short-term interest rate¹ (annual average)			
Long-term interest rate (annual average)			
USD/€ exchange rate (annual average)			
Nominal effective exchange rate			
World excluding EU, GDP growth			
EU GDP growth			
Growth of relevant foreign markets			
World import volumes, excluding EU			
Oil prices (Brent, USD/barrel)			

⁽¹⁾ If necessary, purely technical assumptions.

Table 0.ii): **Main assumptions. Non-exhaustive check list. (Similar information can be provided in different formats)**

	Year	Year	Year
	t-1	t	t+1
1. External environment			
a. Prices of commodities			
b. Spreads over the German bond			
2. Fiscal policy			
a. General government net lending / net borrowing			
b. General government gross debt			
3. Monetary policy / Financial sector / interest rates assumptions			
a. Interest rates:			
i. Euribor			
ii. Deposit rates			
iii. Interest rates for loans			
iv. Yields to maturity of 10 year government bonds			
b. Evolution of deposits			
c. Evolution of loans			
d. NPL trends			
4. Demographic trends			
a. Evolution of working-age population			
b. Dependency ratios			
5. Structural policies			

⁽¹⁷⁰⁾ Provision of data on variables in bold characters is a requirement. Provision of data on other variables is optional but highly desirable.

Table 1.a.: **Macroeconomic prospects**

	ESA Code	Year t-1	Year t-1	Year t	Year t+1	Year t+2	Year t+3	Year t+4
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g							
Of which								
1.1. Attributable to the estimated impact of aggregated budgetary measures on economic growth ⁽¹⁾		---	---					
2. Potential GDP						✓	✓	✓
contributions:								
- labour								
- capital								
- total factor productivity								
3. Nominal GDP	B1*g					✓	✓	✓
Components of real GDP								
4. Private final consumption expenditure	P.3							
5. Government final consumption expenditure	P.3							
6. Gross fixed capital formation	P.51g							
7. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53							
8. Exports of goods and services	P.6							
9. Imports of goods and services	P.7							
Contributions to real GDP growth								
10. Final domestic demand			-					
11. Changes in inventories and net acquisition of valuables	P.52 + P.53		-					
12. External balance of goods and services	B.11		-					

(1) Please report here the estimated impact on real GDP growth of the aggregated budgetary measures contained in the DBP.

Table 1.b.: **Price developments**

	ESA Code	Year t-1	Year t-1	Year t	Year t+1	Year t+2	Year t+3	Year t+4
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator						✓	✓	✓
2. Private consumption deflator								
3. HICP								
4. Public consumption deflator								
5. Investment deflator								
6. Export price deflator (goods and services)								
7. Import price deflator (goods and services)								

Table 1.c.: Labour market developments

	ESA Code	Year t-1	Year t-1	Year t	Year t+1
		Level	rate of change	rate of change	rate of change
1. Employment, persons⁽¹⁾					
2. Employment, hours worked ⁽²⁾					
3. Unemployment rate (%)⁽³⁾					
4. Labour productivity, persons⁽⁴⁾					
5. Labour productivity, hours worked ⁽⁵⁾					
6. Compensation of employees	D.1				
7. Compensation per employee					

(1) Occupied population, domestic concept national accounts definition.

(2) National accounts definition. Please, provide the series in terms of average annual hours worked per person employed. This series is needed for internal calculations.

(3) Harmonised definition, Eurostat; levels.

(4) Real GDP per person employed.

(5) Real GDP per hour worked.

Table 1.d.: Sectoral balances

	ESA Code	Year t-1	Year t	Year t+1
1. Net lending/net borrowing vis-à-vis the rest of the world	B.9	% GDP	% GDP	% GDP
<i>of which:</i>				
- Balance on goods and services				
- Balance of primary incomes and transfers				
- Capital account				
2. Net lending/net borrowing of the private sector	B.9			
3. Net lending/net borrowing of general government	B.9			
4. Statistical discrepancy				

2. Budgetary Targets

Table 2.a.: General government budgetary targets broken down by subsector

	ESA Code	Year t	Year t+1	Year t+2	Year t+3	Year t+4
		% GDP	% GDP	% GDP	% GDP	% GDP
Net lending (+) / net borrowing (-) (B.9) by sub-sector¹						
1. General government	S.13			✓	✓	✓
1a. Central government	S.1311					
1b. State government	S.1312					
1c. Local government	S.1313					
1d. Social security funds	S.1314					
2. Interest expenditure	D.41					
3. Primary balance²						
4. One-off and other				✓	✓	✓

temporary measures³						
5. Real GDP growth (%) (=1 in Table 1.a)						
6. Potential GDP growth (%) (=2 in Table 1.a)				✓	✓	✓
contributions:						
- labour						
- capital						
- total factor productivity						
7. Output gap (% of potential GDP)				✓	✓	✓
8. Cyclical budgetary component (% of potential GDP)				✓	✓	✓
9. Cyclically-adjusted balance (1 - 12) (% of potential GDP)						
10. Cyclically-adjusted primary balance (13 + 6) (% of potential GDP)						
11. Structural balance (13 - 8) (% of potential GDP)				✓	✓	✓

(1) TR-TE= B.9.

(2) The primary balance is calculated as (B.9, item 1) plus (D.41, item 2).

(3) A plus sign means deficit-reducing one-off measures.

Table 2.b.: **General government debt developments**

	ESA Code	Year t	Year t+1	Year t+2	Year t+3	Year t+4
		% GDP	% GDP	% GDP	% GDP	% GDP
1. Gross debt⁽¹⁾				✓	✓	✓
2. Change in gross debt ratio						
Contributions to changes in gross debt						
3. Primary balance (= item 3 in Table 2.a)						
4. Interest expenditure (= item 2 in Table 2.a)	D.41					
5. Stock-flow adjustment				✓	✓	✓
<i>of which:</i>						
- Differences between cash and accruals ⁽²⁾						
- Net accumulation of financial assets ⁽³⁾						
<i>of which:</i>						
- privatisation proceeds						
- Valuation effects and other ⁽⁴⁾						
p.m.: Implicit interest rate on debt⁽⁵⁾						
Other relevant variables						
6. Liquid financial assets⁽⁶⁾						
7. Net financial debt (7=1-6)						
8. Debt amortisation (existing bonds) since the end of the						

previous year				
9. Percentage of debt denominated in foreign currency				
10. Average maturity				

(1) As defined in amended Regulation 479/2009.

(2) The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

(3) Currency and deposits, government debt securities, government controlled enterprises and the difference between listed and unlisted shares could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

(4) Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

(5) Proxied by interest expenditure divided by the debt level of the previous year.

(6) Liquid assets are here defined as stocks of AF.1, AF.2, AF.3 (consolidated for general government, i.e. netting out financial positions between government entities), AF.511, AF.52 (only if listed on stock exchange).

Table 2.c.: **Contingent liabilities**

	Year t	Year t+1
	% GDP	% GDP
Public guarantees		
Of which: linked to the financial sector		

3. Expenditure and Revenue Projections under the no-policy change scenario⁽¹⁷¹⁾

Table 3.: **General government expenditure and revenue projections at unchanged policies broken down by main components**

	ESA Code	Year T	Year t+1
General government (S13)		% GDP	% GDP
1. Total revenue at unchanged policies	TR		
Of which			
1.1. Taxes on production and imports	D.2		
1.2. Current taxes on income, wealth, etc	D.5		
1.3. Capital taxes	D.91		
1.4. Social contributions	D.61		
1.5. Property income	D.4		
1.6. Other ⁽¹⁾ p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995) ⁽²⁾			
2. Total expenditure at unchanged policies	TE ³		
Of which			
2.1. Compensation of employees	D.1		
2.2. Intermediate consumption	P.2		

⁽¹⁷¹⁾ Please note that the no-policy change scenario involves the extrapolation of revenue and expenditure trends before adding the impact of the measures included in the forthcoming year's budget.

2.3. Social payments	D.62+D.632		
of which Unemployment benefits⁽⁴⁾			
2.4. Interest expenditure	D.41		
2.5. Subsidies	D.3		
2.6. Gross fixed capital formation	P.51g		
2.7. Capital transfers	D.9		
2.8. Other⁽⁵⁾			

4. Expenditure and Revenue targets

Table 4.: **General government expenditure and revenue targets, broken down by main components**

	ESA Code	Year T	Year t+1
General government (S13)		% GDP	% GDP
1. Total revenue target	TR		
Of which			
1.1. Taxes on production and imports	D.2		
1.2. Current taxes on income, wealth, etc.	D.5		
1.3. Capital taxes	D.91		
1.4. Social contributions	D.61		
1.5. Property income	D.4		
1.6. Other⁽¹⁾ p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)⁽²⁾			
2. Total expenditure target	TE ³		
Of which			
2.1. Compensation of employees	D.1		
2.2. Intermediate consumption	P.2		
2.3. Social payments	D.62+D.632		
of which Unemployment benefits⁽⁴⁾			
2.4. Interest expenditure (=item 2 in Table 2.a)	D.41		
2.5. Subsidies	D.3		
2.6. Gross fixed capital formation	P.51		
2.7. Capital transfers	D.9		
2.8. Other⁽⁵⁾			

(1) P.11+P.12+P.131+D.39rec+D.7rec+D.9rec (other than D.91rec).

(2) Including those collected by the EU and including an adjustment for uncollected taxes and social contributions D.995), if appropriate.

(3) TR-TE = B.9.

(4) Includes social benefits other than social transfers in kind (D.62) and social transfers in kind via market producers (D.632) related to unemployment benefits.

(5) D.29pay + D.4pay (other than D.41pay) +D.5pay +D.7pay +P.52+P.53+NP+D.8.

Table 4.b: **General government expenditure and revenue targets, broken down by main components**

	ESA Code	Year t-1	Year t-1	Year t	Year t+1
		Level	% GDP	% GDP	% GDP
1. Expenditure on EU programmes fully matched by EU funds revenue					
<i>1a. of which investments fully matched by EU funds revenue</i>					
2. Cyclical unemployment benefit expenditure⁽¹⁾					
3. Effect of discretionary revenue measures⁽²⁾					
4. Revenue increases mandated by law					

Table 4.c: **General government expenditure by function**

4.c.i) General government expenditure on education, healthcare and employment

	Year t		Year t+1	
	% GDP	% general government expenditure	% GDP	% general government expenditure
Education ⁽¹⁾				
Healthcare ⁽¹⁾				
Employment ⁽²⁾				

(1) These expenditure categories should correspond respectively to items 9 and 7 in table 4.c.ii).

(2) This expenditure category should contain, inter alia, government spending related to active labour market policies (ALMPs) including public employment services. On the contrary, items such as compensation of public employees or vocational training programmes should not be included here.

4.c.ii) Classification of the functions of the Government

Functions of the Government	COFOG Code	Year t	Year t+1
		% GDP	% GDP
1. General public services	1		
2. Defense	2		
3. Public order and safety	3		
4. Economic affairs	4		
4. Environmental protection	5		
6. Housing and community amenities	6		
7. Health	7		
8. Recreation, culture and religion	8		
9. Education	9		
10. Social protection	10		
11. Total Expenditure (= item 2 in Table 4.a)	TE		

5. Description of discretionary measures included in the draft budget

Table 5.a: **Discretionary measures taken by General Government**

List of measures	Detailed description ⁽¹⁾	Target (Expenditure / Revenue component) ESA Code	Accounting principle	Adoption Status	Budgetary impact			
					Year t	Year t+1	Year t+2	Year t+...
					% GDP	% GDP	% GDP	% GDP
(1)								
(2)								
...								
TOTAL								

(1) Please describe in further detail in case of major fiscal policy reform plans with potential spillover effects for other Member States in the Euro Area.

Table 5.b: **Discretionary measures taken by Central Government**

List of measures	Detailed description ⁽¹⁾	Target (Expenditure / Revenue component) ESA Code	Accounting principle	Adoption Status	Budgetary impact			
					Year t	Year t+1	Year t+2	Year t+...
					% GDP	% GDP	% GDP	% GDP
(1)								
(2)								
...								
TOTAL								

(1) Please describe in further detail in case of major fiscal policy reform plans with potential spillover effects for other Member States in the Euro Area.

Table 5.c: **Discretionary measures taken by sub-sectors of the General Government⁽¹⁾**

List of measures	Detailed description ⁽²⁾	Target (Expenditure / Revenue component) ESA Code	Accounting principle	Adoption Status	Budgetary impact			
					Year t	Year t+1	Year t+2	Year t+...
					% GDP	% GDP	% GDP	% GDP
(1)								
(2)								
...								
TOTAL								

(1) Please name whether State Government, Local Government and/or Social Security Funds.

(2) Please describe in further detail in case of major fiscal policy reform plans with potential spillover effects for other Member States in the Euro Area.

6. Indications on how the measures in the DBP address CSR and the targets set by the Union's Strategy for growth and jobs

Table 6.a: **CSR recommendations**

CSR number	List of measures	Description of direct relevance

Table 6.b: **Targets set by the Union's Strategy for growth and jobs**

National 2020 headline targets	List of measures	Description of direct relevance to address the target
National 2020 employment target [...]		
National 2020 R&D target [...]		
GHG emission reduction target [...]		
Renewable energy target [...]		
National energy efficiency target [...]		
National early school leaving target [...]		
National target for tertiary education [...]		
National poverty target [...]		

7. Divergence from latest SP

Table 7: **Divergence from latest SP**

	ESA Code	Year t-1	Year t	Year t+1
		% GDP	% GDP	% GDP
Target general government net lending/net borrowing	B.9			
Stability Programme				
Draft Budgetary Plan				
Difference				
General government net lending projection at unchanged policies	B.9			
Stability Programme				
Draft Budgetary Plan				
Difference⁽¹⁾				

(1) This difference can refer to both deviations stemming from changes in the macroeconomic scenario and those stemming from the effect of policy measures taken between the submission of the SP and the submission of the DBP. Differences are expected due to the fact that the no-policy change scenario is defined differently for the purpose of this Code of Conduct with respect to the Stability Programme.

8. Distributional impact of the main expenditure and revenue measures

In accordance with Article 6(3)(d) of Regulation 473/2013, Member States should provide, to the extent possible, qualitative information and quantitative estimations on the distributional effects of budgetary measures, presented as best fits each Member State's specific measures and available analytical frameworks.

Quantifying the distributional impact of budgetary measures is a challenging task. For this reason no standardised table on this aspect of DBPs is included in this Annex. Quantitative estimations of the distributional impact of budgetary measures could be assessed by computing the expected changes in the Gini index, the S80/S20 indicator or the poverty rates as a result of them. This methodology could represent one possible way forward among others.

Annex to the DBP: Methodology, economic models and assumptions underpinning the information contained in the DBP

Table 8: **Methodological aspects**

Estimation Technique	Step of the budgetary process for which it was used ⁽¹⁾	Relevant features of the model/ technique used	Assumptions
Tool n.1			
Tool n.2			
...			

(1) Modeling tools may have been used:

- when doing macro forecasts
- when estimating expenditure and revenue under the no policy change scenario
- when estimating the distributional impact of the main expenditure and revenue measures
- when quantifying the expenditure and revenue measures to be included in the draft budget
- when estimating how reforms included in the DBP address targets set by the Union's Strategy for growth and jobs and CSRs.

ANNEX 12

TABLES TO BE INCLUDED UNDER THE ADDITIONAL REPORTING INTRODUCED IN THE TWO PACK

These tables are to be submitted in accordance with Article 10(3) of Regulation (EU) No 473/2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area. In all tables, year t corresponds to the year of submission of the report. Reporting for the items indicated in bold is compulsory. The conceptual framework agreed in the context of Directive 2011/85/EU should be implemented.

Table 1a: **In-year quarterly budgetary execution on cash basis^(a) for the general government and its sub-sectors^(b)**

<i>EUR millions</i>	Year t^(*)			
	Q1	Q2	Q3	Q4
Overall balance by sub-sector (6-7)				
1. General government				
2. Central government				
3. State government				
4. Local government				
5. Social security funds				
For each sub-sector (please indicate which)				
6. Total revenue / inflows				
Of which (indicative list)				
<i>Taxes, of which:</i>				
<i>Direct Taxes</i>				
<i>Indirect taxes, of which:</i>				
<i>VAT</i>				
<i>Social contributions</i>				
<i>Sales</i>				
<i>Other current revenue</i>				
<i>Capital revenue</i>				
<i>Inflows from operations in financial instruments</i>				
7. Total expenditure / outflows				
Of which (indicative list)				
<i>Purchase of goods and services</i>				
<i>Compensation of employees</i>				
<i>Interest</i>				
<i>Subsidies</i>				
<i>Social benefits</i>				
<i>Other current expenditure</i>				
<i>Capital transfers payable</i>				
<i>Capital investments</i>				
<i>Outflows from operations in financial instruments</i>				

(*) The reporting is mandatory up to the current quarter included. If the data for the current quarter is not available, please provide latest available monthly data, indicating which month it corresponds to. For the overall balance of the general government, please provide the information until the latest available quarter (i.e. q-1). The normal quality assurance and revision policy should apply.

(a) Equivalent figures from public accounting may be provided if cash-based data are not available; please specify the accounting basis used to fill all the information provided in this table.

(b) Corresponding to the reporting to be provided in accordance with Article 3(2) of Directive 2011/85/EU.

Table 1b: **In-year quarterly budgetary execution and prospects in accordance with ESA standards and seasonally non-adjusted^(a) for the general government and its sub-sectors**

The data of budgetary execution provided in Tables 1a and 1b should be consistent; a reconciliation table showing the methodology of transition between the two tables should be communicated.

EUR millions	ESA code	Year t ^(*)			
		Q1	Q2	Q3	Q4
Net lending (+)/ net borrowing (-)					
1. General government^(a)	S.13				
2. Central government	S.1311				
3. State government	S.1312				
4. Local government	S.1313				
5. Social security funds	S.1314				
For the general government (voluntary for the sub-sectors)					
6. Total revenue^(a)	TR				
Of which					
<i>Taxes on production and imports</i>	D.2				
<i>Current taxes on income, wealth, etc.</i>	D.5				
<i>Capital taxes</i>	D.91				
<i>Social contributions</i>	D.61				
<i>Property income</i>	D.4				
<i>Other^(b)</i>					
7. Total expenditure^(a)	TE				
Of which					
<i>Compensation of employees</i>	D.1				
<i>Intermediate consumption</i>	P.2				
<i>Social payments</i>	D.62, D.632 ^(c)				
<i>Interest expenditure</i>	D.41				
<i>Subsidies</i>	D.3				
<i>Gross fixed capital formation^(a)</i>	P.51				
<i>Capital transfers</i>	D.9				
<i>Other^(d)</i>					
8. Gross debt^(e)					

(*)The reporting shall span until the end of the current Year t; quarterly prospects are not binding and reported as estimates (possibly subject to revisions) for informational and monitoring purposes.

(a) For the general government, the items labelled with "a" are to be additionally provided in seasonally-adjusted terms; if it cannot be provided by the national authorities, the seasonal adjustment will be performed by Eurostat, in liaison with the Member State concerned.

(b) P.11+P.12+P.131+D.39rec +D.7rec +D.9rec (other than D.91rec).

(c) Under ESA95: D6311_D63121_D63131pay; in ESA2010 D632pay.

(d) D.29pay+D.4pay (other than D.41 pay) +D.5pay+D.7pay+P.52+P.53+K.2+D.8.

(e) As defined in Regulation (EC) No 479/2009.

Table 1c: **Annual budgetary targets in accordance with ESA standards for the general government and its sub-sectors**

	ESA Code	Year t-1	Year t	Year t + ... ^(*)
Net lending(+)/ net borrowing (-) by sub-sector (% GDP)				
1. General government	S.13			
2. Central government	S.1311			
3. State government	S.1312			
4. Local government	S.1313			

5. Social security funds	S.1314			
General government (S.13) (% GDP)				
6. Total revenue	TR			
7. Total expenditure	TE			
8. Interest expenditure	D.41			
9. Primary balance^(a)				
10. One-off and other temporary measures^(b)				
		rate of change	rate of change	rate of change
11. Real GDP growth				
12. Potential GDP growth				
contributions:				
- labour				
- capital				
- total factor productivity				
		% potential GDP	% potential GDP	% potential GDP
13. Output gap				
14. Cyclical budgetary component				
15. Cyclically-adjusted balance (1 – 14)				
14. Cyclically-adjusted primary balance (13 + 6)				
15. Structural balance (13 – 10)				

(*)Following the request from the Commission to activate the reporting requirements provided for by Article 10(3) of Regulation (EU) No 473/2013, the reporting starts from the year of the opening of the excessive deficit procedure in accordance with Article 126(6) TFEU, and spans until the excessive deficit is planned to be corrected, in accordance with the deadline set by the Council recommendation in accordance with Article 126(7) TFEU or decision to give notice in accordance with Article 126(9) TFEU.

