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Vade mecum on the Stability and Growth Pact

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The authorship of the vade mecum does not reflect the contribution of the many colleagues in the Directorate-General of Economic and Financial Affairs of the European Commission on whose work it is based. The various aspects of the Stability and Growth Pact and the provisions for its implementation have been developed and described in a series of policy briefs and notes on which this manual draws heavily, in some cases word for word. Due to the large number of people who have contributed to this body of work over the last fifteen years it has not been possible to name them all. Nevertheless their contribution has been central. As always, any errors of interpretation or understanding remain the authors' responsibility. This vade mecum is not a legal text and is not intended in any way to bind the European Commission in its application of the Stability and Growth Pact or any related legislation.

Comments on the vade mecum would be gratefully received and should be sent, by mail or e-mail to the authors:

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0. INTRODUCTION

This vade mecum is a manual prepared by DG ECFIN presenting the procedures and methodologies for implementing the Stability and Growth Pact (SGP). It is primarily aimed at individuals and organisations working on public finance issues in European Union (EU) countries, but should be of interest to anyone wanting an in-depth understanding of the SGP's functioning or searching for details on its implementation. It is not, however, aimed at those seeking a general overview of the Pact. Instead, a more immediately accessible guide, *Building a Strengthened Fiscal Framework in the European Union: A Guide to the Stability and Growth Pact* is also being published at the same time and is available here: http://ec.europa.eu/economy_finance/publications/occasional_paper/index_en.htm.

This manual describes the implementation of the SGP at the time of writing, step by step, and should not be considered to be definitive, in two ways. First, the electronic copy will be updated when there are changes or clarifications to the way the Pact is implemented. For example, when the legislative package known as the Two Pack, which is currently going through the European legislative process, becomes law, the vade mecum will be updated to reflect the changes to the surveillance procedures. Second, in many parts the vade mecum presents an agreed or historic interpretation of a feature of the SGP which might be adapted as the need arises.

The SGP is defined by the Treaty on the Functioning of the European Union (TFEU) and implemented through secondary legislation in the form of Regulation (EC) 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies and Regulation (EC) 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure. Further details for its implementation are published in a Code of Conduct([1]), entitled "Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence programmes". The SGP has evolved over the years through amendments to the legislation. Box 0.1 presents a short overview of its history.

This vade mecum covers the preventive and the corrective arms of the Pact in two different parts, with each part starting with a background section providing an overview. The background sections present the legal bases and the rationale behind each arm, followed by the monitoring provisions.

Part 1, on the preventive arm of the Pact, contains four sections. Section1.1 gives the background and is followed by section 1.2 which 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 are undertaken and section 1.4 describes the conditions and procedures linked to the introduction of sanctions for euro area Member States.

Part 2, 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 that are taken after a recommendation under Article 126(7) is issued. Section 2.4 and 2.5 explain the procedures that follow a non-effective action decision under Article 126(8). Section 2.6 explains how an EDP is abrogated.

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

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

The secondary legislation governing the SGP was adopted in 1997. The first amendment of the SGP occurred in 2005 and involved changes to both the preventive and the corrective arms. The main aim was to take economic circumstances and country-specific characteristics better into account, as the first years of operation of the SGP highlighted the shortcomings of a uniform nominal approach, particularly in times of economic uncertainty. In the preventive arm, the horizontal requirement of achieving a budgetary position of close to balance or surplus in nominal terms was replaced by a country-specific objective set in structural terms, based on Member States' gross government debt level and on the magnitude of the fiscal challenge posed by population ageing. In the corrective arm, the possibility of extending the EDP deadline for countries that had taken effective action but were faced with unexpected adverse economic circumstances with a significant impact on its public finances – a principle labelled as conditional compliance – was introduced. For both arms, the legislation indicated the size of the correction to be made for countries either not at their MTO or with an excessive deficit. Furthermore, in order to enhance the growth-oriented dimension of the Pact, the adjustment path to the MTO could take the short-term budgetary costs of structural reforms into account, provided that they would improve long-term public finance sustainability, either through a direct impact (such as for pension reforms) or by raising the growth potential.

Following the onset of the economic and financial crisis in 2008, the SGP was amended for a second time in 2011, as part of a package of legislation known as the Six Pack. A schematic overview of these reforms is presented in tables 0.1 and 0.2. The package amended both Regulations and added a system of graduated enforcement mechanisms (financial sanctions), to address the weaknesses in the surveillance framework that the crisis exposed. In particular, the changes strengthened the preventive arm of the Pact to ensure that good economic times were used to pursue policies leading to healthy public finances. In particular, 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 which could lead to sanctions, The corrective arm was changed by putting the debt requirement on an equal footing to the deficit one, in light of the damaging impact of sovereign sustainability concerns during the crisis.

The sanctions for the euro area Member States were strengthened, frontloaded and extended to the preventive arm. Complementing the SGP Regulations, the Six Pack also contained a Directive on requirements for budgetary frameworks in the Member States, imposing certain requirements on domestic budgetary arrangements, procedures, rules and institutions, to better ensure national budgetary positions are in line with the EU fiscal framework. In March 2012, twenty-five EU countries[1] signed the intergovernmental Treaty on Stability Coordination and Governance in the Economic and Monetary Union (TSCG), which contains the fiscal compact. Ensuring that the national processes are able to fulfil European obligations and that national policy is in line with the requirements of the SGP is at the heart of the TSCG and its main features are also set out in Table 0.1.