(a) The primary balance is calculated as (B.9, item 8) plus (D.41, item 9).

(b) A plus sign means deficit-reducing measures.

Table 2: **Targets for the expenditure and revenues of the general government (S.13) in accordance with ESA standards**

% GDP	ESA Code	Year t-1	Year t	Year t+1	Year t + ...^(*)
1. Total revenue target (= table 1c. 6)	TR				
Of which					
1.1. Taxes on production and imports	D.2				
1.2. Current taxes on income, wealth, etc.	D.5				
1.3. Capital taxes	D.91				
1.4. Social contributions	D.61				
1.5. Property income	D.4				
1.6. Other^(a)					
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995) ^(b)					

2. Total expenditure target (= table 1c.7)	TE ^(c)				
Of which					
2.1. Compensation of employees	D.1				
2.2. Intermediate consumption	P.2				
2.3. Social payments	D.62, D.6311, D.63121, D.63131 ^(f)				
of which Unemployment benefits^(d)					
2.4. Interest expenditure	D.41				
2.5. Subsidies	D.3				
2.6. Gross fixed capital formation	P.51				
2.7. Capital transfers	D.9				
2.8. Other^(e)					

(*)Following the request from the Commission to activate the reporting requirements provided for by Article 10(3) of Regulation (EU) No 473/2013, the reporting starts from the year of the opening of the excessive deficit procedure in accordance with Article 126(6) TFEU, and spans until the excessive deficit is planned to be corrected, in accordance with the deadline set by the Council recommendation in accordance with Article 126(7) TFEU or decision to give notice in accordance with Article 126(9) TFEU.

(a) P.11+P.12+P.131+D.39rec+D.7rec+D.9rec (other than D.91rec).

(b) Including those collected by the EU and including an adjustment for uncollected taxes and social contributions D.995), if appropriate.

(c) TR-TE = B.9.

(d) Includes cash benefits (D.621 and D.624) and in kind benefits (D.631) related to unemployment benefits.

(e) D.29+D.4 (other than D.41) +D.5+D.7+P.52+P.53+K.2+D.8.

(f) In ESA2010: D.62, D.632.

Table 3a: **Budgetary measures adopted and envisaged by the general government and its sub-sectors on both the expenditure and the revenue side to achieve the targets presented in Table 2**

Expected budgetary impact of measures adopted and envisaged ^(a)										
List of measures	Detailed description ^(b)	Target (Expenditure / Revenue) ESA Code	Accounting principle ^(c)	Adoption Status	Incremental budgetary impact (EUR million) on year					
					t-1	t	t+1	t+2	t+ ^(*)	
					TOTAL					

(*)Year when the excessive deficit is planned to be corrected, in accordance with the deadline set by the Council recommendation in accordance with Article 126(7) TFEU or decisions to give notice in accordance with Article 126(9) TFEU.

(a) Only measures sufficiently detailed and credibly announced should be reported.

(b) Including reporting on which sub-sector is taking the measure.

(c) By default, the impact of the measures will be reported on accrual basis, but, if impossible and reporting is in cash, it should be indicated explicitly. The impact is to be recorded in incremental terms – as opposed to levels – compared to the previous year's baseline projection. Simple permanent measures should be recorded as having an effect of +/- X in the year(s) they are introduced and zero otherwise (the overall impact on the level of revenues or expenditures must not cancel out). If the impact of a measure varies over time, only the incremental impact should be recorded in the table. By their nature, one-off measures should be always recorded as having an effect of +/-X in the year of the first budgetary impact and -/+ X in the following year, i.e. the overall impact on the level of revenues or expenditures in two consecutive years must be zero.

Table 3b: In-year quarterly reporting on the budgetary impact of the measures presented in Table 3a

List of measures ^(a)	In-year reporting for measures having an effect on year t (choose one of the alternatives below) ^(b)				Expected annual budgetary impact for year t (EUR million) (= Table 3a)	
	Quarterly observed budgetary impact (EUR million) ^(c)					Cumulative observed budgetary impact since the start of the year (EUR million)
	Q1	Q2	Q3	Q4		
TOTAL						

(a) Select the measures reported in Table 3a which have a budgetary impact in year t.

(b) Filling one of the two alternatives is mandatory; quarterly reporting (estimates possibly subject to revisions) at least until the current quarter and/or sum of the observed budgetary impact until the current date.

(c) Indicate for each quarter whether the data reported corresponds to observed data; the reporting is mandatory up to the current quarter included.

Table 4: General government (S.13) debt developments and prospects

		Year t-1	Year t	Year t + ... *
	ESA Code	% GDP	% GDP	% GDP
1. Gross debt^(a) (=Table 1b.8 for the general government)				
2. Change in gross debt ratio				
Contributions to changes in gross debt				
3. Primary balance (= Table 1c. 9)				
4. Interest expenditure (= Table 1c.8)	D.41			
5. Stock-flow adjustment				
<i>of which:</i>				
- Differences between cash and accruals ^(b)				
- Net accumulation of financial assets ^(c)				
<i>of which:</i>				
- Privatisation proceeds				
- Valuation effects and other ^(d)				
p.m.: Implicit interest rate on debt^(e) (%)				
Other relevant variables				
6. Liquid financial assets ^(f)				
7. Net financial debt (7=1-6)				
8. Debt amortisation (existing bonds) since the end of the previous year				
9. Percentage of debt denominated in foreign currency (%)				
10. Average maturity (years)				

11. Real GDP growth (%) (= Table 1c row 11)				
---	--	--	--	--

(*)Following the request from the Commission to activate the reporting requirements provided for by Article 10(3) of Regulation (EU) No 473/2013, the reporting starts from the year of the opening of the excessive deficit procedure in accordance with Article 126(6) TFEU, and spans until the excessive deficit is planned to be corrected, in accordance with the deadline set by the Council recommendation in accordance with Article 126(7) TFEU or decision to give notice in accordance with Article 126(9) TFEU.

(a) As defined in Regulation (EC) No 479/2009.

(b) The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

(c) Liquid assets (currency), government securities, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

(d) Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

(e) Proxied by interest expenditure divided by the debt level of the previous year.

(f) Liquid assets are here defined as AF.1, AF.2, AF.3 (consolidated for general government, i.e. netting out financial positions between government entities), A.F511, AF.52 (only if quoted in stock exchange).

ANNEX 13

A NUMERICAL EXAMPLE OF THE FLEXIBILITY CLAUSES IN THE PREVENTIVE ARM

The aim of this annex is to guide the reader through the use of "flexibility" clauses within the rules of the SGP. It illustrates how the adjustment path towards the MTO or the adherence to the MTO is impacted by the temporary deviation allowed under i) the structural reform clause (introduced in Section 1.3.2.3), ii) the investment clause (introduced in Section 1.3.2.4) and iii) the cumulation of both clauses.

The methodology applied to determine the eligibility to the clauses and the impact of flexibility clauses on the achievement of the MTO is displayed in the two Sections mentioned above. Those conditions are summarised in Table A13.1.

Table A13.1: **Overview of conditions displayed in Section 1.3.2.3 and 1.3.2.4 related to the Structural reform clause and the Investment Clause**

	Structural Reform Clause	Investment Clause
Eligibility criteria	<ul style="list-style-type: none"> ▪ Remain in the preventive arm ▪ Safety margin with respect to the 3% of GDP reference value for the deficit (minimum benchmark) 	
	<ul style="list-style-type: none"> ▪ Major structural reform with positive long-term budgetary effects 	<ul style="list-style-type: none"> ▪ Negative GDP growth or output gap inferior to -1.5% of GDP ▪ Additionality principle: total public investments are not reduced, i.e. co-financed expenditure should not substitute for nationally financed investments
Integrity of the MTO	<ul style="list-style-type: none"> ▪ Achievement of the MTO within the four-year horizon of the current SCP should be sought (less than 1.5% deviation from MTO in initial year) ▪ Additional application of the clauses restricted until achievement of the MTO 	
Temporary deviation from the MTO (or adjustment path)	<ul style="list-style-type: none"> ▪ The deviation cannot exceed 0.5% of GDP, except in the case of pension reforms introducing a mandatory fully-funded pillar 	<ul style="list-style-type: none"> ▪ The deviation cannot exceed 0.5% of GDP ▪ Applies to national expenditure on projects co-financed by the EU under the Structural and Cohesion policy (including the YEI), TEN, CEF, EAFRD, EMFF and the EFSI
	<ul style="list-style-type: none"> ▪ The cumulated deviation for the two clauses cannot exceed 0.75% of GDP 	
	<ul style="list-style-type: none"> ▪ The temporary deviation remains valid over a period of three years 	

1. The low output gap condition: eligibility criterion specific to the Investment Clause

While the temporary deviation stemming from the structural reform clause does not depend on the economic situation of a Member State, this is not the case for the investment clause. The application of the investment clause is only possible for a Member State in bad (or worse) economic times (output gap below -1.5% of GDP or negative growth).

2. The safety margin (i.e. respect of the minimum benchmark): a constraint on the temporary deviation for both clauses

When assessing a Member State's application for use of the clause, it is checked that Member States continuously preserve a safety margin with respect to the 3% reference value.⁽¹⁷²⁾ This means that the structural balance should always be equal to or above the minimum benchmark, a measurement which is detailed in Annex 2.⁽¹⁷³⁾ In other words, the temporary deviation stemming from the application of the clauses should not imply that the structural balance goes below the minimum benchmark. According to the 2015 European Commission spring forecast, only eight Member States in the preventive arm would fulfil that criterion in 2016 before any temporary deviation is even applied.

Table A13.2: **Respect of the safety margin and available fiscal scope – spring forecast 2015 (forecast available when assessing eligibility of the clauses at the occasion of the 2015 European Semester)**

	Minimum Benchmark	Structural Balance	Respect of the safety margin	Fiscal scope		Minimum Benchmark	Structural Balance	Respect of the safety margin	Fiscal scope
BE	-1.7	-2.1	No	0.0	HU	-1.5	-2.6	No	0.0
BG	-1.7	-2.4	No	0.0	MT	-1.9	-1.7	Yes	0.2
CZ	-1.7	-1.4	Yes	0.3	NL	-1.4	-1.4	No	0.0
DK	-0.7	-1.4	No	0.0	AT	-1.8	-1.0	Yes	0.8
DE	-1.5	0.7	Yes	2.2	PL	-1.9	-2.6	No	0.0
EE	-1.8	0.2	Yes	2.0	PT	-1.8	-2.3	No	0.0
IE	-1.2	-2.1	No	0.0	RO	-1.8	-2.7	No	0.0
IT	-1.7	-1.5	Yes	0.2	SI	-1.7	-2.5	No	0.0
LV	-1.8	-1.9	No	0.0	SK	-1.5	-2.0	No	0.0
LT	-1.8	-1.4	Yes	0.4	FI	-0.5	-1.5	No	0.0
LU	-1.7	0.9	yes	2.6	SE	-0.9	-1.0	No	0.0

Note: Minimum benchmarks as updated in 2012.
Source : European Commission spring forecast 2015.

3. The Maximum initial distance to the MTO: the starting point for considering eligibility to both clauses

In order to respect the requirement to return to the MTO within the four-year timeframe, while assuring for a maximum deviation of 0.5% of GDP under the structural reform clause, it is necessary to introduce a maximum initial distance that a Member State's structural balance can be from the MTO when applying for the clause. The following considerations must be allowed for in determining this distance:

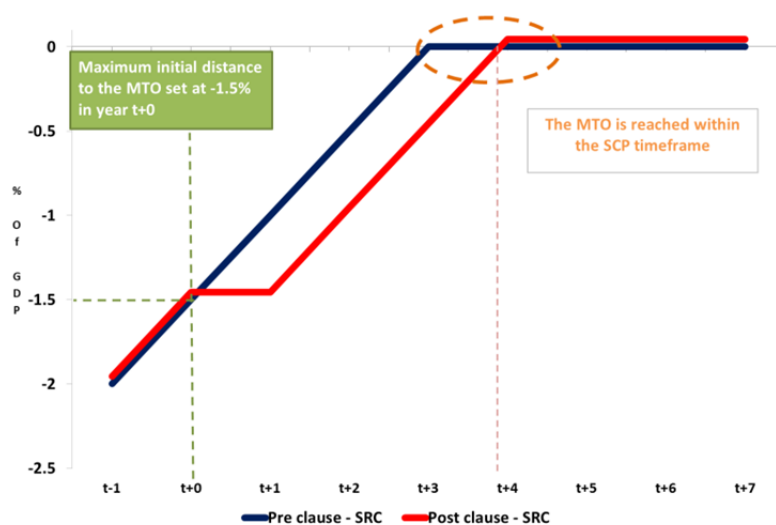
The year that a Member State is required to reach its MTO will be a function of, amongst other things, the adjustment that it is required to make in each individual year as defined by the matrix (displayed in Box 1.6). Consequently, it is not possible to define ex ante a year in which a Member State, whether availing of the structural reform clause or not, must reach its MTO. It was therefore proposed to make the simplifying assumption that the requirement to return to MTO within the four-year timeframe should be based on the benchmark adjustment being applied.

⁽¹⁷²⁾ For the sake of predictability, clauses are not retracted once granted, if compliance with the Minimum Benchmark is altered due to future Minimum Benchmark revisions.

⁽¹⁷³⁾ The minimum benchmark is a level of structural balance which takes into account past output volatility and budgetary sensitivity to output fluctuations.

On that basis, the maximum initial distance which the structural balance of a Member State applying for the structural reform clause can be from the MTO is 1.5% of GDP in year t. That limit will ensure that, in the benchmark case of an annual adjustment of 0.5% of GDP, the Member State can regain its MTO within the required four-year timeframe.⁽¹⁷⁴⁾

Benchmark simulation: Member State with a structural balance of -1.5% of GDP the year prior to the application of the structural reform clause



4. Underlying working assumptions for further simulations

To undertake credible simulations, some working assumptions are necessary.

a. The MTO

The MTO is illustratively set at 0% of GDP.

b. The size of the temporary deviation

For the structural reform clause, the illustrative requested temporary deviation (by a Member State) has been set at 0.5% of GDP.

For the investment clause, the illustrative requested temporary deviation (by a Member State) has been set at 0.5% of GDP.

⁽¹⁷⁴⁾ For the investment clause, the maximum initial distance to the MTO is set at 1.5% of GDP, in order to ensure consistency with the structural reform clause. However, benefiting from the investment clause is only possible in bad economic times, which is associated with a lower fiscal effort stemming from the matrix. This may imply that a maximum initial distance from the MTO of 1.5% of GDP does not necessarily ensure the attainment of the MTO within the SCP time frame.

When both clauses are cumulated, the maximum initial distance to the MTO is also set 1.5% of GDP for consistency purposes. Such cumulation is only possible in bad economic times (otherwise the investment clause cannot apply), implying here again that the maximum initial distance from the MTO of 1.5% does not necessarily ensure the attainment of the MTO within the SCP time frame.

For the cumulation of the structural reform clause and the investment clause, the illustrative requested temporary deviation (by a Member State) has been set at 0.75% of GDP.

In the three cases, the requested temporary deviation corresponds to the maximum temporary deviation that can be granted and corresponds to the individual caps of 0.5% of GDP (for the structural reform clause and the investment clause) and to the cap on the cumulated temporary deviation (0.75% of GDP). Those assumptions are conservative as the temporary deviation could be lower.

c. The benchmark adjustment stemming from the Matrix

The benchmark adjustment represents the adjustment path stemming from the Matrix and which should be implemented when adjusting towards MTO. It depends on the level of debt and the cyclical conditions.

For the structural reform clause, the benchmark adjustment has been set at 0.5% of GDP for each and every year under consideration. It corresponds to the situation of a Member State with low debt and in normal economic times.

For the investment clause as well as for the cumulation of both clauses, the benchmark adjustment has been set at 0% of GDP the year the clause(s) apply and 0.5% of GDP for the other years. It reflects the fact that a Member State needs to be in bad economic times in order to benefit from the investment clause or the cumulation of both clauses. Being in bad economic conditions implies a lower adjustment effort stemming from the Matrix.

Those adjustments have been chosen for illustrative purposes. Member States with high debts (above 60%) can be subject to higher adjustment requirements under the Matrix. The underlying assumptions are here again conservative: the benchmark adjustment from the Matrix could thus be higher in practice than in the simulations below.

5. The simulations

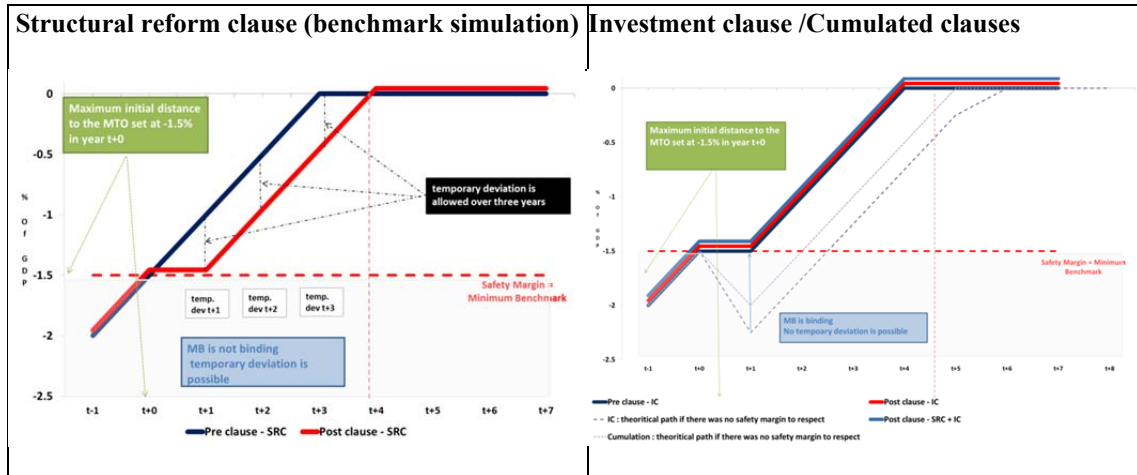
A set of four simulations are displayed. They aim at covering a wide range of potential cases under realistic assumptions for the structural balance and the safety margin.

The simulations are performed for four initial levels of structural balance (-1.5%, -1%, -0.5% and 0%). That range aims at illustrating the impact of the initial position of the structural balance on the adjustment path towards MTO both with and without the application of the clauses. In economic terms, it sets out the adjustment path towards MTO for two different types of Member States:

- Member States faced with a relatively deteriorated fiscal situation with respect to their MTO (SB of -1.5%, -1% and -0.5% of GDP)
- Member States with sound public finances, i.e. Member States at MTO (SB of 0% of GDP).

Each simulation takes into account the need to preserve the safety margin with respect to the 3%. For illustrative purposes, the minimum benchmark is assumed to be at -1.5% of GDP, which is the average minimum benchmark for the European Union. In the simulations, the clause is applied for in year $t+0$ with the temporary deviation to be implemented in $t+1$.

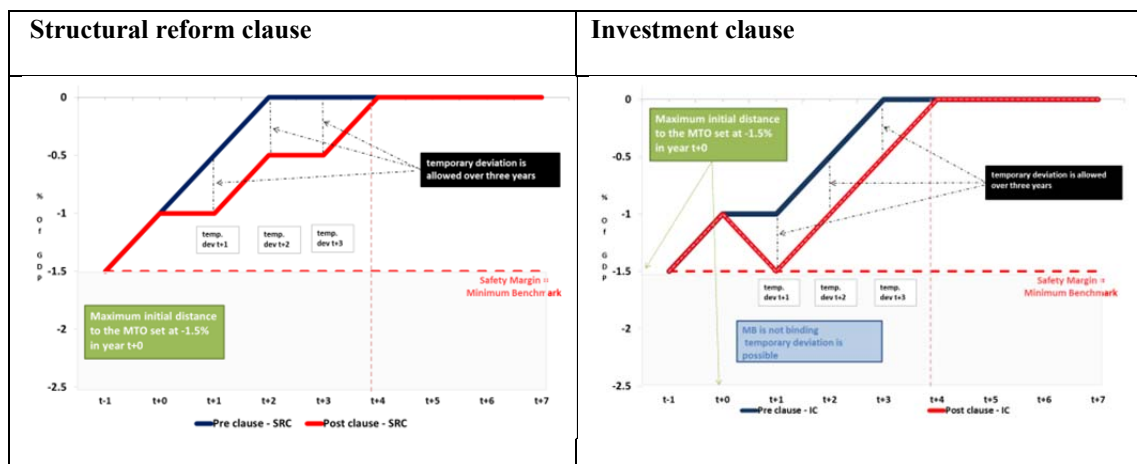
Simulation 1: Member State with a Structural balance of -1.5% of GDP the year prior to the application of the clause



Comment:

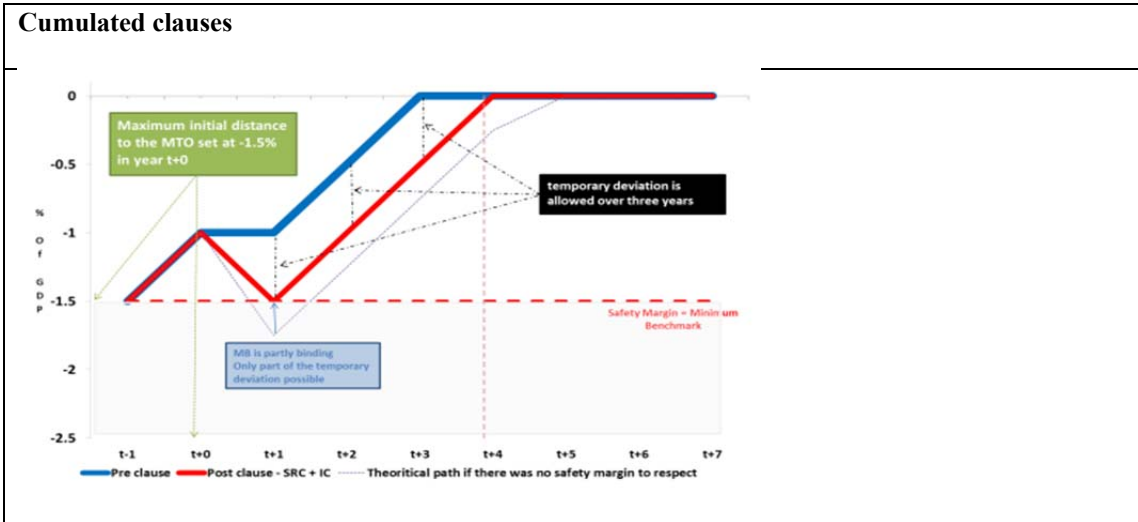
- | | |
|--|--|
| <p>1. <u>Maximum initial distance to the MTO</u>: the initial structural balance is at the maximum initial distance from the MTO in t+0 (1.5% of GDP). The Member State is eligible for the clauses on that basis.</p> <p>2. <u>Safety margin</u>: the temporary deviation stemming from the application of the clause in t+1 does not imply that the structural balance goes below the minimum benchmark. The Member State preserves the safety margin.</p> <p>3. <u>Integrity of the MTO</u>: Following the new adjustment path, the MTO is reached in t+4 instead of t+3.</p> | <p>2. <u>Safety margin</u>: the temporary deviation stemming from the application of the clause in t+1 implies that the structural balance goes below the minimum benchmark. The Member State would not preserve the safety margin.</p> <p>3. <u>Integrity of the MTO</u>: The adjustment path remains unchanged and the MTO is reached in t+4 (consequence of the absence of adjustment when the Member State is in bad economic times)</p> |
|--|--|

Simulation 2: Member State with a Structural balance of -1% of GDP the year prior to the application of the clause



Comment:

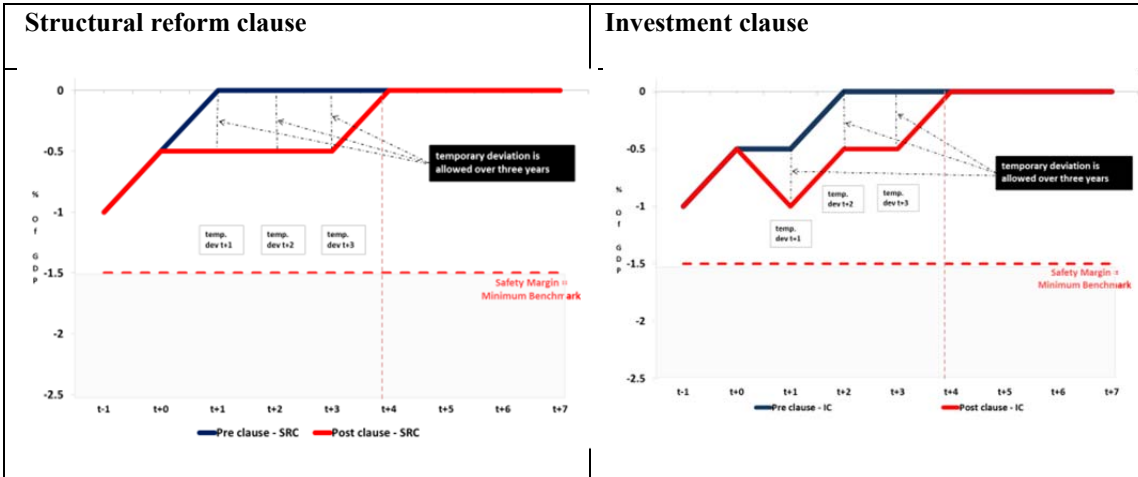
- Maximum initial distance to the MTO: The Member State is eligible for the clauses on that basis.
- Safety Margin: The Member State preserves the safety margin.
- Integrity of the MTO: Following the new adjustment path, the MTO is reached in t+4 instead of t+3.



Comment:

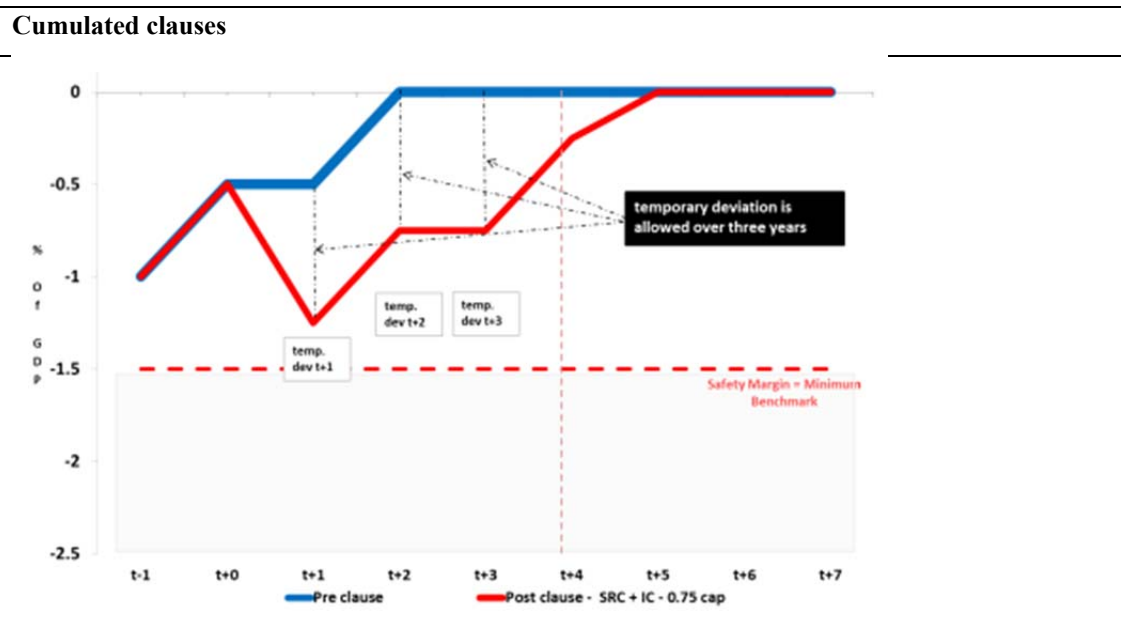
- Maximum initial distance to the MTO: The Member State is eligible for the clauses on that basis.
- Safety Margin: the temporary deviation stemming from the application of the clause in t+1 implies that the structural balance goes partly below the minimum benchmark. To preserve the safety margin, the cumulated deviation needs to be limited to 0.5% of GDP (i.e. the difference between the structural balance, -1% of GDP, and the minimum benchmark, -1.5% of GDP).
- Integrity of the MTO: Following the new adjustment path, the MTO is reached in t+4 instead of t+3.

Simulation 3: Member State with a Structural balance of -0.5% of GDP the year prior to the application of the clause



Comment:

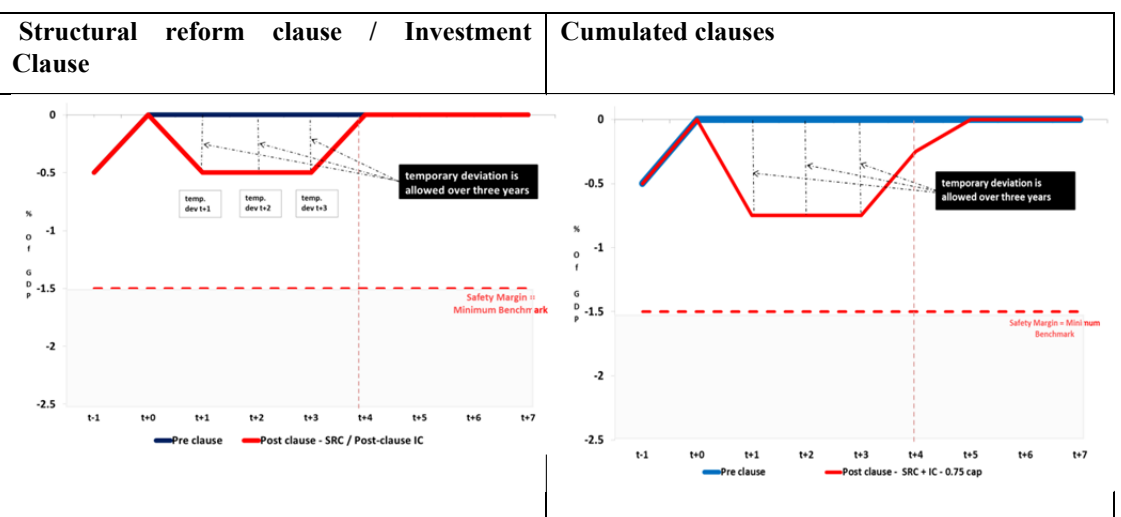
<ol style="list-style-type: none"> <u>Maximum initial distance to the MTO:</u> The Member State is eligible for the clauses on that basis. <u>Safety Margin:</u> The Member State preserves the safety margin. 	<ol style="list-style-type: none"> <u>Integrity of the MTO:</u> Following the new adjustment path, the MTO is reached in t+4 instead of t+1.
<ol style="list-style-type: none"> <u>Integrity of the MTO:</u> Following the new adjustment path, the MTO is reached in t+4 instead of t+2. 	



Comment:

1. Maximum initial distance to the MTO: The Member State is eligible for the clauses on that basis.
2. Safety Margin: The Member State preserves the safety margin.
3. Integrity of the MTO: Following the new adjustment path, the MTO is reached in t+5 instead of t+2.

Simulation 4: Member State with a structural balance at MTO (structural balance at 0% of GDP) the year prior to the application of the clause



Comment:

<ol style="list-style-type: none"> 1. <u>Maximum initial distance to the MTO</u>: The Member State is eligible for the clauses on that basis. 2. <u>Safety Margin</u>: The Member State preserves the safety margin. 	<ol style="list-style-type: none"> 3. <u>Integrity of the MTO</u>: Following the new adjustment path, the MTO is reached in t+4 while it would have remained at the MTO without a temporary deviation.
<ol style="list-style-type: none"> 3. <u>Integrity of the MTO</u>: Following the new adjustment path, the MTO is reached in t+4 while it would have remained at the MTO without a temporary deviation. 	<ol style="list-style-type: none"> 3. <u>Integrity of the MTO</u>: Following the new adjustment path, the MTO is reached in t+5 while it would have remained at the MTO without a temporary deviation.

7. Conclusions

The MTO would be met in t+4 or before in most of the cases presented.

In a limited number of cases, the MTO would be met in t+5. This is the case when a Member States is allowed to cumulate both clauses and benefits from the maximum allowed temporary deviation (0.75% of GDP), while at the same time having sound public finances, i.e. initial structural balance close to (-0.5% of GDP) or at MTO.

All in all, the simulations show that under some specific circumstances it is possible to extend the deadline to reach the MTO by one year. This is justified by the need to encourage structural reforms and preserve public investments in Member States faced with difficult economic conditions (sole eligible to the investment clause and consequently allowed to cumulate clauses).

ANNEX 14

PLAUSIBILITY ANALYSIS FOR ESTIMATING IMPACT OF STRUCTURAL REFORMS

The Commission Communication of 13 January 2015 on “Making the best use of the flexibility within the existing rules of the Stability and Growth Pact”, provided additional guidance on how the Commission would operationalise the so-called “structural reform clause” of Regulation (EC) 1466/97. On that basis, the Council decided on the implementation of the flexibility within the SGP, as reflected in the commonly agreed position confirmed by the ECOFIN Council of 12 February 2016.

Under the Regulation, Member States implementing major structural reforms with positive long-term budgetary impacts are allowed to deviate temporarily from the MTO or from the adjustment path towards it.

An intuitive way to formalise the eligibility criterion for Member States applying for use of the structural reform clause is to require that the reform produces significant sustainability gains in net present value terms, taking into account both the direct fiscal impact of the reform (including savings and/or costs, where applicable) and their indirect budgetary effects *via* higher output.

Noting that:

- B_j represents the direct primary budgetary savings in period j , while C_j denotes the possible budgetary costs, the direct net savings thus amounts to $B_j - C_j$;
- A_j denotes the possible output effect of a reform in period j , implying indirect budgetary effects essentially on the revenue side. Given a semi-elasticity of the budget balance equal to τ , the indirect budgetary gain is thus τA_j ;

A reform would yield a net gain $D_j = \tau A_j + B_j - C_j$ for the primary balance in period j (assuming a horizon of 25 years and that the reform kicks in in the first period). Noting β_j the actualisation rate⁽¹⁷⁵⁾, the inter-temporal sum of those effects is equivalent in actuarial terms to a permanent annuity Z :

$$Z = (\sum_j \beta_j D_j) / \sum_j \beta_j$$

A major reform could then be expected to result in a significant improvement in the long-term sustainability of a Member State’s public finances as measured by Z .

Box 1 provides further detail on how to get some preliminary order of magnitude associated with the effect of structural reforms. It is presented with an illustrative purpose and does not limit the kind of reforms that can be considered nor the models or the parameter values used to assess their impact. It should be highlighted that the translation of a specific reform into a policy shock that can be incorporated by the model may remain the most significant challenge. Therefore any assessment by the Commission will have to be of qualitative nature and will necessarily build on elements of judgement over the plausibility of the estimates of the reforms. The plausibility exercise may help in some cases to frame that judgement. In particular, it could be the case when the measure being considered appears to be far below the standard shock used in the simulation but is claimed to provide a much larger impact.

⁽¹⁷⁵⁾ The actualisation rate is: $\beta_j = 1/\prod_{k=1, \dots, j} (1+r_k)$, with r_k the growth corrected interest rate (i.e. the difference between the nominal interest rate and the nominal growth rate) at date k . Figures for the growth and interest rates can be taken from the Aging Working Group assumptions which are regularly used to compute long-term costs of aging.

BOX 1.: HOW TO CALCULATE THE INDIRECT IMPACT OF STRUCTURAL REFORMS? A METHOD FOR A PLAUSIBILITY ASSESSMENT

Beyond their direct effect, structural reforms can have an indirect impact on the budget balance, via their effect on potential output. The purpose of this box is to outline a transparent methodology to provide some first order of magnitude of this indirect effect.

First, we focus on the lasting effect of the reforms on GDP, which corresponds more technically to the impact of the reforms on potential output. Therefore, we do not consider the short-term effects on GDP, which are transitory by nature and difficult to measure, owing to implementation lags and complex dynamics in domestic demand. As a result, we estimate the effects of reforms on GDP as of five years and then every five years (10, 15 and 20 years). Between those years, we interpolate the effects linearly.

Table A14.1: **Effect of stylised structural reforms on GDP (% deviation from baseline)**

Stylised policy impulse	Size	GDP effect (% deviation from baseline)			
		5 years	10 years	15 years	20 years
Product market					
Reduction of the final goods market mark-up	-1 p.p.	0.5	0.7	0.8	0.9
Reduction of the intermediate goods market mark-up	-1 p.p.	0.3	0.3	0.3	0.2
Reduction in final good firms' administrative burdens	10%	0.4	0.4	0.4	0.4
Reduction of tangible capital costs	-50 b.p.	0.9	1.5	2.0	2.4
Reduction of intangible capital costs	-50 b.p.	0.0	0.0	0.1	0.1
Labour market					
Reduction in the benefit replacement rate	5 p.p.	0.4	0.4	0.5	0.5
Wage mark-up reduction	5 p.p.	0.9	1.0	1.0	1.0
Tax shift from labour to VAT	1% GDP	0.2	0.3	0.3	0.3
Knowledge and innovation					
Wage subsidy to the R&D sector	0.1% GDP	0.0	0.1	0.2	0.2
Increase of the share of medium skilled workers	1 p.p.	0.1	0.1	0.2	0.3
Increase of the share of high skilled workers	1 p.p.	0.1	0.2	0.3	0.4

Second, we simulate the impact of a set of stylised structural reforms using the DSGE model QUEST for the whole EU. This is technically captured by the parameter A referred to above. Those reforms are standard policy “shocks” affecting key economic parameters in the product market, the labour market or knowledge and innovation (see Röger et al., 2008 for more details). Some of those parameters correspond to performance indicators (e.g. tangible capital costs), while others refer to policy instrument indicators, such as a tax shift of 1% or R&D wage subsidies of 0.1% GDP. Every concrete reform planned by Member States would then need to be “translated” into one (or several) of these policy shocks, which would require a judgement - or analysis - on how the reform is expected to modify those parameters. That translation of concrete reforms into standard shocks could be very tricky in practice, especially for some concrete measures and would anyway require some informed judgement on the impact of the measure on the performance of labour, product or innovation markets. Moreover, the standard policy shocks are not fully comparable across types of reforms and the estimates are surrounded by large uncertainties and should be interpreted with a great deal of caution. For instance, the estimates could vary from country to country and depend on baseline values of structural reform indicators or on the macroeconomic conditions (e. g. monetary policy stance and size of public debt). However, they provide a ballpark proxy of significant reforms in each of the areas considered, which can be used in the context of that plausibility exercise. As set out in Table A14.1, some reforms, in particular those reducing the cost of tangible capital, improving the functioning of the labour market (leading to a wage mark-up reduction) or increasing competition (reflected by a cut in the final good mark-up), seem to lead to a long- term increase in potential GDP by around 1% or more, compared with a no policy change baseline. Those reforms already display some non-negligible effects after five years. Some other reforms have more moderate effects, such as a reduction in the benefit replacement rate or in firms' administrative burden, a tax shift from labour to indirect taxes or an increase in the share of low- and medium-skilled workers. The effects of the other stylised reforms appear more marginal, although slightly positive.

Third, we compute the reaction of the output effect to the budget balance. It corresponds to the parameter τ above, with $\Delta\tau$ being the indirect effect of a structural reform. That parameter differs slightly from country to country.