[1] All except the Czech Republic and the United Kingdom.

Table 0.1: **Changes to the preventive arm of the SGP from the 2011 reforms (*bold) and the specifics of the Treaty on Stability, Coordination and Governance (TSCG)**

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

Table 0.2: **Changes to the corrective arm of the SGP from the 2011 reforms (*bold)**

	Specification	Adjustment path	Enforcement specification
Objective: Correct gross policy errors	Sets limits: • Deficit of 3% of GDP • Debt of 60% of GDP or sufficiently diminishing ***Definition of sufficiently diminishing = respect of debt reduction benchmark** ***Debt reduction benchmark = reduction of 5% per year on average over 3 years of the gap to 60% taking the cycle into account or respect in the next two years.** ***Transition period for MS in EDP at entry into force (Dec 2011) for three years after the correction of the deficit.**	Minimum annual improvement of at least 0.5% of GDP as a benchmark in structural terms Possible extension of the deadline: • If effective action has been taken and unexpected adverse economic events with major unfavourable consequences for government finances against the economic forecasts underlying the recommendation • *** In case of severe economic downturn in the euro area or in the Union as a whole provided that this does not endanger fiscal sustainability in the medium-term**	***Early and gradual sanction system to be activated at each stage of the EDP procedure**

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

	Regulation on enhanced monitoring	Regulation on enhanced surveillance
Applies to	All euro area Member States, with special provisions for those in EDP	Euro area Member States experiencing severe difficulties with regard to its financial stability (defined by a Commission decision), receiving financial assistance on a precautionary basis or subject to a full macroeconomic programme
Main provisions	Member States provide draft budgetary plans to the Commission by 15 October.	Enhanced surveillance means countries must adopt measures to address their weaknesses, in cooperation with the Commission (and ECB).
	Commission issues an opinion on the plan to inform the national debate. Commission can request a revised draft if serious breach of European rules.	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.
	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.	Council can recommend (on a Commission recommendation) that a country adopt a precautionary programme or prepare a draft programme.
	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.	Streamlining of reporting requirements for countries under programme.
		Special provisions for the post-programme period, when countries remain under enhanced surveillance until 75% of funds repaid.

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

1.1. LEGAL BASIS, RATIONALE AND MONITORING

The objective of the preventive arm of the SGP is to promote sound budgetary positions and to ensure the sustainability of public finances of the Member States. Compliance with the preventive arm should avoid the occurrence of excessive budget deficits. The preventive arm is based primarily on Article 121 TFEU (multilateral surveillance) and its operation is set out in Council Regulation (EC) No 1466/97 and its subsequent amendments.

At the core of the preventive arm is the country-specific medium-term objective (MTO) which corresponds to the structural budgetary position that Member States should achieve, and maintain, over the cycle, in order to ensure sustainable public finances and provide room to safeguard respect of the Treaty reference values for the deficit and the debt at times of negative output gaps. The SGP sets out certain rules that Member States have to respect when drawing up their multi-annual budgetary plans, in order to progressively reach their MTO. These rules have recently been strengthened by the introduction of an expenditure benchmark which sets an upper limit for the net growth of government expenditure (i.e. the growth of government expenditure which is not financed by corresponding changes to revenues), thereby providing more operational guidance and by the possibility of sanctions in the case of a repeated failure to comply with the requirements of the preventive arm.

In order to enable the Commission and the Council to assess budgetary plans against these rules, regular reporting obligations apply to all Member States as part of a multilateral surveillance framework. Member States provide information on their plans for the coming years (in the form of Stability or Convergence Programmes – see section 1.3.1). The surveillance is centred on the European Semester, which corresponds to the first six months of every calendar year. It is during this time-period that compliance with the preventive arm is assessed – in time to allow Member States to take the conclusions of the EU Semester, in the form of country-specific recommendations, on board when preparing their budgets for the next year during the second half of the year.

1.1.1. Legal basis of the preventive arm

Article 121 of the Treaty on the Functioning of the European Union (see Box 1.1) is the Treaty basis of the preventive arm of the SGP. This Article states that the Member States shall regard their economic policies as a matter of common concern and that they shall coordinate them. It establishes a multilateral surveillance procedure based on the broad economic policy guidelines – discussed at European Council level and adopted by the Council – which set out the overall context against which Member States' policies will be assessed. The Council monitors the developments in the Member States, based on reports prepared by the Commission. Economic policies that are assessed as not being consistent with the broad guidelines or which risk jeopardising the proper functioning of Economic and Monetary Union can lead to a Commission warning for the Member State in question, while the Council can also address a recommendation, based on a recommendation from the Commission. Detailed rules governing this multilateral procedure may be adopted by the European Parliament and the Council, using ordinary legislative procedure. It is on the basis of the ability to adopt these detailed rules – Article 121(6) TFEU – that the secondary legislation implementing the preventive arm of the Pact has been adopted.

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

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.

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. ([2])

([2]) 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.

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).

Regulation 1466/97 states that "The exact nature of the information [to be provided by Member States under the preventive arm of the Pact] shall be set out in a harmonised framework established by the Commission in cooperation with the Member States". This harmonised framework is the Code of Conduct ([3]) entitled "Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence programmes". It presents the specifications that have been agreed in terms of how the requirements of the Regulations should be interpreted by the Member States and the Commission.