The approach presented below largely builds on the methodology to compute the cyclically-adjusted budget balance (see Mourre et al., 2014). We compute the semi-elasticity of the budget balance, which measures the change in the budget balance brought about by a 1% increase in GDP. Four relevant factors influence the results. First, all tax elasticities (which are different across countries in the short term) are assumed to converge to unity after ten years, which is in line with the theoretical expectation of revenue moving along with economic activity after some time. Second, we assume that non-tax revenue follows GDP as well after five years. Those two assumptions mean that, in the long term, structural reforms are neutral regarding the revenue-to-GDP ratio. Third, public spending (except the unemployment-related expenditures) is frozen in real terms, only following inflation. Therefore, an increase in output due to a reform would automatically decrease the spending-to-GDP ratio, by raising the denominator, which leads to a reduction in the budget balance. As shown in Mourre et al. (2014), that effect increases with the size of public spending as percentage of GDP in a given country. Fourth, the reduction of unemployment-related expenditure in case of output increase will add slightly to this effect. This additional impact depends upon the share of unemployment-related expenditures in GDP and upon the reactivity of unemployment to output. We assume for simplicity that the elasticity of unemployment to potential output is the same as the reaction of unemployment to short-term output fluctuation. An alternative method, more complicated, would have been to estimate the impact of each structural reform on unemployment. It may be done as a robustness check.

Table A14.2: Reaction of the output effect to the budget balance (varying across countries)

	Semi-elasticity of the budget balance	
	5 years	from 10 years onwards
BE	0.61	0.59
BG	0.39	0.39
CZ	0.47	0.45
DK	0.65	0.62
DE	0.58	0.56
EE	0.46	0.41
IE	0.54	0.51
EL	0.52	0.51
ES	0.55	0.53
FR	0.63	0.60
HR	0.50	0.48
IT	0.53	0.50
CY	0.52	0.45
LV	0.43	0.41
LT	0.43	0.39
LU	0.46	0.44
HU	0.54	0.51
MT	0.48	0.45
NL	0.65	0.58
AT	0.60	0.57
PL	0.54	0.49
PT	0.55	0.53
RO	0.38	0.38
SI	0.51	0.48
SK	0.42	0.40
FI	0.64	0.60
SE	0.63	0.61
UK	0.55	0.47

ANNEX 15

A COMMONLY AGREED POSITION ON FLEXIBILITY WITHIN THE STABILITY AND GROWTH PACT

This annex contains the text of the “Commonly agreed position on Flexibility within the SGP”, which the ECOFIN Council formally endorsed on 12 February 2016.⁽¹⁷⁶⁾ That text builds on the interpretative Commission’s Communication on *Flexibility within the SGP* of January 2015⁽¹⁷⁷⁾.

PREAMBLE

On 13 January 2015 the Commission adopted its Communication on flexibility within the Stability and Growth Pact (SGP). Between January and April 2015, the Economic and Financial Committee (EFC) and the EFC-Alternates (Alternates) discussed three Commission notes on the operationalisation of the Communication, namely on the new matrix of required adjustment under the preventive arm, the structural reform clause and the investment clause. On 7 April, the Council Legal Service provided to the EFC its Opinion on flexibility in the SGP. At the meeting of the EFC on 8 April 2015, the President noted that for the preparation of the 2015 European Semester Council Recommendations, the Commission would use its interpretation of the rules of the SGP as expressed in its Communication on flexibility. On 29 April 2015, the EFC agreed that the EFC-Alternates would work on preparing a commonly agreed position on the flexibility in the SGP for cyclical conditions, structural reforms, and government investments aiming at, ancillary to, and economically equivalent to major structural reforms. The commonly agreed position should preferably be reflected in an updated Code of Conduct (CoC).

This document presents the commonly agreed position on flexibility in the SGP, as agreed by the EFC on 27 November 2015, taking into account the Commission Communication and the Commission notes on the operationalisation of the Communication, the above-mentioned discussions by the Alternates and the members of the EFC between January and April 2015, and the opinion of the Council Legal Service on flexibility in the SGP. The concession of such flexibility is without prejudice to the requirement for Member States to reduce their government debt at a satisfactory pace, thereby contributing to the long-term sustainability of their public finances, in accordance with Article 126.2 of the Treaty on the functioning of the European Union and Article 2 of Regulation 1467/97. This document is intended to serve as a basis for the codification in the Code of Conduct of a commonly agreed position on flexibility in the SGP.

1. INTRODUCTION

A commonly agreed position on flexibility in the SGP would provide guidance on the best possible use of the flexibility that is built into the existing rules of the preventive arm of the SGP, without changing or replacing the existing rules. The preventive arm aims at guaranteeing a sound budgetary position in all Member States: its core is the attainment by each Member State of its medium-term sound budgetary position (so-called Medium-Term Objective or MTO), which is established according to the commonly agreed principles set out in Sub-section A(1) of Section I of the *Specifications on the Implementation of the Stability and Growth Pact*⁽¹⁷⁸⁾ (hereafter “the Code of Conduct”).

The corrective arm of the Pact deals with situations in which the government deficit and/or the debt are above the reference values set in the Treaty: in these cases, Member States are then subject to an Excessive Deficit Procedure (“EDP”), which entails stricter conditions and monitoring. The commonly agreed principles on the implementation of the corrective arm of the SGP remain those established in the Code of Conduct endorsed by the ECOFIN in September 2012 and complemented by the effective action methodology endorsed by the ECOFIN in June 2014.

⁽¹⁷⁶⁾ <http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf>

⁽¹⁷⁷⁾ Communication from the Commission *Making the best use of the flexibility within the existing rules of the Stability and Growth Pact*, COM(2015) 12 of 13.01.2015:

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

⁽¹⁷⁸⁾ http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf

Subject to the rules of the SGP and without modifying existing legislation, the commonly agreed position clarifies how three specific policy dimensions can best be taken into account in applying the rules. These relate to: (i) cyclical conditions; (ii.) structural reforms; and (iii.) government investments aiming at, ancillary to, and economically equivalent to major structural reforms.

2. FLEXIBILITY FOR CYCLICAL CONDITIONS

2.1 Matrix specifying the annual fiscal adjustment towards the Medium-Term Objective

Member States should achieve a more symmetrical approach to fiscal policy over the cycle through enhanced budgetary discipline in periods of economic recovery, with the objective to avoid pro-cyclical policies and to gradually reach their medium-term budgetary objective, thus creating the necessary room to accommodate economic downturns and reduce government debt at a satisfactory pace, thereby contributing to the long-term sustainability of public finances.

Member States that have not yet reached their MTO should take steps to achieve it over the cycle. Their adjustment effort should be higher in good times; it could be more limited in bad times. In order to reach their MTO, Member States of the euro area or of ERM-II should pursue an annual adjustment in cyclically adjusted terms, net of one-off and other temporary measures, of 0.5 of a percentage point of GDP as a benchmark. In parallel, the growth rate of expenditure net of discretionary revenue measures in relation to the reference medium-term rate of potential GDP growth should be expected to yield an annual improvement in the government balance in cyclically adjusted terms net of one-offs and other temporary measures of 0.5 of a percentage point of GDP.

The following matrix clarifies and specifies the fiscal adjustment requirements under the preventive arm of the Pact. This matrix is symmetrical, differentiating between larger fiscal effort to be undertaken during better times and a smaller fiscal effort to be undertaken during difficult economic conditions.

Matrix for specifying the annual fiscal adjustment towards the Medium-Term Objective (MTO) under the preventive arm of the Pact

	Condition	Required annual fiscal adjustment ^(*)	
		Debt below 60 and no sustainability risk	Debt above 60 or sustainability risk
Exceptionally bad times	Real growth < 0 or output gap < -4	No adjustment needed	
Very bad times	-4 ≤ output gap < -3	0	0.25
Bad times	-3 ≤ output gap < -1.5	0 if growth below potential, 0.25 if growth above potential	0.25 if growth below potential, 0.5 if growth above potential
Normal times	-1.5 ≤ output gap < 1.5	0.5	> 0.5
Good times	output gap ≥ 1.5	> 0.5 if growth below potential, ≥ 0.75 if growth above potential	≥ 0.75 if growth below potential, ≥ 1 if growth above potential

(*) All figures are in percentage points of GDP.

Given the volatility of the output gap estimates and of the structural balance level, the requirements for annual fiscal adjustment will be frozen on the basis of the vintage data available at spring $t-1$.

In order to avoid unwarranted consequences in the event of worsened economic conditions or when it is not necessary anymore to progress towards the medium-term objective (MTO), the following shall apply:

- first, in case the actual data signal a worsening of the economic situation so that the country is considered to be in either exceptionally (OG <-4% or negative real growth) or very bad times (OG < -3%), the requirements based on the most recent data will prevail over the frozen requirements, allowing to consider exceptionally and very bad economic circumstances;
- second, in case the actual data are revised so that the country has already achieved its MTO in year t, the assessment of the country as being at or above its MTO will prevail over the frozen requirements.
- The “sustainability risk” in the matrix specifying the annual fiscal adjustment refers to the medium-term overall debt sustainability as measured by the S1 indicator, among other information⁽¹⁷⁹⁾.

Progress towards the MTO is assessed on the basis of two pillars, with the structural balance being complemented by the expenditure benchmark. The expenditure benchmark establishes a maximum growth rate (i.e. the reference rate) for government spending net of discretionary revenue measures. The medium-term reference rate (as well as the share of government primary expenditure used in the convergence margin) will be updated on a yearly basis, as from spring 2015. In practice, this means that each spring of year t, when setting the required adjustment towards the MTO for the year to come t + 1, an updated medium-term reference rate is computed as the 10-year average potential GDP growth on the period [t-5, t+4]. The budgetary process in some MS requires identification of the reference rate for the expenditure benchmark before spring. A Member State may ask the Commission to provide for indicative purposes an update of its reference rate for the expenditure benchmark already in the winter of year t. However, the Commission assessments and recommendations under the framework of the European Semester will be based on the reference rate for the expenditure benchmark as calculated in the spring of year t. Should significant differences between the winter and spring computations of the reference rate materialise, these would be taken into account as appropriate in the ex post analysis under the preventive arm of the SGP.

2.2 *Review of the flexibility clause for cyclical conditions*

The Commission shall submit a review report to the Council before 30 June 2018 on the effectiveness of the matrix specifying the annual fiscal adjustment towards the Medium-Term budgetary Objective (MTO). In particular, the review will examine the success of the matrix in promoting counter-cyclical fiscal policies and the achievement by the Member States of their MTOs, thereby creating the necessary room to accommodate economic downturns. The review will also assess whether the new matrix has ensured a reduction in government debt at a satisfactory pace, thereby contributing to the long-term sustainability of public finances, in line with the requirements under the debt rule as specified in Sub-section B(1) of Section I of the Code of Conduct.

3. **STRUCTURAL REFORMS**

In order to enhance the growth oriented nature of the Pact, structural reforms will be taken into account when defining the adjustment path to the medium-term objective for countries that have not yet reached this objective and in allowing a temporary deviation from this objective for countries that have already reached it.

⁽¹⁷⁹⁾ S1 shows the adjustment effort required, in terms of a steady improvement in the structural primary balance to be introduced till 2020 and then sustained for a decade, to bring debt ratios to 60% of GDP in 2030, taking also into account the costs arising from an ageing population.

3.1 *Criteria for eligible reforms*

To be fully operational, the “structural reform clause” has to rely on well-defined principles regarding the eligibility of such reforms. The Commission and the Council will base their assessment on the following criteria:

- i) The reforms must be **major**. While there are some individual reforms with a major positive impact on growth and the long-term sustainability of public finances, such as pension reforms, well-designed and comprehensive packages of reforms addressing structural weaknesses may also have a major positive impact. This is notably the case when the reforms reinforce each other’s impact through an appropriate choice of policy mix and sequencing of implementation. The assessments by the Commission and the Council on whether a reform or set of reforms can be considered as major will take into account available Commission quantitative estimates on the long-term positive budgetary effects of those reforms. In any case the Commission will provide an explanation of its judgement that the reforms are to be considered as major.
- ii) The reforms must have direct **long-term positive budgetary effects**, including by raising potential sustainable growth, and therefore a verifiable impact on the long-term sustainability of public finances. The sustainability effects can stem either from direct budgetary savings from the reforms (such as in pensions or healthcare), or from the increased revenues drawn in the medium to long-run from a more efficient economy with a higher potential output (e.g. due to lower structural unemployment or an increased labour force), or from a combination of both kinds of effects. The long-term positive budgetary effects could be measured as the improvement in the primary budget balance in net present value equivalent terms. The budgetary effects of the reforms over time are assessed by the Commission and the Council in a prudent way, making due allowance for the margin of uncertainties associated to such an exercise.
- iii) The reforms must be **fully implemented**. The reforms must be adopted by the national authorities through provisions of binding force, whether legislative or not, in accordance with the applicable domestic laws and procedures. In case the structural reform is not yet fully implemented, the Member State should also submit a dedicated structural reform plan – subsumed, as relevant, in the National Reform Programme (NRP) or Corrective Action Plan (CAP). A plan announcing upcoming reforms as a simple manifestation of political intentions or of wishes would not fulfil the requirements for the application of Article 5(1) of Regulation 1466/97. While it is understood that all the reforms should be adopted through provisions of binding force before being considered as eligible for the clause, it is also true that the effective implementation of adopted reforms may take time and may be subject to delays and setbacks. This raises the question of introducing strong safeguards against the risk of implementation failures.

3.2 *Activation of the structural reform clause*

Member States that want to benefit from the structural reform clause should apply for it in their Stability and Convergence Programmes (SCPs). The flexibility is granted in the context of the assessment of the SCPs, specifically in the relevant Country Specific Recommendation. This Country Specific Recommendation could make the granting of flexibility conditional on the subsequent fulfilment of certain eligibility criteria (e.g. the respect of the safety margin). Euro area Member States may request to benefit from the Structural Reform Clause at the time of the Draft Budgetary Plans to be submitted by 15 October. Non-euro area Member States may also apply for the structural reform clause by 15 October

through an *ad hoc* application⁽¹⁸⁰⁾. The structural reform clause may be granted provided it is endorsed by the Council in the autumn of the same year as an updated Country Specific Recommendation. The Commission and the Council will consider that the criterion related to the implementation of reforms is in part fulfilled *ex ante* when:

- The Member State presents a medium-term structural reform plan which is comprehensive and detailed and includes well-specified measures and credible timelines for their adoption and delivery. The implementation of the reforms will be monitored closely in the context of the European Semester.
- In the specific case of a Member State in the Excessive Imbalances Procedure (EIP), it has submitted a Corrective Action Plan (CAP) providing the necessary information. The implementation of the reforms will then be monitored through the EIP.

In both cases, Member States will be expected to provide in-depth and transparent documentation, providing quantitative analysis of the short-term costs –if any– and of both their medium-term budgetary and potential growth impact. The documentation must also include details on the timetable of implementation of the reforms. Concurrently, Member States will provide an independent evaluation of the information provided to support their application for a temporary deviation under the reform clause, including on the estimated short and medium-term impact on the budgetary position and on the timetable for the implementation of the reforms. Alternatively, Member States should provide comprehensive independent information to support the estimated impact and planned timetable. The Commission will when possible also provide to the Council its estimate of the quantitative impact of the reforms on the long-term positive budgetary effects and on potential growth.

3.3 Operationalisation of the structural reform clause

In the specific case of pension reforms consisting in introducing a multi-pillar system that includes a mandatory, fully-funded pillar, the methodology to allow them to be taken into account in the preventive arm of the Pact is outlined in Article 5 of Regulation (EC) No 1466/97.

For other structural reforms, the Commission and the Council will base themselves on the information contained in the dedicated structural reform plan (or Corrective Action Plan). In this case, the Council will grant eligible Member States additional time to reach the MTO, hence allowing temporary deviations from the structural adjustment path towards it, or to deviate temporarily from the MTO for Member States that have reached it, provided that:

- i) the reforms meet the above criteria;
- ii) the temporary deviation does not exceed 0.5 % of GDP;
- iii) the cumulative temporary deviation granted under the structural reform clause and the investment clause (see Section 4) does not exceed 0.75 % of GDP;
- iv) in case the structural reform is planned but not yet fully implemented, the Commission and the Council –when setting via the CSR the required structural effort for the year $t+1$ – will base themselves on the requirements as per the matrix of the preventive arm, i.e. without any deviation from the adjustment path from the MTO or from the MTO itself. However, the CSR

⁽¹⁸⁰⁾ In order to ensure equal treatment of all Member States, the Commission and the Council shall have regard to the different budgetary year of the United Kingdom, with a view to taking decisions with regards to the United Kingdom at a point in its budgetary year similar to that at which decisions have been or will be taken in the case of other Member States.

will also state that if the planned reform is fully implemented, the ex post assessment of compliance with the requirements of the preventive arm will incorporate the allowed deviation, i.e. by subtracting it from the requirement set by matrix of adjustment;

- v) the MTO is reached within the four year horizon of the Stability or Convergence Programme of the year in which the clause is activated. In order to ensure that, in the benchmark case of an annual adjustment of 0.5% of GDP, the Member State can regain their MTO within the required four year timeframe, the maximum initial distance which the structural balance of a Member State applying for the structural reform clause can be from the MTO is 1.5% of GDP in year t ;
- vi) the application of the structural reform clause is restricted to one single time per period of adjustment towards the MTO. In other words, once a Member State has benefitted from the structural reform clause, it will not be allowed to benefit from the clause again until it has attained its MTO. This restriction maintains the integrity of the MTO as the central target of the Preventive Arm of the Pact, as to allow multiple or concurrent applications of the clauses could effectively negate the requirement for Member States to achieve their MTO in the medium-term. This conclusion is supported by the record of Member States since the inception of the SGP evidencing in several cases a 100% failure rate in terms of achieving the MTO;
- vii) an appropriate safety margin is continuously preserved so that the deviation from the MTO or the agreed fiscal adjustment path does not lead to an excess over the 3 % of GDP reference value for the deficit.

While the Pact does not provide the tools for monitoring the enforcement of structural reforms, the legal framework in which the Pact operates –notably the European Semester process and the new Excessive Imbalances Procedure (EIP)– allows the Commission and the Council to assess challenges and imbalances requiring structural reforms, and for monitoring action taken by the Member States. When a Member State is granted a temporary deviation under the reform clause, the Commission shall prepare an assessment of the progress or full adoption and delivery of the reforms in line with the agreed timetable of implementation.

The Council shall grant the temporary deviation after the Commission assessment confirms the full implementation of the agreed reforms. In case a Member State fails to implement or reverses the agreed reforms, the temporary deviation from the MTO, or from the adjustment path towards it, will be considered as not warranted. If such a failure results in a significant deviation from the MTO or the path towards it, the Commission will apply the procedure envisaged in Article 6(2) and Article 10(2) of Regulation (EC) No 1466/97. This means that the Commission will issue a warning to that Member State, followed by a proposal for a Council recommendation, to ensure that the Member State takes the appropriate policy measures within five months to address that deviation. For euro area Member States, continued failure to comply can ultimately lead to a requirement to lodge an interest-bearing deposit⁽¹⁸¹⁾.

3.4 *Trajectory of the temporary deviation*

Member States qualifying of the structural reform clause will be granted a temporary deviation of up to 0.5% of GDP in year $t+1$ which permits their structural balance to worsen by this amount from the balance that would have prevailed in the absence of the structural reform clause. In order to provide equality of treatment among Member States that are both at and on a path towards the MTO, it is necessary to require the Member States to adjust on a trajectory that is parallel to their original path, but to halt that adjustment if, while being entitled to the deviation, they reach the point where they are within 0.5% of GDP of their MTO (i.e. their MTO minus the temporary deviation). In the fourth year of the

⁽¹⁸¹⁾ Article 4 of Regulation (EU) No 1173/2011.

adjustment period covered by the structural reform clause, the deviation is no longer applied and the Member State is then required to adjust according to the matrix. In the benchmark case, this will return the Member State to its MTO. Therefore, a Member State which is at the MTO will be allowed to depart from the MTO for three years. A Member State that starts out at 1.0% of GDP from the MTO in the year the clause is applied for, will not be required to adjust in year t+1, implement an adjustment in year t+2, apply no adjustment in year t+3 and finally adjust again in year t+4. A Member State that starts out at 1.5% of GDP from the MTO in the year the clause is applied for will not be required to adjust in year t+1 and will implement the adjustment in years t+2, t+3, and t+4.

4. GOVERNMENT INVESTMENTS AIMING AT, ANCILLARY TO, AND ECONOMICALLY EQUIVALENT TO THE IMPLEMENTATION OF MAJOR STRUCTURAL REFORMS

Under the preventive arm of the Pact, some investments aiming at, ancillary to, and economically equivalent to the implementation of major structural reforms may, under certain conditions, justify a temporary deviation from the MTO of the concerned Member State or from the adjustment path towards it.