The Amsterdam European Council Resolution on the SGP of 17 June 1997 ([4]) 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 technically form part of the preventive arm of the Pact, but do not contain additional operational requirements.

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

Finally, as part of the November 2011 legislative package that amended the Stability and Growth Pact, the Council adopted *Directive 2011/85/EU of 8 November 2011* on requirements for budgetary frameworks of the Member States, which should be transferred into national law by the end of 2013 ([5]). This Directive sets out minimum requirements on the national budgetary decision making that the Member States must adhere to, and as such affects the implementation of the preventive arm of the Pact

([3]) http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf
([4]) Official Journal C 236 of 02.08.1997
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:1997:236:0001:0002:EN:PDF
([5]) By virtue of Protocol 15 on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland annexed to the TFEU, chapter IV on of the budgetary frameworks directive which concerns numerical fiscal rules does not apply to the United Kingdom.

Box 1.3: **Key features of the TSCG**

The TSCG commits the signatories to greater budgetary and economic coordination, and signals their commitments to abiding by the rules of the SGP. The provisions on the budgetary side are contained in the fiscal compact, which covers articles 3 to 8 of the TSCG. The fiscal compact (see annex 8) aims to complement fiscal surveillance under the SGP 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 no risks to sustainability, their MTO should not be below a structural balance of -1% of GDP, otherwise a tighter constraint of -0.5% of GDP applies. A temporary deviation from the medium-term objective or the adjustment path towards it will only be possible in exceptional circumstances, as defined in the SGP. In case of significant observed deviations from the MTO or the adjustment path towards it – the SGP concept – correction mechanisms will be triggered automatically at the national level.

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

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

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

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

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

in terms of the process and the content of the budgetary plans that Member States must prepare and present. ([6])

The objective of ensuring that national decision-making processes are set up with a view to achieving budgetary positions in line with EU requirements is also at the heart of the Intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), signed by all EU countries except the Czech Republic and the UK in March 2012 and which entered into force on 1 January 2013. Euro area signatory countries[7] have committed to integrating the core principles of the preventive arm of the SGP straight into their national legal framework though provisions of binding force and permanent character, preferably constitutional or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary process. These provisions will include a national correction mechanism supervised by an independent monitoring body to ensure compliance with the budgetary targets in the preventive arm of the Pact. Although it is intergovernmental, the TSCG foresees the

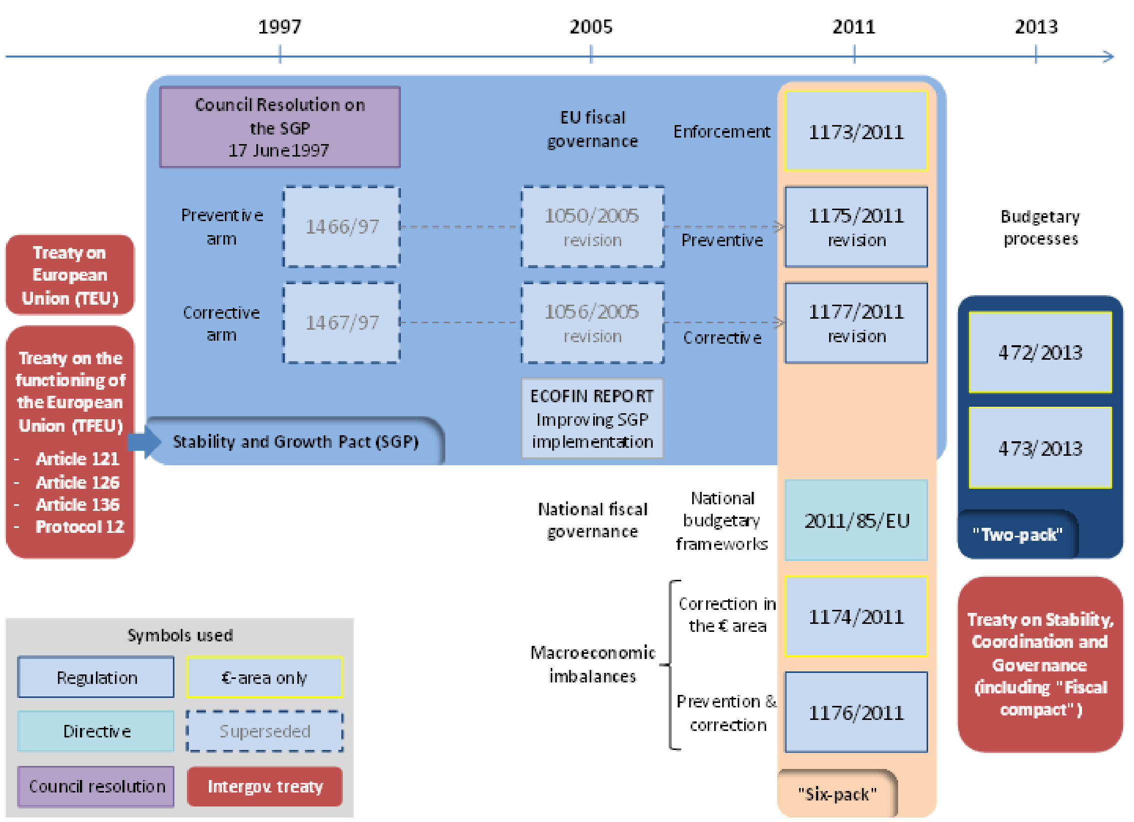
([6]) The Interim Progress Report on the implementation of this directive is available here: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0761:FIN:EN:PDF, the accompanying Staff Working Document here: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SWD:2012:0433:FIN:EN:PDF