4.1 Legal framework

Regulation (EC) No 1466/97, in Article 5(1) and Article 2a of the Regulation, recognises “major structural reforms” and “public investment” as two different concepts.

Article 5(1) of Regulation 1466/97 (also known as the “flexibility clause”) provides that “*When defining the adjustment path to the medium-term budgetary objective for Member States that have not yet reached this objective, and in allowing a temporary deviation from this objective for Member States that have already reached it, provided that an appropriate safety margin with respect to the deficit reference value is preserved and that the budgetary position is expected to return to the medium-term budgetary objective within the programme period, the Council and the Commission shall take into account the implementation of major structural reforms which have direct long-term positive budgetary effects, including by raising potential sustainable growth, and therefore a verifiable impact on the long-term sustainability of public finances.*”

Article 2a of Regulation (EC) 1466/97 states that “*The medium-term budgetary objectives shall ensure the sustainability of public finances or a rapid progress towards such sustainability while allowing room for budgetary manoeuvre, considering in particular the need for public investment.*” Such a room of manoeuvre is however limited by the Code of Conduct to Member States with relatively low debt.

Public investments cannot be assimilated “*tout court*” as structural reforms, unless it is duly shown that they are instrumental to the achievement and implementation of the said reforms. It is not legally feasible to establish ex ante that all co-financing expenditure by Member States in investment projects amounts to structural reforms and that such expenditure qualifies for the application of Article 5(1) of Regulation 1466/97.

Government investments that can be eligible for a temporary deviation must be national expenditures on projects that are to a large extent financed by co-funding by the EU under the European Structural and Investment Funds⁽¹⁸²⁾, Trans-European Networks and the Connecting Europe Facility, as well as national co-financing of projects also co-financed by the European Fund for Strategic Investments. The temporary

⁽¹⁸²⁾ See Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006.

deviation for such investments will be subject to a plausibility assessment by the Commission and the Council, where consideration is given to whether the priority or project in question aims at, is ancillary to, and economically equivalent to the implementation of structural reforms. An investment can be considered economically equivalent to a major structural reform only if it can be shown that the investment has a major net positive impact on potential growth and on the sustainability of public finances.

The Commission's plausibility assessment will be based on the detailed information on the contribution of the investment projects to the implementation of structural reforms and their economic equivalence to a structural reform, including on the positive, direct and verifiable long-term budgetary effect of the expenditure covered by the temporary deviation. This information is necessary to ensure compatibility with Article 5(1) and Article 9(1) of Regulation 1466/97, i.e. the SGP provisions which allow temporary deviations from the MTO or the adjustment path towards it to accommodate structural reforms with positive, direct and verifiable effect on fiscal sustainability, including via potential growth. Therefore the Member State should present information by main category of projects co-financed by the EU (including the EFSI), the size of the expenditure involved, the key features and objectives of the investment project and specifying how it will contribute to boost potential growth and the long-term sustainability of public finances.

4.2 European Fund for Strategic Investments (EFSI)

On 25 June 2015, the Council adopted a regulation on a European Fund for Strategic Investments (EFSI) aimed at stimulating the economy. The Fund will offer a new risk-bearing capacity which will allow the EIB to invest in equity, subordinated debt and higher risk tranches of senior debt, and to provide credit enhancements to eligible projects. An initial contribution to this risk-bearing capacity will be made from the EU budget, in the form of a new guarantee fund, and from the EIB's own resources. The use of this EU guarantee and of EIB funds has no impact on the deficit or debt levels of Member States.

The capacity of the EFSI can be further increased through additional financial contributions from Member States. In addition to contributing to the EFSI, Member States will have the possibility to co-finance individual projects also co-financed by it.

4.2.1 Financial contributions from Member States to the EFSI

In their assessment of the necessary fiscal adjustment under the preventive and corrective arms, the Council and the Commission will consider that:

- Initial deficit increasing contributions into the EFSI can be considered as one-off expenditures. Under the preventive arm of the Pact, one-off expenditures will not affect the MTO or the required fiscal adjustment towards it, as these are set in structural terms.
- Under the corrective arm of the Pact (the EDP), compliance with the fiscal adjustment effort recommended by the Council would not be affected, since this is also measured in structural terms. A contribution to the EFSI should therefore not lead to a Member State being found non-compliant with its EDP recommendation.
- In case of a non-respect of the deficit reference value, when preparing the report envisaged under Articles 126(3) and 126(4) TFEU, the Commission and the Council will consider the contribution to the EFSI to be a "relevant factor" in line with Article 2(3) of Regulation (EC) No 1467/97. This means that an EDP will not be launched if this non-respect is due to the contribution, and if the excess over the reference value is small and is expected to be temporary.

- In case of a non-respect of the debt reference value, when preparing the report envisaged under Articles 126(3) and 126(4) TFEU, the Commission and the Council will consider the contribution to the EFSI to be a “relevant factor” in line with Article 2(3) of Regulation (EC) No 1467/97. This means that an EDP will not be launched if the non-respect is due to the contribution.

4.2.2 *Co-financing by Member States of investment projects also co-financed by the EFSI*

From the point of view of the implementation of the Pact, the Commission and the Council will take into account national co-financing of investment projects that are to a large extent financed by co-financing by the EFSI in the application of a temporary deviation under the conditions set out in Section 4.3 below.

4.3 *Criteria for eligible investments under the EFSI and other investment under the preventive arm of the Pact*

Under the preventive arm of the Pact, some other investments aiming at, ancillary to, and economically equivalent to the implementation of major structural reforms may, under certain conditions, justify a temporary deviation from the MTO of the concerned Member State or from the adjustment path towards it. An investment can be considered economically equivalent to a major structural reform only if it can be shown that the investment has a major net positive impact on potential growth and on the sustainability of public finances.

For such investments, a Member State will benefit from a temporary deviation of up to 0.5% of GDP from the structural adjustment path towards the MTO, or from the MTO for Member States that have reached it, if the following conditions are met:

- i) its GDP growth is negative or GDP remains well below its potential (resulting in a negative output gap greater than 1.5 % of GDP);
- ii) the deviation from the MTO or the agreed fiscal adjustment path towards it does not lead to an excess over the reference value of 3 % of GDP deficit and an appropriate safety margin is preserved;
- iii) subject to a total maximum temporary deviation of 0.5% of GDP for an application for flexibility for investment by a Member State, the deviation is equal to the national expenditure on eligible projects that are to a large extent financed by co-funding by the EU under the European Structural and Investment Funds⁽¹⁸³⁾, Trans-European Networks and Connecting Europe Facility, and to national co-financing of eligible investment projects also co-financed by the EFSI, which have direct long-term positive and verifiable budgetary effects;
- iv) the cumulative temporary deviation granted under the structural reform clause and the investment clause does not exceed 0.75 % of GDP;
- v) co-financed expenditure should not substitute for nationally financed investments, so that total public investments are not decreased. In order to evaluate the respect of this condition, the Commission will assess the change in gross fixed capital formation for the year of the application of the clause on the basis of the Commission forecasts to check that there is no fall in overall investment;
- vi) the Member State must compensate for any temporary deviations and the MTO must be reached within the four-year horizon of its current Stability or Convergence Programme.

⁽¹⁸³⁾ Including eligible projects co-financed through the Youth Employment Initiative.

- vii) As with the Structural Reform Clause, in order to preserve the integrity of the MTO, the full temporary deviation (corresponding to the total amount of the national part of eligible co-financed expenditure but not exceeding 0.5% of GDP) will be granted for one single time per period of adjustment towards the MTO. For the following years, only positive incremental changes would be added to the initial temporary deviation. In other words, once a Member State has benefitted from a total temporary deviation of 0.5% of GDP under the “investment clause”, it will not be allowed to benefit from the clause again until it has attained its MTO.

The trajectory of the temporary deviation stemming from the application of the “investment clause” should be established in line with the “structural reform clause”.

The country-specific temporary deviation will depend on several factors. Ex ante, the potential deviation will depend on the commitments of the EU structural funds towards each Member State as well as on the level of planned co-financing. Ex-post, the allowed deviation will depend on the effective payments of EU structural funds and on the correspondent effective co-financing. In case the actual co-financing falls short of projected co-financing, a correction will be added to the required change in the structural balance, which could potentially lead to the opening of a significant deviation procedure.

4.4 Activation of a temporary deviation for eligible investments

The “investment clause” (IC) is activated ex ante upon request from Member States in their Stability and Convergence Programmes (SCPs). The flexibility is granted in the context of the assessment of the SCPs, specifically in the relevant Country Specific Recommendation. This Country Specific Recommendation could make the granting of flexibility conditional on the subsequent fulfilment of certain eligibility criteria (e.g. the respect of the safety margin). Euro area Member States may request to benefit from the “investment clause” also at the time of the Draft Budgetary Plans to be submitted by 15 October. Non-euro area Member States may also apply for the “investment clause” by 15 October through an *ad hoc* application⁽¹⁸⁴⁾. The “investment clause” may be granted provided it is endorsed by the Council in the autumn of that same year as an updated Country Specific Recommendation. The application should be submitted in the year ahead of the application of the clause. That is, in the SCP or at the time of the DBP (or the *ad hoc* application by a non-euro area MS) submitted in year *t* for an application of the clause in year *t+1*.

Ex ante, the Commission will assess the eligibility of such investments where on the basis of the detailed information provided by the Member States (see Section 4.1 above), consideration is given to whether the priority or project in question aims at, is ancillary to, and economically equivalent to the implementation of structural reforms. The Commission will conclude that an investment can be considered as being economically equivalent to a major structural reform if it can be shown that the investment has a major net positive impact on potential growth and on the sustainability of public finances. The Commission will also assess ex ante whether the projects satisfy the requirement that they are to large extent financed by EU co-funding.

Ex ante, the Commission will also assess eligibility to the IC with respect to the spring forecast of year *t* and will factor it in the ex ante guidance it provides at the occasion of the European Semester. Ex-post assessment will be based on outturn data available in year *t+2*, as it is usually the case. The temporary deviation will be reviewed in order to reflect the effective co-financing of the Member States. The (downward) revision of this temporary deviation shall not imply that a Member State implements an effort superior to the one necessary to reach its MTO.

⁽¹⁸⁴⁾ In order to ensure equal treatment of all Member States, the Commission and the Council shall have regard to the different budgetary year of the United Kingdom, with a view to taking decisions with regards to the United Kingdom at a point in its budgetary year similar to that at which decisions have been or will be taken in the case of other Member States.

When requesting the application of the IC, Member States should include in their SCPs the following information (for the years t to $t+4$):

- The forecast path of co-financing expenditure, including for EFSI projects (as a % of GDP).
- The corrected path of its structural balance resulting from the application of the IC, while planning to reach the MTO within the timeframe of the SCP. Member States shall also take due consideration of the annual fiscal adjustment requirements towards the MTO as defined in Section 2.1 given their projections for GDP and the output gap in their SCPs.
- As specified in Section 4.1, detailed information on the contribution of the investment projects to the implementation of structural reforms and their economic equivalence to a structural reform, including the positive, direct and verifiable long-term budgetary effect of the expenditure covered by the temporary deviation. This information is necessary to ensure compatibility with Article 5(1) and Article 9(1) of Regulation 1466/97, i.e. the SGP provisions which allow temporary deviations from the MTO or the adjustment path towards it to accommodate structural reforms with positive, direct and verifiable effect on fiscal sustainability, including via potential growth.
- Member States will provide an independent evaluation of the information provided to support their application for a temporary deviation under the investment clause, including on the estimated long-term impact on the budgetary position. Alternatively, Member States should provide comprehensive independent information to support the estimated impact.
- The Member State should demonstrate that the eligible co-financed investment does not substitute for nationally funded investments, so that the total share of public capital expenditure is not decreased.
- Member States who have benefitted from the IC will also report in the SCPs on the actual level of co-financing, including for EFSI projects, following the year of application.

5. REVIEW OF THE STRUCTURAL REFORM CLAUSE AND THE INVESTMENT CLAUSE

By the end of June 2018, the Commission will carry out a review on the application of the structural reform and investment clauses, taking full account of the economic situation at that time and the achievement of its objectives. The review will examine the achievement by the Member States of their MTOs, thereby creating the necessary room to accommodate economic downturns. The review will examine to what extent the projects eligible for the investment clause were co-funded by the EU and whether the investment clause led to new investments. The review will also examine the implications of the continuation of the investment clause. The review may, as appropriate, be accompanied by proposals to the Economic and Financial Committee for a possible modification of the commonly agreed position on flexibility in the SGP.

ANNEX 16

IMPROVING THE PREDICTABILITY AND TRANSPARENCY OF THE SGP: A STRONGER FOCUS ON THE EXPENDITURE BENCHMARK IN THE PREVENTIVE ARM



Economic and Financial Committee

The Secretariat

Brussels, 29 November 2016

ecfin.cef.cpe(2016)6489812

**IMPROVING THE PREDICTABILITY AND TRANSPARENCY OF THE SGP:
A STRONGER FOCUS ON THE EXPENDITURE BENCHMARK IN THE PREVENTIVE ARM**

(Opinion of the Economic and Financial Committee)

INTRODUCTION

The preventive arm of the SGP endeavours to ensure that fiscal policy is conducted so as to lead to healthy public finances over the short and longer term. It requires that Member States attain a country-specific medium-term budgetary objective (MTO) for their budgetary position after adjusting for the cyclical position of the economy. 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 cyclically-adjusted terms the preventive arm 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 fiscal stabilisers. The country-specific MTOs are set taking into account their respective debt levels, the country-specific sustainability challenges posed by the costs of ageing population and the standard operation of automatic stabilisers. The adjustment paths are without prejudice to the requirement for Member States to reduce their government debt at a satisfactory pace, thereby contributing to the long-term sustainability of their public finances, in accordance with Article 126.2 of the Treaty on the functioning of the European Union and Article 2 of Regulation 1467/97.

1. THE ADJUSTMENT REQUIREMENTS

The working of the preventive arm is based on a two-pillar approach: the (change in the) structural balance and an analysis of the growth rate of an expenditure aggregate net of discretionary revenue measures. The expenditure aggregate is comprised of overall government expenditure net of interest payments, spending on EU programmes paid for by EU funds and the cyclical component of unemployment benefits, while investment spending (not matched by the EU funds) is smoothed over four years. When estimating the budgetary impact of a discretionary revenue measure, micro-level behavioural responses, including cautiously estimated tax compliance effects that are clearly attributable to well specified measures directly aiming at improving tax compliance, should also be factored in.

To remain at, or make adequate progress towards, their MTO, Member States shall ensure that annual government expenditure growth does not exceed a maximum allowable rate, known as the “expenditure benchmark”. In particular, Member States at their MTO shall ensure that government expenditure grows at most in line with a medium-term rate of potential GDP growth –which is the rate which ensures adherence to the MTO over time⁽¹⁸⁵⁾– unless any excess expenditure growth is matched by discretionary measures yielding additional revenues. Member States on the adjustment path to the MTO shall ensure that their expenditure grows at a rate below that medium-term rate of potential GDP growth –the difference in growth rates being the convergence margin– unless the excess growth in expenditure is matched by discretionary measures yielding additional revenues.

The expenditure benchmark, that is the maximum allowable growth rate of expenditure net of discretionary revenue measures, is derived (as specified in Box 1) from the required improvement in the structural balance, so to be consistent with, and conducive to, the fulfilment of the required adjustment towards the MTO.

The country-specific adjustments requirements are set on an annual basis, as part of the Council’s country-specific recommendations under the European Semester. Specifically, for Member States that have not yet attained their MTO, the recommendations indicate the required fiscal effort formulated in terms of the change in the structural balance and the expenditure benchmark. For Member States that are at their MTO, the expenditure benchmark does not reflect any required improvement in the structural balance but indicates the maximum growth rate of expenditure compatible with the Member State remaining at the MTO.

⁽¹⁸⁵⁾ Under the implicit assumption that, in the medium term, revenues grow proportionally in line with potential GDP.

Box 1: Derivation of the expenditure benchmark

The expenditure benchmark provides guidance on how net expenditure should be set to maintain the structural balance at the MTO once it is attained or to fulfil the adjustment path defined as per the matrix of requirements⁽¹⁸⁶⁾ when a country is not at its MTO.

The expenditure benchmark is derived from a medium-term growth rate of potential output and a country-specific convergence margin.

Specifically, the expenditure benchmark L_t for year t is derived from the medium-term growth rate R_t by the deduction of a convergence margin C_t (all expressed in percentage points), as follows:

$$L_t = R_t - C_t$$

The medium-term growth rate is calculated over a 10-year window, on the basis of forward-looking projections and backward-looking estimates from the Commission's spring forecast of the preceding year. It is expressed in nominal terms using the increase in the GDP deflator for year t projected in that forecast. The medium-term growth rate is recalculated every year.

For Member States that have not yet attained their MTO, the convergence margin is calibrated to be consistent with the required improvement in the structural balance adj_t (expressed in percentage points). Its size depends on the share of government primary expenditure in GDP in the preceding year (P_{t-1} , expressed in percentage points). Thus, the convergence margin is given by:

$$C_t = \frac{adj_t}{P_{t-1}} \times 100$$

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

2. THE OVERALL ASSESSMENT

Sufficient progress towards the MTO shall be evaluated on the basis of an overall assessment with the structural balance as the reference, including an analysis of expenditure net of discretionary revenue measures, as per Article 5(1) of Council Regulation (EC) No 1466/97.

Compliance with the preventive arm requirements is evaluated notably on the basis of the structural balance and the expenditure benchmark, taking their respective strengths into account. The indication provided by the structural balance and the expenditure benchmark is always qualified through an overall assessment. This focuses on the possible sources of discrepancy between the two indicators and, on that basis, reaches a conclusion. The overall assessment can conclude that there is compliance with the requirements, or some deviation,⁽¹⁸⁷⁾ or a significant deviation, with the latter triggering a "significant deviation procedure" if the conclusion is based on outturn data.

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

⁽¹⁸⁶⁾ Possibly adjusted for allowed deviations under "flexibility" clauses, and capped at the level of the initial distance from the MTO.

⁽¹⁸⁷⁾ "Some" deviation refers to any deviation which is not significant – for the purposes of Articles 6(3) and 10(3) of Council Regulation (EC) No 1466/97.

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.⁽¹⁸⁸⁾ 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.

It is important that reliance on either indicator ensures consistency with the required path of adjustment and therefore ensures the achievement of the MTO.

Because of their nature, one-off measures have only a temporary effect and thus cannot lead to a sustained improvement in the government's fiscal position. One-off measures are excluded from the calculation of the structural balance. When assessing compliance with the expenditure benchmark, the impact of one-off measures is systemically corrected for in the context of the overall assessment: in particular, the removal of one-off expenditure measures is systematically taken into account in the overall assessment; similarly, any one-off revenue measures are systematically removed from the amount of discretionary revenue measures. Taking systematically account of such measures in the overall assessment ensures that the expenditure benchmark is consistent with the required improvement in the structural balance, in line with the spirit of Council Regulation (EC) No 1466/97. This is also consistent with the approach retained when assessing "effective action" under the Excessive Deficit Procedure.

In addition, when assessing compliance with the expenditure benchmark, expenditure is measured excluding, in particular, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure (see Box 2). This is consistent with the methodology and assumptions underpinning the calculation of the structural balance, to the extent that expenditure on Union programmes is budget neutral (precisely because matched by Union funds revenue) and that non-discretionary changes in unemployment benefit expenditure are filtered out when removing the "cyclical component" of the budget balance.

Box 2: Assessing ex post compliance with the expenditure benchmark

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 4-year period. In addition, any possible fiscal policy measures on the revenue side (including also revenue increases mandated by law) are netted out.

The net expenditure growth rate g_t for year t is computed as follows:

⁽¹⁸⁸⁾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 countries, the averaging formula can lead to an estimated 10-year potential growth rate that is much lower than estimates made for more recent and future years.

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

where G_t and ΔR_t are the expenditure aggregate and the estimated impact of revenue measures having an incremental (positive or negative) effect on revenues in year t .

In the context of the overall assessment, the net expenditure growth rate g_t is corrected for the effect of one-off measures OO_t (both on the expenditure and on the revenue side):

$$g_t^{corr} = g_t - \frac{OO_t}{G_{t-1}}$$

If the net expenditure growth rate corrected for one-off and measures g_t^{corr} is at or below the benchmark rate L_t , the country is compliant with the expenditure benchmark for year t . Otherwise it is not compliant with the expenditure benchmark. In the latter case, the excess growth over the benchmark is converted into a share of GDP, to judge whether the excess (if positive) is significant or not. If the figure exceeds 0.5% of GDP over 1 year, it is judged to be significant. If the figure exceeds 0.25% of GDP when averaged over 2 consecutive years, the deviation is judged significant over 2 years.

As defined in Articles 6(3) and 10(3) of Council Regulation (EC) No 1466/97, the assessment of whether a deviation from the requirements is significant includes, in particular, the following criteria, for Member States that have not yet attained their MTO:

- i. When assessing the change in the structural balance, whether the deviation is at least 0.5% of GDP in a single year or at least 0.25% of GDP on average per year in 2 consecutive years;
- ii. 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 at least 0.25% of GDP on average per year in 2 consecutive years (see Box 2).

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

- i. The deviation of the structural balance from the appropriate adjustment path is at least 0.5% of GDP in one single year or at least 0.25% of GDP on average per year in two consecutive years; and
- ii. An excess of the rate of growth of expenditure net of discretionary revenue measures over the appropriate adjustment path defined in relation to the reference medium-term rate of growth has had a negative impact on the government balance of at least 0.5 of a percentage point of GDP in one single year, or cumulatively in two consecutive years;

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

While the initial requirements for year t in terms of (the change in) the structural balance and the expenditure benchmark, set in the spring of year $t - 1$, are kept unchanged throughout the successive assessments, the ex post assessment of compliance (in the spring of year $t + 1$) shall take into account a possible worsening of the economic situation such that the Member State is found to have been in “exceptionally bad” or “very bad” times, as well as the achievement of the MTO, which is the cornerstone of the preventive arm.

In assessing compliance with the requirements and in line with Council Regulation (EC) No 1466/97, a deviation from the expenditure benchmark is in general left out of consideration if the Member State is

found to have exceeded its MTO on the basis of the structural balance pillar. However, in line with Council Regulation (EC) No 1466/97, an assessment of compliance with the expenditure benchmark is performed in the specific situation where the Member State is found to have exceeded the MTO solely thanks to significant revenue windfalls. An assessment of compliance with the expenditure benchmark is also performed –over the 2-year average– when the country, having exceeded its MTO, has deviated from it in the next year.

ANNEX 17

IMPROVING THE ASSESSMENT OF EFFECTIVE ACTION IN THE CONTEXT OF THE EXCESSIVE DEFICIT PROCEDURE



Economic and Financial Committee

The Secretariat

Brussels, 29 November 2016

[ecfin.cef.cpe\(2016\)4275398](#)

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

(Opinion of the Economic and Financial Committee)

INTRODUCTION

Once a Member State is subject to an Excessive Deficit Procedure (EDP) –the corrective arm of the Stability and Growth Pact (SGP)– the Commission regularly assesses whether it is acting in compliance with the Council recommendation under Article 126(7) TFEU or notice under Article 126(9).⁽¹⁸⁹⁾ That is, it regularly assesses whether “effective action” has been taken. In particular, according to Council Regulation (EC) 1467/97, the Commission has to do so following the expiry of the deadline set by the Council for the Member State to take effective action.⁽¹⁹⁰⁾ Thereafter, the following assessments take place alongside the regular monitoring of budgetary developments.

The need to distinguish between fiscal consolidation actions and fiscal consolidation outcomes implies that a Member State can be found to be compliant with the EDP recommendation even if the headline deficit targets are not attained (consolidation outcome), provided that it is assessed to have taken sufficient measures (consolidation actions) to ensure adequate progress towards the correction of the excessive deficit situation, in the face of unexpected events with a significant impact on the public finances.⁽¹⁹¹⁾ Accordingly, since the 2005 reform of the SGP, the change in the structural balance plays a central role in the fiscal surveillance framework, by approximating the extent of the consolidation actions implemented by the concerned Member State.

The use of the structural balance to assess fiscal effort is well known and widely used among experts. However, it suffers from its own weaknesses, mainly related to its endogenous relation with GDP which in turn may distort the estimations of governments’ fiscal actions. In other words, the structural balance may be, and frequently is, affected by non-policy effects. The 2011 six-pack reform and subsequent non-legislative changes to the fiscal surveillance framework have sought to address the shortcomings of the structural balance approach. Namely, in the corrective arm of the Pact, the decision was made to take into account revisions affecting the estimates for potential output and the response of revenues to economic developments at the time of assessments. This was made through the so-called alpha and beta corrections. In addition, the structural balance approach has been complemented by a quantification of individual fiscal policy measures (essentially on the revenue side), which is known as the “bottom-up approach” to fiscal effort.

These changes have allowed capturing better Member States’ fiscal actions but have also led to increased complexity. Acknowledging that, the Commission Communication of 21 October 2015 on “*Steps towards Completing Economic and Monetary Union*”⁽¹⁹²⁾ identified a number of pathways towards improving the transparency and reducing the complexity of the current fiscal rules, among which exploring “*ways for increasing reliance on a single practical indicator of compliance*” with the SGP. For that matter, the Commission prepared a note⁽¹⁹³⁾ for the Alternates of the Economic and Financial Committee outlining an approach whereby the expenditure benchmark currently used in the preventive arm of the SGP, or a variant thereof, would gain greater prominence in the working of the Pact. The April 2016 informal Economic and Financial Affairs Council agreed that more work should be done on exploring the use of the expenditure benchmark in the EU’s fiscal framework and to continue improving the common methodology for estimating the output gap. On this basis, the Commission’s original note was complemented by an additional note⁽¹⁹⁴⁾ illustrating the suggested changes to the working of the corrective arm of the Pact and clarifying a number of issues that had been raised by Alternates. The Commission’s notes were extensively discussed by the EFC between April and November 2016.

⁽¹⁸⁹⁾ Hereinafter both referred to as “the EDP recommendation”.

⁽¹⁹⁰⁾ Article 9(3) of Council Regulation (EC) 1467/97.

⁽¹⁹¹⁾ Article 3(5) of Council Regulation (EC) 1467/97.

⁽¹⁹²⁾ COM(2015) 600 final (available at: <https://ec.europa.eu/transparency/regdoc/rep/1/2015/EN/1-2015-600-EN-F1-1.PDF>).

⁽¹⁹³⁾ “*Exploring ways for simplifying the assessment of compliance with the Stability and Growth Pact*”, note for the Alternates of the Economic and Financial Committee, ref. Ares(2016)1480115 – 29/03/2016.

⁽¹⁹⁴⁾ “*Exploring ways for simplifying the assessment of compliance with the Stability and Growth Pact: Numerical examples*”, note for the Alternates of the Economic and Financial Committee, ref. Ares(2016)2533344 – 01/06/2016.

This document updates the Commission's original note reflecting the outcome of the discussions with respect to the corrective arm of the Pact. It presents the commonly agreed methodology for assessing effective action, as revised by the Economic and Financial Committee on 29 November 2016.

The document is structured as follows. Section 1 describes the terms in which the adjustment requirements are expressed under the EDP. Section 2 sets out the order of logical and procedural steps for assessing effective action, commonly designated as the "EDP decision tree". Section 3 focuses on the expenditure benchmark, which constitutes the main novelty in the assessment of effective action. Section 4 recalls the need for economic judgement in interpreting the outcome of the expenditure benchmark, which forms an integral part of the so-called "careful analysis". Finally, Section 5 addresses the specific case of multi-year EDP recommendations.

In order to increase transparency of the exercise, the Commission will supply EFC Alternates with all data, as well as the underlying calculations, needed to replicate the Commission's estimates of the structural balance, the expenditure benchmark and the debt-reduction benchmark for all concerned Member States for each vintage of the Commission's forecasts. These data will be made available on a dedicated website after the publication of the Commission's forecast, with access restricted to the EFC Alternates. These commitments should be seen in the context of the continuing efforts to develop further transparency on the sides of both the Commission and the Member States, and at a later stage consideration could be given to make this data available to the broader public.

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. This list will be updated with every forecast. In order to reduce complexity further and in line with the Commission Communication of 21 October 2015 and the mandate by the Council, the Commission services together with Alternates will in parallel examine the possibility of a stronger role of the expenditure benchmark in the preventive arm without prejudice to the structural budget balance indicator as established in Regulation (EC) No 1466/97.

1. THE EDP RECOMMENDATION

The EDP recommendation sets out annual targets for the headline deficit, with the final year target at or below 3% of GDP, "*consistent with a minimum annual improvement of at least 0.5% of GDP as a benchmark*"⁽¹⁹⁵⁾ in the structural balance. The EDP recommendation is also formulated in terms of the expenditure benchmark, that is, the maximum allowable growth rate of expenditure net of discretionary revenue measures consistent with, and conducive to, the fulfilment of the targets for the headline deficit and the underlying improvement in the structural balance. This ensures that, 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.

The expenditure benchmark is net of the possible fiscal policy (discretionary) measures assumed 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 4-year period. Any possible one-off measures, whether on the expenditure or on the revenue side, are also excluded.

⁽¹⁹⁵⁾ Articles 3(4) and 5(1) of Council Regulation (EC) 1467/97.

The expenditure benchmark set in the EDP recommendation is expressed in nominal terms for all the years covered by the EDP recommendation.

Annex 1 provides an example of how the EDP recommendation is formulated. Annex 2 provides a simplified numerical example of how the expenditure benchmark is determined.

2. THE EDP DECISION TREE FOR ASSESSING EFFECTIVE ACTION

The EDP decision tree sets out the systematic sequencing for the implementation of the methodology for assessing effective action, which plays a central role in different phases of the EDP. The process, which is described in Graph 1, reads as follows.

If the Member State concerned is compliant with the headline deficit target and the underlying improvement in the structural balance, the procedure is held in abeyance. If the Member States fails or is at risk of failing to meet the headline deficit target or the required improvement in the structural balance, or both, a careful analysis of the reasons of the shortfall will be undertaken.⁽¹⁹⁶⁾ The careful analysis is, therefore, a centrepiece in the assessment of effective action.

The careful analysis first uses the expenditure benchmark to assess fiscal effort. All in all, the aim of the careful analysis is to provide an adequate estimation of the extent of policy actions, to evaluate whether the Member State concerned has delivered on its policy commitments as set in the EDP recommendation. 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 expenditure benchmark is not met, there is a presumption the Member State has not delivered on its policy commitments.

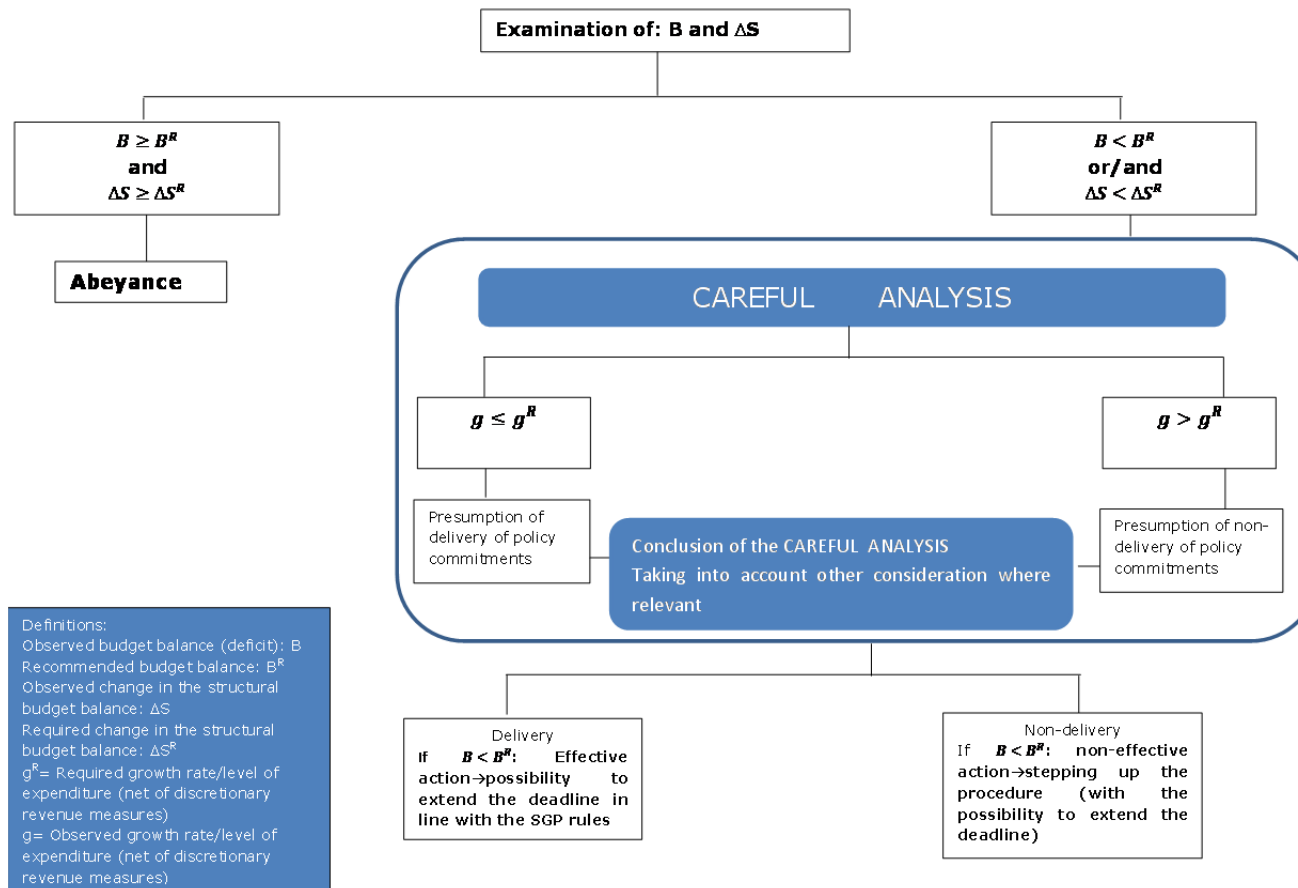
The Commission uses qualitative economic judgement in making its final assessment where relevant, in particular of the outcome of the expenditure benchmark, as part of the careful analysis which the Commission uses to determine whether the Member State concerned has delivered or not on its policy commitments. In other words, the careful analysis evaluates 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 –mostly of qualitative nature– that do not emerge from the benchmark itself. These 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 Section 4 for details).

If the careful analysis concludes that the Member State concerned has delivered on its policy commitments, the assessment will conclude that effective action has been taken, with a possibility to extend the deadline, even if the headline deficit target has not been met. If the careful analysis concludes that policy commitments have not been delivered and that the headline deficit target is not met, the assessment will conclude on non-effective action and the procedure should be stepped up including by setting a new correction path (and possibly deadline) as appropriate.

It must be emphasised that if the intermediate headline deficit target has been met, the procedure will not be stepped up even if the policy commitments have not been delivered. However, it should be stressed that where the absence of a stepping-up of the procedure is taken based on in-year data, should the (notified) ex post data show that the intermediate headline deficit target was eventually not been met, the EDP can still be stepped up.

⁽¹⁹⁶⁾ The Code of Conduct on the SGP states in this respect that: “In case the observed budget balance proves to be lower than recommended or if the improvement of the cyclically-adjusted balance net of one-off and other temporary measures falls significantly short of the adjustment underlying the target, a careful analysis of the reasons of the shortfall will be made”.

Graph 1: The EDP decision tree for assessing effective action



3. THE CAREFUL ANALYSIS: THE EXPENDITURE BENCHMARK

As per the decision tree described in Section 2, a careful analysis is warranted when the Member State concerned fails or it is at risk of failing to meet the headline deficit target or the required improvement in the structural balance, or both. In order to determine the reasons of the shortfall and ultimately whether the country has delivered on the policy commitments laid down in the recommendation, the careful analysis first and foremost builds on the outcome 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 in that respect. Specifically, it focuses on aggregate expenditure developments and revenue-increasing (or decreasing) fiscal policy measures, that is, on what is more directly under the control of the government.

3.1. Concept

The expenditure benchmark approach aims at identifying the budgetary impact of individual fiscal policy measures. However, the different nature of public expenditures and revenues requires a separate treatment. While the total amount of revenues largely depends on exogenous factors, beyond the direct control of the government (e.g. changes in the tax bases –disposable income, overall consumption, production, etc.– or tax compliance), expenditures can be considered largely under the direct control of the government, except for a limited number of exogenously driven expenditure changes. As such, with few exceptions, nominal changes in government expenditure can be broadly considered as resulting from autonomous decisions by the government. This fundamental difference has obvious implications for the way the developments on the two sides of the budget balance are to be treated when assessing effective action.

Expenditure trends are influenced by active or explicit governmental decisions as well as by indirect ones, as governments can influence expenditures either through their action or their inaction.⁽¹⁹⁷⁾ Therefore, from the perspective of the expenditure benchmark approach, the required fiscal effort should be deemed achieved if annual expenditure growth has not exceeded the expenditure benchmark, that is, the maximum allowable growth rate of spending compatible with the fulfilment of the headline and structural deficit targets forecast at the time of adoption of the EDP recommendation. Any excess in annual expenditure growth over the expenditure benchmark should be funded by revenue-increasing fiscal policy measures.

3.2. Methodology

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 4-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:

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

⁽¹⁹⁷⁾ For example, not acting on future age-related spending is a policy decision that carries with it inherent fiscal sustainability risks.

where G_t and ΔR_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.

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 ΔR_t requires that the measures are defined and their budgetary impacts are quantified. For a government action to be considered as a discretionary revenue measure with a permanent effect, it should be: (i) an autonomous intervention by the government;⁽¹⁹⁸⁾ (ii) enacted or credibly announced in sufficient detail; and (iii) with a direct budgetary impact. On the contrary, commitments or targets (e.g. deficit targets, deficit rules) which are not underpinned by specific measures to achieve them should not be considered discretionary revenue measures.⁽¹⁹⁹⁾ When estimating the budgetary impact of a discretionary revenue measure, micro-level behavioural responses, including cautiously estimated tax compliance effects that are clearly attributable to well specified measures directly aiming at improving tax compliance, should also be factored in. By contrast, the macroeconomic feedback loops, or “second-round”, effects that are material in relation to the whole economy should not be taken into account.⁽²⁰⁰⁾

Overall, if the net expenditure growth rate g_t is lower than, or equal to, the maximum allowable growth rate g_t^R calculated following the methodology outlined in Section 1, 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.

4. THE CAREFUL ANALYSIS: OTHER CONSIDERATIONS

The Commission uses qualitative economic judgement in making its final assessment where relevant, in particular of the outcome of the expenditure benchmark, as part of the careful analysis which the Commission uses to determine whether the Member State concerned has delivered or not on its policy commitments. In other words, the careful analysis evaluates whether the Member State concerned has put in place enough actions to comply with the EDP recommendation. 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 determining whether a Member State has put in place enough actions to comply with the EDP recommendation. It is, therefore, the final step in the assessment of effective action that aims at capturing any factor that is relevant to analyse fiscal effort beyond the expenditure benchmark indicator.

With the exclusion of interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure and nationally financed gross fixed capital formation smoothed over a 4-year period as well as 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)

⁽¹⁹⁸⁾ In some specific cases, a government action triggered by an event beyond the direct control of the government can be also considered as a measure, e.g. exceptional events outside the control of government (like natural disasters), some court cases, rulings by international organisations, etc. However, often those events take the form of a one-off measure, in which case they would be excluded from the calculation of the expenditure benchmark.

⁽¹⁹⁹⁾ By contrast, conditional measures such as “revenues mandated by law” can be taken into account if the condition is sufficiently operational and if the measures are specified in sufficient detail and adopted or at least credibly announced.

⁽²⁰⁰⁾ These are the possible indirect, wider effect of a measure on the public finances that stem from its macroeconomic impact on the economy (size and composition of economic activity, employment, inflation). Only large measures, or packages of measures, are expected to generate this kind of effects. This convention fully concurs with the principles of estimating the budgetary effects of discretionary measures underpinning the Commission’s economic and budgetary forecasts.

revenues to economic fluctuations is left out of consideration, since not affecting the expenditure benchmark. However, there might still be cases where the sole focus on the expenditure benchmark could lead to a biased conclusion.