[7] Non-euro area signatories may also declare themselves bound by certain provisions of the TSCG. On 1 April 2013, for example, Denmark and Romania declared to be bound by Titles III, IV and V. The progress of the ratification process can be followed here: http://www.consilium.europa.eu/policies/agreements/search-the-agreements-database?command=details&id=&lang=en&aid=2012008&doclang=EN%22

incorporation of its provisions in European law on the basis of an assessment of the experience with its implementation by 1 January 2018. Box 1.3 provides an overview of its key features.

Graph1.1 presents a graphical overview of how the various pieces of legislation and their amendments over time, fit together.

Graph 1.1: **A guide to the SGP over the years**



1.1.2. Rationale behind the preventive arm

The fundamental idea behind Article 121 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. As a result, Article 121 has served as the legal basis of two procedures: the preventive arm of the SGP which deals with budgetary policy and the macroeconomic imbalances procedure.

The preventive arm of the SGP endeavours to ensure that policy setting 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 countries that are not at their MTO, an appropriate adjustment path towards the MTO should be defined and adhered to. By setting a budgetary target in structural terms – i.e. cyclically adjusted and net of one-off and temporary measures – 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 debt levels, the sustainability challenge posed by ageing and the dynamics of the automatic stabilisers into account. Section 1.2 presents a detailed guide to the MTO.

Since the 2011 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 the first pillar, is complemented by an analysis of the growth rate of an expenditure aggregate net of discretionary revenue measures, which constitutes the second pillar. Compliance with the preventive arm therefore consists of an overall assessment which takes both these elements into account.

The expenditure aggregate is comprised of overall government expenditure net of interest payments, spending on Union programmes paid for by Union funds and cyclical elements of unemployment benefits, while investment spending is smoothed over four years. The underlying rationale is to focus on government spending (i) that is independent of cyclical conditions (by netting out the cyclical elements of unemployment spending), (ii) within the government's control (by netting out interest expenditures) and (iii) has to be paid for out of tax revenues (by netting out spending on programmes directly funded by the European Union) (iv) without penalising peaks investment (by averaging investment over a number of years). Countries at their MTO must ensure that government expenditure grows at most in line with a reference medium-term rate of potential GDP growth – which is the rate at which revenues should increase over time – unless any excess growth is matched by discretionary revenue measures yielding additional revenues (see Box 1.4). Countries on the adjustment path to the MTO must ensure that their expenditure grows at a rate below this reference medium-term rate of potential GDP growth – with the difference in growth rates being known as the convergence margin – again unless the excess growth is matched by additional funds from discretionary revenue measures.

It should be stressed that the expenditure benchmark does not limit or in any way determine the size of government spending. All that is required is that any expenditure growth is funded by equivalent discretionary revenue measures.

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

Box 1.4: **The reference medium-term rate of potential GDP growth**

The reference 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 countries at or above their MTOs) or to a tightening of the budgetary position (for countries 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 is calculated by a 10-year average of potential GDP, comprising 5 years of outturn data, the year underway and four years of forward-looking data. It is updated at the same time as the MTOs. The Commission forecasts are used to compute the figures, with forecasts based on the methodology set out by the Output Gap Working Group being used for the years beyond the scope of the Commission forecasts. The reference rates that will be applicable for the ex post and in-year assessments in 2013 are given in annex 3.

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

Member State at MTO	Member State not at MTO
Net expenditure growth in line with the reference potential growth rate	Net expenditure growth in line with a rate below the reference potential growth rate
% government expenditure in GDP constant in the absence of revenue measures	% government expenditure in 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. Monitoring under the preventive arm – the role of the SCPs

In accordance with Regulation No 1466/97, Member States are required to submit annually Stability or Convergence Programmes (SCPs) to the Council and the Commission in April. Countries in the euro area submit Stability Programmes while countries outside the euro area submit Convergence Programmes. Detailed requirements on what should be included in the SCPs are jointly agreed by the Member States in conjunction with the Commission in Council committees, and recorded in the Code of Conduct.

The function of the SCPs is to allow the Commission and the Council to assess compliance with the MTO and the adjustment path towards it, including compliance with the expenditure benchmark. In order for this to be possible, a range of economic and budgetary data should be included, as set out in the tables annexed to the Code of Conduct and replicated in annex 3. The forecasts contained in the SCPs must be prepared in a sound and realistic manner, consistent with the requirements of Council Directive 2011/85/EU on the requirements for budgetary frameworks of the Member States, and should therefore be based on the most likely macro-fiscal scenario or a more prudent one. Both the macroeconomic and budgetary forecasts must be compared with the most recent Commission forecasts (the winter forecasts) and, if appropriate, those of other independent bodies. With the entry into force of the Two Pack, euro area Member States will have to base their SCPs on forecasts produced or endorsed by an independent body.