In this sense, other considerations may be taken into account where relevant, including:

(i) Possible statistical revisions in data. National accounts are updated on a regular basis to take account of improvements in methods, data sources and classification changes. These may result in, sometimes significant, revisions to historical data. Large revisions most often lead to level shifts, with only small if any effects on annual changes. The expenditure benchmark is largely immune to such level shifts to the extent that it is formulated in terms of the growth rate of expenditure net of any revenue-increasing (or decreasing) fiscal policy measures. However, in the event of statistical revisions affecting significantly expenditure growth in a particular year, the implied impact on the fiscal effort as measured by the expenditure benchmark will be considered in the careful analysis. Eurostat closely monitors the list of public sector entities in the Member States and their calculation basis in the accounts (use of actual accounts, trends, estimates, etc.). This safeguards against strategic changes in the delimitation of the general government sector for the years under assessment. Eurostat also pays close attention to the time and horizontal consistency of its guidance in order to preserve the reliability of the expenditure benchmark.

(ii) Unexpected dynamics in certain expenditure items driven by unusual events out of government control. In principle, any expenditure trend should be considered and internalised by governments when deciding their fiscal policy mix. Fiscal authorities cannot, however, be held accountable for unusual events with major unfavourable consequences for public finances that go beyond their control. Under the expenditure benchmark approach, this will be considered as an expenditure slippage, given that the formula systematically corrects for some exogenous expenditure items but not for other more specific ones. The careful analysis will allow differentiating such more specific expenditure developments from discretionary actions and/or predictable trends.

(iii) Unforeseen inflation developments. Inflation surprises can affect compliance with the expenditure benchmark, if they have a material impact on government spending. In such a case, a country may find it “easier”, or instead “more difficult”, to keep net expenditure growth in line with the allowable rate. The issue may be mostly of relevance for multi-year EDPs and in such cases should be considered in the assessment of the results.

(iv) Discretionary revenue measures. Any excess of spending growth over the allowable rate shall be funded by revenue-increasing fiscal policy measures in order to comply with the expenditure benchmark. The quantitative assessment of the yields/costs of fiscal measures plays a crucial role in assessing compliance with the benchmark. In some cases, however, it can be surrounded by a high degree of uncertainty, for example due to a lack of data or linked to the inevitable need to make assumptions. This is the case, for instance, of a wide package of measures, a tax shift, measures against tax avoidance or measures decided at sub-central levels or by state-owned enterprises.

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

The report on action taken⁽²⁰¹⁾ 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. These measures should be described in detail so as to facilitate the assessment.

⁽²⁰¹⁾ Articles 3(4a) and 5(1a) of Council Regulation (EC) 1467/97.

5. THE CUMULATIVE FISCAL EFFORT FOR MULTI-YEAR EDPS

A Member State is found compliant with the EDP recommendation if the annual headline target is met.⁽²⁰²⁾ As a result, the EDP procedure would be held in abeyance even if the required annual fiscal effort is not delivered. This can generate an asymmetry in the way compliance with the EDP recommendation is assessed, as explained below.

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

As it has been the case since 2014, the Commission will continue to examine whether the overall fiscal effort over the EDP correction period is delivered in order to balance –at least partially– the asymmetry in the assessment. This ensures that a Member State that meets its headline deficit target in the first year without delivering the recommended annual effort would only be found compliant with the recommendation in the second year if it delivers the cumulative fiscal effort of the first two years even if the headline target is not met. Analogously, by looking at the cumulative fiscal effort, Member States wishing to frontload the required adjustment would not be discouraged to do so.

All in all, Member States are thus better equipped to correct their excessive deficits in a lasting manner, i.e. having a deficit forecast not to exceed the 3% of GDP threshold over the horizon of the Commission's forecast. If the deficit reaches 3% of GDP at maximum in the final year of the EDP, but the durability of the correction is still not ensured, effective action will be assessed against the overall (cumulative) effort as a benchmark.

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 as described in Sections 3 and 4.

From an operational perspective, this implies that compliance with the expenditure benchmark can be assessed in cumulative terms. This can be achieved by calculating the excess (positive or negative) of the growth rate of the net expenditure aggregate over the benchmark rate and converting it into national currency using the figure for the expenditure aggregate in the preceding year. Using the figure for nominal GDP, this difference of net expenditure growth relative to the benchmark rate can be expressed as a share of GDP and then easily calculated on a cumulative basis since the start of the EDP (or the first year of a revised EDP recommendation or EDP notice).

⁽²⁰²⁾ This is consistent with the Code of Conduct on the SGP, which specifies that the EDP procedure shall be abrogated when the deficit is forecast to remain below 3% of GDP in a durable manner (irrespective of whether the fiscal effort has been delivered) and the forward-looking component of the debt reduction benchmark is respected. Recursively, if the intermediary headline deficit targets are fulfilled, the procedure should be held in abeyance.

Annex 1: Fiscal consolidation targets in the EDP recommendation

EDP recommendations up to MONTH/YEAR

% of GDP	20xx	20yy	20zz
Headline deficit	X%	Y%	Z%
Annual improvement in the structural balance	A%	B%	C%
Cumulative improvement in the structural balance		B''%=(A+B)%	C'''%=(A+B+C)%

Additional consolidation measures

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

EDP recommendations from MONTH/YEAR

% of GDP	20xx	20yy	20zz
Headline deficit	X%	Y%	Z%
Annual improvement in the structural balance	A%	B%	C%
Cumulative improvement in the structural balance		B''%=(A+B)%	C'''%=(A+B+C)%

Expenditure benchmark

% change from previous year	20xx	20yy	20zz
Maximum allowable growth rate of expenditure ⁽²⁰³⁾ net of discretionary revenue measures (DRM)	K%	L%	M%

[Option 2: Expenditure benchmark (updated)]

$$L''\% = \frac{(1 + L\%) \times (1 + \pi_{20yy}^{COM SF 20xx0}\%) }{(1 + \pi_{20yy}^{EDP}\%)} - 1$$

$$M''\% = \frac{(1 + M\%) \times (1 + \pi_{20zz}^{COM SF 20yy0}\%) }{(1 + \pi_{20zz}^{EDP}\%)} - 1$$

⁽²⁰³⁾ Government expenditure 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 4-year period.

Annex 2: Calculation of the expenditure benchmark: A simplified numerical example

The EDP scenario

			T	T+1
Government expenditure	bn EUR	(1)	50.0	52.0
Government revenue	bn EUR	(2)	46.0	48.8
<i>Of which DRM</i>	<i>bn EUR</i>	<i>(2)'</i>		<i>1</i>
Government balance	bn EUR	(3) = (2) – (1)	-4.0	-3.2
Nominal GDP	bn EUR	(4)	100.0	104.0
Government balance (*)	% of GDP	(5) = (3) / (4) x 100	-4.0	-3.0
Output gap	% of pot. GDP	(6)	0	0
Structural balance	% of pot. GDP	(7) = (5) – ε x (6)	-4.0	-3.0
Change in structural balance (*)	% of pot. GDP	(7)' = (7) _{T+1} – (7) _T		1.0
Expenditure growth	% change	(8) = 100 x [(1) _{T+1} – (1) _T] / (1) _T		4.0
Expenditure growth net of DRM**	% change	(9) = 100 x [(1)_{T+1} – (2)'_{T+1}] / (1)_T		2.0

(*) Targets already mentioned in current EDPs.

(**) Targets to be added in future EDPs.

In the example, a Member State is recommended to bring its headline deficit from 4.0% of GDP in year T to 3.0% in year T+1. This is deemed consistent with the structural balance improving by 1.0% of GDP.⁽²⁰⁴⁾ Government expenditure is forecast to increase by EUR 2 billion in year T+1, a 4% change from year T. At the same time, the Member State is assumed to implement revenue-increasing measures worth EUR 1 billion. In net terms, this means that government expenditure is assumed to increase by EUR 1 billion in year T+1, a 2% change from year T. In this example, the expenditure benchmark for year T+1, that is, the maximum allowable growth rate of net expenditure, is thus 2%. Note that the benchmark rate is the same if the adjustment is composed differently, for example exclusively based on expenditure cuts. In this case, government expenditure is projected to increase by EUR 1 billion in year T+1, a 2% change from year T, both in “gross” and in “net” terms.

In the example, the EDP recommendation will thus call on the Member State to bring their deficit at 3.0% of GDP in year T+1 and state that this is deemed consistent with the structural balance improving by 1.0% of GDP and government expenditure growing by no more than 2%, unless the excess is funded by revenue-increasing measures.

⁽²⁰⁴⁾ For the sake of simplicity we assume that the output gap is 0 in both years.

Annex 3: Calculation of the ex post deviation from the expenditure benchmark in cumulative terms

The outcome

			T	T+1	T+2
Government expenditure	bn EUR	(1)	50.0	52.5	55.1
Government revenue	bn EUR	(2)	46.0	48.8	51.8
<i>Of which DRM</i>	<i>bn EUR</i>	<i>(2)'</i>		<i>1.0</i>	<i>1.0</i>
Government balance	bn EUR	(3) = (2) – (1)	-4.0	-3.7	-3.3
Nominal GDP	bn EUR	(4)	100.0	104.0	108.2
Government balance	% of GDP	(5) = (3) / (4) x 100	-4.0	-3.5	-3.1
Output gap	% of pot. GDP	(6)	0	0	0
Structural balance	% of pot. GDP	(7) = (5) – ε x (6)	-4.0	-3.5	-3.1
Change in structural balance	% of pot. GDP	(7)' = (7) _{T+1} – (7) _T		0.5	0.4
Expenditure growth	% change	(8) = 100 x [(1) _{T+1} – (1) _T] / (1) _T		5.0	5.0
Expenditure growth net of DRM	% change	(9) = 100 x [(1) _{T+1} – (2)' _{T+1}] / (1) _T		3.0	3.1
Expenditure growth net of DRM as per EDP recommendation	% change	(10)		2.0	2.0
Deviation, if negative in excess over EDP target	bn EUR	(11) = [(10) – (9)] x (1) _T / 100		-0.5	-0.6
Deviation, if negative in excess over EDP target	% of GDP	(12) = (11) / (4) x 100		-0.5	-0.5
Cumulated deviation, if negative in excess over EDP target	% of GDP	(13) = (12)_{T+1} + (12)_T		-0.5	-1.0

In the example, we consider a two-year EDP recommendation, with the Member State recommended to keep the growth rate of government expenditure net of discretionary revenue measures at or below 2% both in year T+1 and in year T+2.

Here we assume that the *actual* growth rate of government expenditure net of discretionary revenue measures is 3% in both years, that is, above the *recommended* growth rate of 2%. The excess over the requirement amounts to 0.5% of GDP in each year. In cumulative terms, the deviation therefore amounts to 0.5% of GDP in year T+1 and 1.0% of GDP in year T+2.

ANNEX 18

THE COMMISSION'S "CONSTRAINED JUDGEMENT" APPROACH

This annex explains why the use of "constrained judgement" was introduced and how the Commission implemented it. The content of this annex is based on Part II – Chapter 3 of the 2017 Public Finance Report⁽²⁰⁵⁾, where the constrained judgement approach is explained in detail. The content also builds upon Box 1 of the Commission Communication on the "2017 Draft Budgetary Plans: Overall Assessment", published on November 16, 2016. For an overview of the fiscal surveillance implications of the constrained judgement approach in autumn 2016 and in spring and autumn 2017 please refer to Section II.3.4 of the 2017 Public Finance Report. The EFC agreed on the application of the constrained judgement approach for a trial period of up to 2 years. At the same time, the Commission will continue to work with the Member States to explore further ways to improve the common output gap methodology, including by the possible introduction of country-specific elements in the commonly agreed production function methodology.

1. Background: why apply constrained judgement?

A key input into the calculation of the structural balance is the output gap estimates, i.e. the numerical assessment of the current cyclical position of the economy. The estimates of the output gap used in the surveillance process are calculated using a production function methodology. ⁽²⁰⁶⁾ That methodology is decided collectively through committee work by all of the relevant actors involved in surveillance. Given the importance of those estimates, the EU's Economic Policy Committee (EPC) has a dedicated working group (i.e. the "Output Gap Working Group" - OGWG) which meets regularly to discuss the operational effectiveness, relevance and possible further improvement of the existing production function methodology.

As an unobservable variable, there is an unavoidable degree of uncertainty surrounding all output gap estimates. Potential growth used to compute the output gap is not directly observable whilst actual GDP in real time is subject to significant historical and forecast revisions. This could have a sizeable influence on output gap estimates. In March 2016, the Ministers of Finance of eight Member States sent a letter to the Commission expressing their concerns regarding the estimation of potential output. Subsequently, the April 2016 Amsterdam Informal ECOFIN Council requested that improvements be made to the commonly agreed methodology for the estimation of potential growth and the output gap.

As a response to the request of the Member States, the Output Gap Working Group agreed on a "plausibility tool", which could allow for the exercising of some "constrained judgement" in the conduct of fiscal surveillance. In line with the mandate from the Council, two concrete steps were agreed in October 2016. First, a revised methodology for the estimation of the non-accelerating wage rate of unemployment (NAWRU) would be introduced in the commonly agreed methodology. That change was implemented in the Commission's autumn 2016 forecast. Second, the "plausibility tool" could be used to signal cases where the results of the agreed methodology could be interpreted as being subject to a large degree of uncertainty. Specifically, the Economic and Financial Committee endorsed the use of this tool within the autumn 2016 surveillance exercise as part of a wider approach to considering estimates of the output gap within the fiscal framework. That wider approach has been named "constrained judgement".

The constrained judgment 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 when conducting its fiscal assessments. In other words, the Commission can apply a constrained degree of judgement in conducting Member States' budgetary assessments. The boundaries to that discretion have been agreed by the Economic and

⁽²⁰⁵⁾ https://ec.europa.eu/info/sites/info/files/economy-finance/ip069_ii_recent_developments_in_fiscal_surveillance.pdf

⁽²⁰⁶⁾ See Havik et al. (2014).

Financial Committee, which agreed to the application of the constrained judgement for a trial period of up to two years.

It is important to note that the constrained judgement approach has not affected the Commission's assessments based on the autumn 2016 forecast nor on the spring and autumn 2017 forecast exercises. The output gap and the implied structural balance estimates published in those forecast exercises continue to be based on the results produced by the common methodology.

2. Implementation of the constrained judgement: a two-step approach

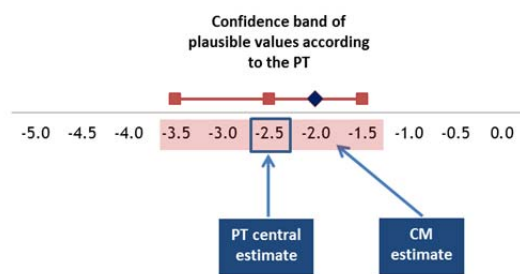
2.1. First step – when is a Member State flagged by the plausibility tool?

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⁽²⁰⁷⁾, which has been agreed within the OGWG.

As highlighted at the Economic and Financial Committee, 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.

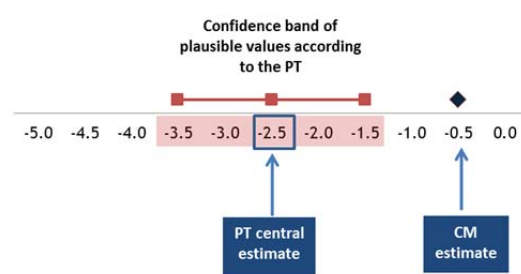
Graph 1 provides a simplified illustrative situation where the estimate of the output gap based upon the common method is not flagged. Let us assume that the interval of reasonable output gap values built around the plausibility tool's central estimate is between -3.5% and -1.5% for a given year. At 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.

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.

Constrained judgment 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.

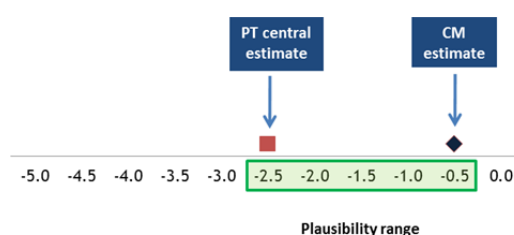
⁽²⁰⁷⁾ The statistical confidence interval is based on two different threshold criteria, depending on the targeted degree of certainty. These threshold criteria correspond respectively to RMSE68 and RMSE90, the latter being stricter than the former. For more details, please see Box II.3.1 in the 2017 Report on Public Finances in EMU.

2.2. Second step – expert judgement within a plausibility range

The second step involves the application of constrained judgement. That second step is to be applied when the estimate of the output gap based on the common methodology falls outside the statistically significant range of values around the plausibility tool's central estimate, as described in Graph 2. 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 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 2.

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 judgment approach is intended to allow the Commission to depart from the common methodology estimate, but not to routinely substitute it with an alternative estimate. The plausibility range shown in Graph 3 therefore represents the constraints within which the Commission identifies a plausible level of the output gap. Essentially, based on sound economic judgement, the Commission could consider a value of the output gap other than that estimated by the common methodology, provided that it remains within that range.

Graph 3: **Plausibility range for the scenario of Graph 2**



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

It is important to stress that such a plausibility analysis is performed only on the current or last observed year, and cannot be produced for future years. Therefore it is not possible to generate a plausibility range for future years using the tool's results. The reason for that limitation is that the "plausibility tool" estimates rely on a regression of variables for which future values are not available. The "plausibility tool" relies on a regression of the output gap on the main variables which are considered to be closely correlated with the economic cycle. For the tool to provide reliable results it is crucial that the estimates of those input variables are stable. Consequently, the results of the "plausibility tool" can only be produced 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). In that way the probability of significant revisions is considerably reduced. Therefore, it is not possible to generate a plausibility range for future years or even for the ongoing year (or at least not until the autumn forecasts are available).

However, to make the "plausibility tool" operational for fiscal surveillance purposes covering future years, it is necessary to extrapolate the plausibility range, in order to analyse if a more plausible estimate of the output gap can be identified for those years.

As discussed at the Committee, the Commission implemented a simple and transparent approach. It consists of taking the difference between the two estimates for T (2016 in the case of both the 2017 DBPs and SCPs) and adding it to the output gap estimate based on the common methodology for T+1 (2017) to derive a plausibility range for 2017 and for T+2 (2018) in the case of the SCPs. Although crude, that method is transparent and simple.

The assessment of the plausible level of the output gap under the constrained judgment approach has been carried out by the Commission on the basis of expert country knowledge, drawing upon a sound economic assessment. In making their assessment, Commission experts can take into account the following elements: (i) a comprehensive set of macroeconomic indicators (including but not necessarily confined to those on which the plausibility tool is based); (ii) relevant country-specific factors and (iii) the output gap estimates produced by other international organisations, such as the IMF and OECD.

Following that qualitative assessment, there are two options:

- **To continue to rely on the output gap estimate based on the common methodology.** To do so, implies that the uncertainty on the exact level of the output gap has no implications for the fiscal assessment of the Member State concerned;
- **To apply constrained judgment and consider the output gap estimate based on the common methodology as being subject to a large degree of uncertainty on the basis of the "plausibility tool" outcomes and expert judgment.** 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. That assessment is made in a qualitative manner and is detailed in a transparent manner in the accompanying Commission documents, as was done for the autumn 2016 and spring 2017 surveillance exercises. However, while the alternative output gap estimate emerging from the constrained judgment process is used for surveillance purposes, it does not replace the value of the output gap in the Commission's publications.

3. Implications of constrained judgement for fiscal surveillance

As for formal revisions of the output gap, the freezing principles apply to ensure predictability of the fiscal requirement. While it needs to be checked whether the fiscal requirement derived from the matrix would warrant unfreezing along the lines set out in Section 1.3.2.2 and Box 1.6, it does not lead to an actual revision of the formal requirement set in the country-specific recommendations. Instead, the outcome of the analysis can only be taken into account in qualitative terms when conducting the overall assessment of compliance.

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 (Annex 16). In such a case, it is mentioned in the Commission's assessments.

The "plausibility" tool entails two main limitations for constrained judgement:

- **"Constrained judgement" on future years can only be based on the extrapolation of the plausibility range.** As indicated above, it is not possible to generate a plausibility range for future years or even for the ongoing year (or at least not until the autumn forecasts are available). The plausibility ranges can only be extrapolated to future years from the most recent results available, which underline the fragility of the exercise. Therefore, departing from the commonly methodology estimate should be done with caution, based on sound evidence.
- **"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 judgment" 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 common methodology.