The Member States' plans must be consistent with the broad economic policy guidelines adopted at European Council level and with the National Reform Programmes that Member States submit at the same time and which focus on structural policies and employment measures.

The main economic and fiscal data presented in the SCPs should cover the year that just ended (known as year t-1), the current year (year t) as well as at least the following 3 years (year t+1 to t+3). It is compliance with the MTO or the adjustment path towards it that forms the cornerstone of the budgetary analysis and this is assessed on an ex ante basis for the year that is underway and 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, the Council shall invite the Member State concerned to adjust its programme and re-submit it when it issues its country-specific recommendations.

The ex post assessment of the implementation of the SCPs centres on whether there have been significant divergences from the MTO or the adjustment path towards it in the preceding year or the last two years. If a significant deviation from the adjustment path towards the MTO is observed, the Commission will address a warning to the Member States concerned, under Article 121(4) of the Treaty. This then leads to the examination of the situation by the Council accompanied by a recommendation for appropriate policy measures (on a recommendation by the Commission). If a decision on non-effective action follows, the euro area Member States in question can be asked to lodge an interest-bearing deposit – of 0.2% of GDP as a rule – which can then be turned into a non-interesting deposit if an Excessive Deficit Procedure is opened.

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

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

The European Semester is launched each year by the presentation of the Annual Growth Survey (AGS) ([8]) by the Commission at the end of the previous year. In this document, the Commission presents its assessment of the economic situation in the European Union and sets out its priorities for the coming year in terms of the economic and budgetary policies and reforms to boost growth and employment. The start of the European Semester is therefore marked by the discussion of the AGS in the Council which then reports on its conclusions to the March European Council. The March European Council subsequently issues general, policy guidance for Member States.

Following the adoption of the European Council conclusions, Member States submit their Stability and Convergence Programmes (SCPs) in April. These outline the public finance plans of Member States and are submitted alongside the National Reform Programmes (NRPs) which outline economic plans and report on progress made over the past year. Upon examining the SCPs and NRPs the Commission presents an assessment of each country's plans in the form of a Staff Working Document and proposes an opinion for each Member State on its Stability or Convergence Programme in the form of a country-specific recommendation as well as country-specific recommendations in other relevant policy areas. A Staff Working Document and country-specific recommendations are also prepared for the euro area as a whole.

([8]) 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 opinion on its Stability or Convergence Programme, in the form of country-specific recommendations. These are delivered jointly with the recommendations on the National Reform Programmes adopted by the EPSCO Council. The recommendations for each Member State and for the euro area as a whole are discussed jointly and are endorsed by the European Council in June. In line with Article 2-ab of Regulation 1466/97 the Council is "expected to, as a rule, follow the recommendations and proposals of the Commission or explain its position publicly". This is known as the "comply or explain" principle and is not just confined to the European Semester. It creates a strong presumption in favour of the Council's opinion following the Commission's line, unless any divergence from it can be backed up by strong public explanations.

1.2. 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 1466/97 which sets out how MTOs are to be defined, while the other Articles elaborate the role of MTOs.

1.2.1. Defining the Medium-Term Objective

The MTOs are defined in structural terms, meaning that they represent cyclically-adjusted general government budget position, net of one-off and other temporary measures (see Box 1.5 on the calculation of the structural balance).

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

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

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

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

The Regulation further specifies that euro area and ERM2 Member States must have an MTO that corresponds to at least -1% of GDP. Euro area countries that are signatories to the Treaty on Stability Coordination and Governance in the Economic and Monetary Union (TSCG) have further committed themselves to MTOs of at least -0.5% of GDP, unless their debt ratio is significantly below 60% of GDP and the risks in terms of long-term sustainability of public finances are low. In those cases, the lower limit for the balance is set at -1% of GDP. The MTOs are updated every three years, thereby taking into account the latest economic and budgetary costs of ageing as published in the triennial Ageing Report. The MTO can also be updated more often, if Member States implement structural reforms with a major impact on the sustainability of the public finances. In case of major pension reforms, updated long-term budgetary projections need to be peer reviewed and endorsed by the Economic Policy Committee (Ageing Working Group) before updating the Ageing Report figures for MTO calculations.

1.2.1.1. Calculating an appropriate Medium-Term Objective

The MTOs presented by the Member States in their SCPs need to comply with the requirements set out in section 1.2.1. The compliance with these requirements is assessed by the Commission according to the methodology described in the Code of Conduct, which yields country-specific lower bounds for the MTOs. The Member States then present their MTOs in the forthcoming SCPs by adopting either an MTO in line with these lower bounds or a more ambitious one, if circumstances are deemed to warrant it.

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

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

Box 1.5: **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) – ε*OG, where BAL stands for general government balance, Y for GDP and the cyclical component ε*OG for the product of the semi-elasticity of the budget balance to the cycle, ε, and the output gap, OG. The OG is estimated following a methodology based on production functions.

The semi-elasticity of the budget balance to the cycle ε is computed as the difference between the semi-elasticity of revenue and the semi-elasticity of expenditure. It measures the change in the budget balance (expressed as a percentage of GDP) with respect to the output gap. Semi-elasticities allow the computation of the deficit/surplus ratio that would prevail if the economy were at potential.