ANNEX 19

IMPLEMENTATION OF DISCRETION IN THE AUTUMN 2017 FISCAL SURVEILLANCE EXERCISE

This annex is largely based on the Box 1 of the Commission Communication on the “2018 Draft Budgetary Plans: Overall Assessment”, published on November 22, 2017. This Annex states the Commission position, which is not necessarily that of Member States. The Annex explains why the Commission intends to apply its discretion when assessing a departure from the required adjustment for 2018 and how it did so when assessing the 2018 Draft Budgetary Plans submitted by euro area Member States. In that occasion, and as a reminder, the Commission took a prudent approach and eventually decided to apply its discretion only in two cases, namely when assessing the Draft Budgetary Plans of Italy and Slovenia. Nevertheless, applying discretion changed the overall outcome neither for Italy nor for Slovenia, whose fiscal adjustments for 2018 were not considered adequate.

In the recitals of the Council Recommendations of 11 July 2017 the Commission's intended treatment of Member States for which the matrix implies a fiscal adjustment of 0.5% of GDP or above was highlighted. The recitals state the following: “[...], the assessment of the 2018 Draft Budgetary Plan and subsequent assessment of 2018 budget outcomes will need to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of [Member State]’s public finances. In that context, the Council notes that the Commission intends to carry out an overall assessment in line with Regulation (EC) No 1466/ 97, in particular in the light of the cyclical situation of [Member State].”

The Commission can exercise a degree of discretion when considering departures from the fiscal adjustments implied by the commonly agreed matrix. While compliance continues to be assessed with respect to the matrix-based requirement as indicated in the Recommendations, the Commission can exercise some discretion when assessing compliance with the SGP of a Member State that is flagged by the quantitative indicators as (at risk of) significantly deviating from its required adjustment. In fact, the overall assessment might eventually conclude that a Significant Deviation Procedure is not warranted even in the event of the significant deviation threshold of 0.5% of GDP being exceeded (in a single year or aggregated over two years) with respect to the matrix-based requirement. This is in line with Article 6(3) and Article 10(3) of Council Regulation (EC) No 1466/97 which provides that the overall assessment is linked to precise quantitative criteria without being limited to those criteria, which therefore allows for other elements to be taken into account.

In the 2018 Country Specific Recommendations for some Member States, discretion is conceived as a mean to tackle a specific situation in a time of atypical and incomplete economic recovery. Specifically, as suggested by the Commission 2017 autumn forecast, there is persistent labour market slack, core inflation remains unusually subdued, and the large current account surplus, in excess of its fundamental level, indicates the persistence of a domestic demand shortfall. Lastly, the recovery is supported by ECB's accommodative monetary policy. This becomes even more relevant in the context of monetary policy on a gradual road towards normalisation.

A structured and holistic assessment of a comprehensive set of economic indicators allows the Commission to identify cases where an effort below that required by the commonly agreed matrix could be deemed adequate. For Member States in (at risk of) a significant deviation from the matrix requirements for 2018, the overall assessment may include a methodical scrutiny of its stabilisation and sustainability needs with the ultimate goal of achieving an appropriate fiscal stance at the Member State level. This is based on a structured and systematic analysis of a comprehensive set of economic indicators that is intended to ensure predictability and equal treatment among Member States.

The analysis encompasses both an assessment of sustainability and stabilisation challenges. A thorough analysis of debt levels as well as short and medium term sustainability challenges allow determining if the Member State presents sustainability challenges or not. In parallel, stabilisation needs are assessed considering the position of the economy in the economic cycle and the possible existence of inflationary pressures. In particular, the indication provided by the output gap from the common methodology is complemented by alternative measures of the spare capacity of the economy. In addition, indicators of inflationary pressures can also be taken into account.

Having examined the situation of each euro area Member State, for which the matrix-based fiscal adjustment contained in the Country Specific Recommendation was 0.5% of GDP or above, the Commission concluded that a fiscal adjustment that departs from the requirement can be deemed adequate for Italy and Slovenia, provided that they effectively ensure such a fiscal adjustment in 2018. The analysis considered the following sequential arguments.

- In cases when short-term fiscal sustainability challenges are identified, no discretion is warranted. No Member State was in this situation in autumn 2017.
- In cases when the economic recovery of the Member State was considered sufficiently robust, no discretion was warranted either, as for Belgium, France, and Portugal.

For Member States where the recovery appeared still fragile or a too large fiscal tightening could jeopardise it, as in the cases of Italy and Slovenia, a fiscal adjustment that departs from the requirement could have been deemed adequate. However, if these Member States are also facing sustainability needs in the medium-term and/or have a debt-to-GDP ratio above 60%, an important provision is that they should ensure the effective delivery of a reasonable fiscal adjustment. The latter could be roughly proxied by at least half of the requirement from the matrix. Providing such a cap responds to the need of striking the right balance between the Member State's stabilisation and sustainability needs. Nevertheless, full compliance with this fiscal adjustment is required. Effectively ensuring a minimum fiscal adjustment is essential in particular for Member States not respecting the debt reduction benchmark *prima facie* and therefore facing the possibility of a debt-based Excessive Deficit Procedure.

GLOSSARY

Automatic stabilisers Features of the tax and spending regime which react automatically to the economic cycle and reduce its fluctuations. As a result, the budget balance in percent of GDP tends to improve in years of high growth, and deteriorate during economic slowdowns.

Bottom up fiscal effort A quantification of the fiscal impact of measures introduced, obtained by summing up the impact of the individual measures. See *Top down fiscal effort*.

Broad Economic Policy Guidelines (BEPGs) Annual guidelines for the economic and budgetary policies of the Member States. They are prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN).

Budget balance The balance between total public expenditure and revenue in a specific year, with a positive balance indicating a surplus and a negative balance indicating a deficit. For the monitoring of Member State budgetary positions, the EU uses *general government* aggregates. See also *structural budget balance*, *primary budget balance*, and *primary structural balance*.

Budgetary sensitivity The variation in the budget balance in percentage of GDP brought about by a change in the output gap. In the EU, it is estimated to be 0.5 on average.

Close-to-balance requirement A requirement contained in the “old” *Stability and Growth Pact*, according to which Member States should, over the medium term, achieve an overall *budget balance* close to balance or in surplus; was replaced by country-specific *medium-term budgetary objectives* in the reformed *Stability and Growth Pact*.

Code of Conduct Policy document setting down the specifications on the implementation of the *Stability and Growth Pact* and the format and content of the *Stability and Convergence programmes*.

Convergence margin In the context of the expenditure benchmark, for Member States that have not attained their MTO, a convergence margin is computed so as to ensure the appropriate adjustment towards the MTO (i.e. an adjustment in line with the required change in the structural balance). Hence the convergence margin results from the difference between the reference growth rate for net expenditure and the medium-term potential GDP growth.

Convergence programmes Medium-term budgetary strategies and monetary policies presented by Member States that have not yet adopted the euro. They are updated annually, according to the provisions of the *Stability and Growth Pact*. See also *stability programmes*.

Crowding-out effects Offsetting effects on output due to changes in interest rates and exchange rates triggered by a loosening or tightening of fiscal policy.

Cyclical component of budget balance That part of the change in the *budget balance* that follows automatically from the cyclical conditions of the economy, due to the reaction of public revenue and expenditure to changes in the *output gap*. See *automatic stabilisers*, *tax smoothing* and *structural budget balance*.

Cyclically-adjusted budget balance See *structural budget balance*.

Defined-benefit pension scheme A traditional pension scheme that defines a benefit, i.e. a pension, for an employee upon that employee’s retirement is a defined benefit plan.

Defined-contribution pension scheme A scheme providing for an individual account for each participant, and for benefits based solely on the amount contributed to the account, plus or minus income, gains, expenses and losses allocated to the account.

Demand and supply shocks Disturbances that affect the economy on the demand side (*e.g.* changes in private consumption or exports) or on the supply side (*e.g.* changes in commodity prices or technological innovations). They can affect the economy either on a temporary or permanent basis.

Direct fiscal costs (gross, net) of a financial crisis The direct gross costs are the fiscal outlays in support of the financial sector that increase the level of public debt. They encompass, for example, recapitalisation, purchase of troubled bank assets, pay-out to depositors, liquidity support, payment when guarantees are called and subsidies. The direct net costs are the direct gross cost net of recovery payments, such as through the sale of acquired assets or returns on assets. Thus, the net direct fiscal costs reflect the permanent increase in public debt.

Discretionary fiscal policy Change in the *budget balance* and in its components under the control of government. It is usually measured as the residual of the change in the balance after the exclusion of the budgetary impact of *automatic stabilisers*.

Economic and Financial Committee (EFC) Formerly the Monetary Committee, the EFC is a Committee of the Council of the European Union set up by Article 134 TFEU. Its main task is to prepare and discuss (ECOFIN) Council decisions with regard to economic and financial matters.

Economic Policy Committee (EPC) Group of senior government officials whose main task is to prepare discussions of the (ECOFIN) Council on structural policies. It plays an important role in the preparation of the *Broad Economic Policy Guidelines*, and it is active on policies related to labour markets, methods to calculate cyclically adjusted budget balances and ageing populations.

ESA2010 / ESA95 European accounting standards for the reporting of economic data by the Member States to the EU. As of September 2014, ESA2010 has replaced the earlier ESA95 standard with regard to the comparison and analysis of national public finance data.

European Financial Stability Facility is a company owned by euro area Member States created following the decisions taken in May 2010 by the Council. The EFSF is able to issue bonds guaranteed by euro area Member States to lend to euro area Member States in difficulty, subject to conditions negotiated with the European Commission in liaison with the European Central Bank and International Monetary Fund and to be approved by the Eurogroup.

European semester is the yearly cycle of economic policy coordination which takes place over the first six months of the year. The European Commission undertakes a detailed analysis of Member States' programmes of economic and structural policies and the European Council and the Council of Ministers provide policy advice before Member States finalise their draft budgets.

Excessive Deficit Procedure (EDP) A procedure according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in order to assess and/or correct the risk of an excessive deficit in each Member State. Its application has been further clarified in the *Stability and Growth Pact*. See also *stability programmes* and *Stability and Growth Pact*.

Expenditure rules A subset of *fiscal rules* that target (a subset of) public expenditure.

Fiscal consolidation An improvement in the *budget balance* through measures of *discretionary fiscal policy*, either specified by the amount of the improvement or the period over which the improvement continues.

Fiscal governance Comprises all arrangements, procedures, rules and institutions that underlie the conduct of budgetary policies of general government. The terms fiscal governance and fiscal frameworks are used interchangeably in the document.

(Numerical) Fiscal rule A permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance, such as the government budget deficit, borrowing, debt, or a major component thereof. See also *expenditure rules*.

General government As used by the EU in its process of budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure*, the general government sector covers national government, regional and local government, as well as social security funds. Public enterprises are excluded, as are transfers to and from the EU Budget.

Government contingent liabilities Obligations for the government that are subject to the realisation of specific uncertain and discrete future events. For instance, the guarantees granted by governments to the debt of private corporations bonds issued by enterprise are contingent liabilities, since the government obligation to pay depends on the inability of the original debtor to honour its own obligations.

Government implicit liabilities Government obligations that are very likely to arise in the future in spite of the absence of backing contracts or law. The government may have a potential future obligation as a result of legitimate expectations generated by past practice or as a result of the pressure by interest groups. Most implicit liabilities are contingent, i.e., depend upon the occurrence of uncertain future events.

Indirect taxation Taxes that are levied during the production stage, and not on the income and property arising from economic production processes. Prominent examples of indirect taxation are the value-added tax (VAT), excise duties, import levies, energy and other environmental taxes.

Interest burden *General government* interest payments on public debt as a share of GDP.

Maastricht reference values for public debt and deficits Respectively, a 60 % *general government* debt-to-GDP ratio and a 3 % *general government* deficit-to-GDP ratio. Those thresholds are defined in a protocol to the Maastricht Treaty on European Union. See also *Excessive Deficit Procedure*.

Medium-term budgetary framework An institutional fiscal device that lets policy-makers extend the horizon for fiscal policy making beyond the annual budgetary calendar (typically three-five years). Targets can be adjusted under medium-term budgetary frameworks (MTBF) either on an annual basis (flexible frameworks) or only at the end of the MTBF horizon (fixed frameworks).

Medium-term budgetary objective (MTO) According to the reformed *Stability and Growth Pact*, *stability programmes* and *convergence programmes* present a *medium-term objective* for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risks to the sustainability of public finances, and is defined in structural terms (see *structural balance*).

Minimum benchmarks The lowest value of the structural budget balance that provides a safety margin against the risk of breaching the *Maastricht reference value for the deficit* during normal cyclical fluctuations. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks. They are a lower bound for the *medium-term budgetary objectives (MTO)*.

One-off and temporary measures Government transactions having a transitory budgetary effect that does not lead to a sustained change in the budgetary position. See also *structural balance*.

Output gap The difference between actual output and estimated potential output at any particular point in time. See also *cyclical component of budget balance*.

Pension fund A legal entity set up to accumulate, manage and administer pension assets. See also *private pension scheme*.

Potential GDP The level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate. See also *output gap*.

Primary budget balance The *budget balance* net of interest payments on *general government* debt.

Primary structural budget balance The *structural budget balance* net of interest payments.

Private pension schemes The insurance contract specifies a schedule of contribution in exchange of which benefits will be paid when the members reach a specific retirement age. The transactions are between the individual and the insurance provider and they are not recorded as government revenues or government expenditure and, therefore, do not have an impact on government surplus or deficit.

Pro-cyclical fiscal policy A *fiscal stance* which amplifies the economic cycle by increasing the *structural primary deficit* during an economic upturn, or by decreasing it in a downturn. A neutral fiscal policy keeps the *cyclically-adjusted budget balance* unchanged over the economic cycle but lets the *automatic stabilisers* work.

Public debt Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by public institutions in the Member State, except that part of the debt which is owed to other public institutions in the same Member State.

Public investment The component of total public expenditure through which governments increase and improve the stock of capital employed in the production of the goods and services they provide.

Significant deviation A sizeable deviation from the MTO or the adjustment path towards it. If it is established ex post, it will trigger a Significant Deviation Procedure.

Significant Deviation Procedure (SDP) A procedure according to which the Commission and the Council enforce compliance with the preventive arm in order to correct a significant deviation from the MTO or the adjustment path towards it. The procedure aims at encouraging timely correction of budgetary slippage, reducing the risk for a Member State to run an excessive deficit. Its application has been further clarified in the Stability and Growth Pact.

“Snow-ball” effect The self-reinforcing effect of public debt accumulation or decumulation arising from a positive or negative differential between the interest rate paid on public debt and the growth rate of the national economy.

Sovereign bond spread The difference between risk premiums imposed by financial markets on sovereign bonds for different states. Higher risk premiums can largely stem from (i) the debt service ratio, also reflecting the countries’ ability to raise their taxes for a given level of GDP, (ii) the fiscal track record, (iii) expected future deficits, and (iv) the degree of risk aversion.

Stability and Growth Pact (SGP) Approved in 1997 and reformed in 2005 and 2011, the SGP clarifies the provisions of the Maastricht Treaty regarding the surveillance of Member State budgetary policies and the monitoring of budget deficits during the third phase of EMU. The SGP consists of two Council Regulations setting out legally binding provisions to be followed by the European Institutions and the Member States and two Resolutions of the European Council in Amsterdam (June 1997). See also *Excessive Deficit Procedure*.

Stability programmes Medium-term budgetary strategies presented by those Member States that have already adopted the euro. They are updated annually, in accordance with the provisions of the *Stability and Growth Pact*. See also *Convergence programmes*.

Stock-flow adjustment The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between the net borrowing (flow) and the variation in the stock of gross debt. It includes the accumulation of financial assets, changes in the value of debt denominated in foreign currency, and remaining statistical adjustments.

Structural budget balance The actual *budget balance* net of the *cyclical component and one-off and other temporary measures*. The structural balance gives a measure of the underlying trend in the budget balance. See also *primary structural budget balance*.

Sustainability A combination of budget deficits and debt that ensure that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

Tax elasticity A parameter measuring the relative change in tax revenues with respect to a relative change in GDP. The tax elasticity is an input to the *budgetary sensitivity*.

Top down fiscal effort A quantification of the fiscal impact of government policy, obtained by looking at the overall change in the structural balance. This may differ from the *bottom up* measure due to the incomplete coverage of the latter, second-order economic effects or different assumptions about the non-policy change assumption.

LIST OF ABBREVIATIONS

MEMBER STATES

BE	Belgium
BG	Bulgaria
CZ	Czech Republic
DK	Denmark
DE	Germany
EE	Estonia
EL	Greece
ES	Spain
FR	France
IE	Ireland
IT	Italy
HR	Croatia
CY	Cyprus
LV	Latvia
LT	Lithuania
LU	Luxembourg
HU	Hungary
MT	Malta
NL	The Netherlands
AT	Austria
PL	Poland
PT	Portugal
RO	Romania
SI	Slovenia
SK	Slovakia
FI	Finland
SE	Sweden
UK	United Kingdom
EA	Euro area
EU	European Union

OTHER

AGS	Annual Growth Survey
AMECO	Macro-economic database of the European Commission
CAPB	Cyclically-adjusted primary balance
COFOG	Classification of the functions of government
DBP	Draft Budgetary Plan
DG ECFIN	Directorate-General Economic and Financial Affairs
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
EDP	Excessive deficit procedure
EFC	Economic and Financial Committee
EFSF	European Financial Stability Facility
EMU	Economic and Monetary Union
EPC	Economic Policy Committee
ESA(2010)	European System of National and Regional Accounts
ESM	European Stability Mechanism
GDP	Gross domestic product
LTC	Long-term budgetary cost of ageing
MTBF	Medium-term budgetary framework
MTO	Medium-term budgetary objective
OECD	Organisation for Economic Co-operation and Development
pp	Percentage points
SCPs	Stability and convergence programmes
SFA	Stock Flow Adjustments
SGP	Stability and Growth Pact
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance in the Economic and Monetary Union

EUROPEAN ECONOMY INSTITUTIONAL SERIES

European Economy Institutional series can be accessed and downloaded free of charge from the following address:

[https://ec.europa.eu/info/publications/economic-and-financial-affairs-publications_en?field_eurovoc_taxonomy_target_id_selective=All&field_core_nal_countries_tid_selective=All&field_core_date_published_value\[value\]\[year\]=All&field_core_tags_tid_i18n=22621](https://ec.europa.eu/info/publications/economic-and-financial-affairs-publications_en?field_eurovoc_taxonomy_target_id_selective=All&field_core_nal_countries_tid_selective=All&field_core_date_published_value[value][year]=All&field_core_tags_tid_i18n=22621).

Titles published before July 2015 can be accessed and downloaded free of charge from:

- http://ec.europa.eu/economy_finance/publications/european_economy/index_en.htm
(the main reports, e.g. Economic Forecasts)
- http://ec.europa.eu/economy_finance/publications/occasional_paper/index_en.htm
(the Occasional Papers)
- http://ec.europa.eu/economy_finance/publications/qr_euro_area/index_en.htm
(the Quarterly Reports on the Euro Area)

GETTING IN TOUCH WITH THE EU

In person

All over the European Union there are hundreds of Europe Direct Information Centres. You can find the address of the centre nearest you at: <http://europa.eu/contact>.

On the phone or by e-mail

Europe Direct is a service that answers your questions about the European Union. You can contact this service:

- by freephone: 00 800 6 7 8 9 10 11 (certain operators may charge for these calls),
- at the following standard number: +32 22999696 or
- by electronic mail via: <http://europa.eu/contact>.

FINDING INFORMATION ABOUT THE EU

Online

Information about the European Union in all the official languages of the EU is available on the Europa website at: <http://europa.eu>.

EU Publications

You can download or order free and priced EU publications from EU Bookshop at: <http://publications.europa.eu/bookshop>. Multiple copies of free publications may be obtained by contacting Europe Direct or your local information centre (see <http://europa.eu/contact>).

EU law and related documents

For access to legal information from the EU, including all EU law since 1951 in all the official language versions, go to EUR-Lex at: <http://eur-lex.europa.eu>.

Open data from the EU

The EU Open Data Portal (<http://data.europa.eu/euodp/en/data>) provides access to datasets from the EU. Data can be downloaded and reused for free, both for commercial and non-commercial purposes.