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 change in the output gap. They are then aggregated using the share of each in total revenue as weights, so as to derive the elasticity of total revenue level (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 this value and then multiplying it by the size of total public spending as a share of GDP give the semi-elasticity of expenditure. 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 and are to be updated every 6 years to reflect changes in the government receipts and spending. The weights currently in use are presented in annex 11.

The average budgetary semi-elasticity used for the EU is 0.53 and ranges from 0.30 to 0.61 across Member States, suggesting significant differences in the cyclicality of the budget balance. The semi-elasticity for revenue is close to zero, ranging from -0.13 to 0.04, since revenue is almost as cyclical as GDP, except for non-tax revenue. Therefore, the revenue-to-GDP ratio moves only slowly with the business cycle, especially in Member States where non-tax revenue is relatively low. In contrast, the semi-elasticity for expenditure ranges from -0.38 to -0.67, which accounts for the larger part of the disparity in the budgetary semi-elasticity across Member States. Its value broadly corresponds to the share of total expenditures in GDP. This mirrors the fact that the elasticity of the expenditure-to-GDP ratio to the output gap is close to minus one. Indeed, the cyclical effect of the denominator (GDP) largely dominates the low cyclicality of expenditure in level, given the small share of unemployment-related expenditure in total expenditure.

Once the cyclically adjusted balance has been estimated, one-off and temporary measures are removed in order to obtain an estimate of the structural balance, i.e. the underlying budgetary positions.

The calculation of the minimum benchmark is based on the representative output gap (ROG), multiplied by a semi-elasticity ε:

$$MTO^{MB} = -3 - \varepsilon * ROG$$

Annex 2 – 2012 Update of the Minimum Benchmarks – considers their calculation in more detail.

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

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

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 for 2010-2060 as calculated by the Ageing Working Group (AWG) ([9])

Component (ii) represents the budgetary adjustment that would cover a fraction of the present value of the projected increase in age-related expenditure, where α = 33%.([10])

Component (iii) represents a supplementary debt-reduction effort, specific to countries with general government gross debt above 60% of GDP. It follows a continuous linear function, 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%. ([11])

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

(iii) 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 MTOEuro/ERM2 component, where MTOEuro/ERM2 =-1% of GDP.

The three bounds on the MTO are then combined to yield country specific greatest lower bound for the MTO, which corresponds to the lowest MTO that fulfils all the criteria defined above:

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

If the MTO yielded by these formulae corresponds to an unrealistically tight primary balance, a Member States can ask to benefit from an exception clause.([12])

When Member States present their MTOs in their SCPs, they can adopt the MTO yielded by the formula above or they may present more ambitious MTOs than implied by the formula above 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 MTOs, regular methodological discussions take place in the Economic and Financial Committee.

Regulation 1466/97 requires that the MTOs be revised every 3 years and that they may be further revised in the event of the implementation of a structural reform with a major impact on the sustainability of the public finances. The revision of the MTOs is set so as to come after the publication of the Ageing Report

([9]) The Ageing Working Group in cooperation with the European Commission (DG ECFIN) revises their projections of GDP growth every three years. The most recent projections were released in autumn 2012. See 2012 Ageing Report (Underlying Assumptions and Projection Methodologies), http://ec.europa.eu/economy_finance/publications/european_economy/2011/ee4_en.htm.

([10]) Prior to 2012 Member States could also select an alternative methodology that is based on the fraction of the costs of ageing that corresponds to the pre-financing of the age-related expenditure However, as no Member States activated it, the methodology set out in the text applies to all countries.

([11]) Supplementary debt effort = 0.024*debt –1.24.

([12]) As there is no precedent of a country maintaining a primary surplus significantly above 5.5% of GDP for a sustained period of time, countries have not been required to comply with an minimum value for their MTO implying a primary surplus significantly over this limit. Instead, an exception has been made, which allowed the concerned Member State to present a MTO corresponding to a primary surplus of 5.5% of GDP, as long as the -1% of GDP lower bound for euro area and ERM2 countries is adhered to.

which occurs every 3 years and provides up-to-date data on the ageing challenge facing the Member States.

In addition to the 3 yearly revisions of the minimum MTOs, countries undertaking structural reforms with a major impact on the sustainability of the public finances can also have their minimum MTOs revised on a case-by-case basis, in agreement with the Commission. In particular, the introduction of major pension reforms having an impact on long term fiscal sustainability could result in a minimum MTO revision. ([13])

1.2.2. The role of the Medium-Term Objective in the processes under the preventive arm of the Pact

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

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

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

(ii) second, compliance with the MTO requirement is also judged by looking at whether the evolution of net expenditure is in line with the expenditure benchmark.

This is the case both on an ex ante and an ex post basis, and is of particular importance on an ex post basis, where the assessment can lead to sanctions for euro area Member States. Section 1.3 discusses how both the assessments of the SCPs are undertaken.

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

The role of the SCPs is to elaborate and communicate the Member States' medium-term budgetary plans. Following the submission of the SCPs, the Commission and Council examine the programmes. The Commission publishes a Staff Working Document which it transmits to the Council along with a recommendation for the Council Opinion. The Council then adopts an Opinion on the programmes, in the form of country-specific recommendations. These are issued together with the Council recommendations on employment and economic policies which are based on the Member States' National Reform Programmes, so that an overall assessment is undertaken.

The Commission assesses the content of the programmes in terms of compliance with the information requirements, compliance of the Member State's policies with the previous year's country-specific recommendation and the forward-looking economic policy guidelines endorsed by the European Council, and an assessment of the public finance figures in terms of the requirements to attain or be on the adjustment path towards the MTO. Compliance with the information requirements and coherence with the economic policy guidelines are based on a qualitative assessment and is discussed in section 1.3.1.

([13]) In case of major pension reforms, updated long-term budgetary projections need to be peer reviewed and endorsed by the EPC (AWG) before replacing Ageing Report figures for MTO calculations.

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;
- an *in-year* assessment of the plans for year t, on the basis of in-year estimates;
- an *ex ante* evaluation of the budgetary plans for t+1, 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.

The ex post assessment may lead to a Council decision of a significant deviation from the adjustment path to the MTO which may then lead to the imposition of sanctions for euro area Member States; the in-year and ex ante assessments aim to inform the policy debate and provide guidance to countries. It is therefore useful to consider these assessments as two separate exercises with different purposes. Section 1.3.2 describes how the ex ante assessment is undertaken while section 1.3.3 considers the ex post assessment.

Both the ex ante and the ex post assessments evaluate compliance with the MTO requirement 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 the ex post assessment concludes that a significant deviation from the adjustment path to the MTO has occurred, the Commission will address a warning under Article 121(4) of the Treaty to the Member State concerned, in order to prevent the occurrence of an excessive deficit or if its budgetary policy risks jeopardising the proper functioning of EMU. 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 the imposition of sanctions for euro area countries, in the form of an interest-bearing deposit are possible. Section 1.4 provides more details.

1.3.1. Assessing compliance with the reporting requirements

The content of the SCPs must comply with the requirements of Regulation 1466/97 and the Code of Conduct ([14]), which sets out guidelines on their content and format. Member States are expected to follow these guidelines, and to justify any departure from them. This standardisation of the format and content of the programmes should ensure equality of treatment. The tables to be supplied are replicated in Annex 3 of this vade mecum. Overall, the SCPs should include data to enable a quantitative assessment of the Member State's outturns and plans, which conform to the requirements set out in the legislation, and should show that government policy is in line with the policy guidelines agreed on at European level.

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 variables relative to government finances as well as their relevant components, and a description and quantification of the envisaged budgetary strategy. As the key requirement to show prudent and sustainable budgetary policy over the medium-term under the preventive arm is the MTO, Member States should also present the MTO that they will aim to either achieve or make progress towards achieving. They are also expected to provide the following information: budgetary targets for the general government balance in relation to the MTO, and the projected path for the general government debt ratio; an update of the fiscal plans for the year of submission of the programme, based on the April notification of fiscal data ([15]) , including a description

([14]) http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf
([15]) The requirement to report public finance data to the Commission in the context of the EDP stems from Council Regulation EC(479) 2009 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2009R0479:20100819:EN:PDF

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. Box 1.6 discusses the no-policy change assumption. Structural reforms should be specifically analysed when they are flagged as contributing to the achievement of the objectives of the programme. The budget balances should be broken down by subsector of general government.

The status of the programme and of the measures, with respect to national budgetary procedures and parliamentary processes, should be made explicit. After a new government has taken office, Member States are expected to show continuity with respect to the budgetary targets endorsed by the Council on the basis of the previous programmes. Stability and Convergence Programmes should show how developments have compared with the budgetary targets in the previous programme or update; when significant deviations occur, the update should mention whether measures have been taken to rectify the situation, and should provide information on these measures.

Quality of the data:

The figures presented must be based on realistic and cautious macroeconomic forecasts, with the main assumptions underlying them being presented in the programme – the precise requirement of Regulation 1466/97 is that they be based on the most likely macro-fiscal scenario or on a more prudent scenario. The macroeconomic and budgetary forecasts should be compared to the most recent Commission forecasts and, if appropriate, those of other independent bodies. Significant differences between the chosen macro-fiscal scenario and the Commission's forecast should be explained in detail, especially if the level or growth of external assumptions departs significantly from the Commission's forecasts. In order to enhance cross-country comparability and to ensure quality the concepts used should be in line with the standards established at European level, in particular in the context of the European system of accounts (ESA) as set out in Council Regulation 2223/96 of 25 June 1996. Moreover, the forecasts presented should be prepared in a manner that is consistent with the requirements of *Council Directive 2011/85/EU of the 8th of November 2011 on requirements for budgetary frameworks of the Member States.*

Consistency of policy measures:

In addition to these data, the programmes 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. The SCPs should also provide a description of measures taken or envisaged to improve the quality of the public finances and could include further information on existing and envisaged national budgetary rules (expenditure rules, etc.) as well as on other institutional features relative to public finances. 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.

1.3.2. The ex ante assessments of the SCPs

The ex ante analysis aims to deliver an overall assessment about whether the Member State is compliant with the requirements of the preventive arm, in terms of being at or on the adjustment path towards the MTO. This contains three key elements:

- Is the MTO appropriate? This is discussed in section 1.3.2.1
- Is the Member State at the MTO or on the adjustment path towards the MTO, by considering the position of the structural balance? This is discussed in section 1.3.2.2.

Box 1.6: The 'no policy change' assumption used in the Commission forecasts

The 'no-policy change' assumption, which is used by the Commission services for forecasting, implies that only measures that have been clearly specified and committed to by governments are taken into account. Each Member State should appropriately define a scenario at unchanged policies and make public the involved assumptions, methodologies and relevant parameters, 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 the budget has not yet been adopted, the scenario at unchanged policies will imply the extrapolation of revenue and expenditure trends and the inclusion of measures that are known in sufficient detail.

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

During the assessment of the SCPs, the plausibility of the unchanged policy scenario will be considered.

- Are expenditure plans in line with the expenditure benchmark? This is discussed in section 1.3.2.3.

Section 1.3.2.4 describes how these three elements are put together.

1.3.2.1. Is the MTO appropriate?

The assessment then determines whether the MTO is in line with the minimum MTOs emerging from the formula. In accordance with Article 121(3) of the Treaty and Articles 5(2) and 9(2) of Regulation 1466/97, if the Council considers that the MTO presented in a Stability and 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

Achieving the MTO is assessed by seeing whether the Member State is planning to have a structural balance at least as tight as its MTO for the in-year and ex ante assessments. If the Member State is not planning to be or was not at the MTO in one of the years under consideration, it should nevertheless be on an appropriate adjustment path to its MTO. The planned adjustment path should be set out in the SCP and defined by an annual improvement in the structural balance, respecting the SGP rules for the preventive arm.

Regulation 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 ([16]) , a faster adjustment path, i.e. above 0.5% of GDP is expected.
- All Member States should undertake a greater adjustment in good economic times, while the effort may be more limited in bad economic times.
- 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 1466/97 does not, therefore, specify an appropriate annual adjustment Member States outside the euro area and ERM2 with debt below 60% of GDP and at most moderate risks of debt sustainability. While these countries should pursue greater improvements in good and in bad times, the size of the adjustment is not defined. Nevertheless, the default position is for the Commission to consider an annual improvement of 0.5% per year.

In addition, countries undertaking major structural reforms which have direct long-term positive budgetary effects, including raising potential sustainable growth, may temporarily deviate from the adjustment path to the MTO as long as they are expected to return to the MTO within the programme period and as long as an appropriate safety margin with respect to the 3% deficit rule is respected (as defined by the minimum benchmark). This condition is also applicable to countries that start off at their MTOs, but temporarily deviate from them in order to implement structural reforms, provided they return to the MTO within the programme period and as long as they respect the minimum benchmark. In terms of the specification of structural reforms, particular mention is made to pension reforms, and the mechanism for assessing their impact to both the deviation from the MTO and its adjustment path is set out below.

Taking into account the implementation of structural reforms

In order to enhance the Stability and Growth Pact's support of economic growth, structural reforms can be taken into account when defining the adjustment path to the medium-term objective for countries that have not yet reached this objective. A temporary deviation from this objective may be allowed for countries that have already reached it, with the clear understanding that:

(i) a safety margin to ensure the respect of the 3% of GDP reference value for the deficit is guaranteed. This safety margin will be assessed for each Member State by reference to compliance with the minimum benchmark.

(ii) the budgetary position is expected to return to the MTO within the period covered by the Stability or Convergence Programme. For this purpose, the period under consideration will be limited to – at most – the four years following the year in which the programme was presented.

Only major reforms that have direct long-term positive budgetary effects (including those that raise potential growth) and therefore a verifiable positive impact on the long-term sustainability of public finances will be taken into account.

([16]) In this context, risks to overall debt sustainability are measured in terms of the S1 indicator. This indicator 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, and hence is the most appropriate to reflect the medium-term fiscal sustainability challenge. For more information see the 2012 Fiscal Sustainability Report http://ec.europa.eu/economy_finance/publications/european_economy/2012/fiscal-sustainability-report_en.htm

The Regulation and the Code of Conduct pay special attention to pension reforms introducing a multi-pillar system that includes a mandatory fully-funded pillar, as they have a direct deficit-increasing impact in the short term. This impact stems from the fact that revenue, which used to be recorded as government revenue, is diverted to a pension fund, which is fully-funded and classified in a sector other than general government, and that some pensions and other social benefits, which used to be government expenditure, will be, after the reform, paid by the pension scheme. In this specific case, any allowed deviation from the adjustment path to the MTO or the objective itself will reflect the amount of the direct incremental impact of the reform on the general government balance, provided that an appropriate safety margin with respect to the deficit reference value – as defined by the minimum benchmark – is preserved.

The direct impact of a pension reform that involves a transfer of pension obligations to or from general government is made up of two elements: i) the social contributions or other revenue collected by the pension scheme taking over the pension obligations and which is meant to cover for these obligations and ii) the pension and other social benefits paid by this pension scheme in connection to the obligations transferred. The direct impact of such pension reforms does not include interest expenditure that is linked to the higher accumulation of debt due to forgone social contributions or other revenues.

In line with Article 16(2) of the Two-pack Regulation on enhanced monitoring, the Commission shall report on the possibilities offered by the Union's existing fiscal framework to balance productive public investment needs with fiscal discipline objectives in the preventive arm of the SGP, while complying with it fully by 31 July 2013. When this occurs, the vade mecum will be updated.

In case a temporary deviation from the medium-term objective or the adjustment path towards it is allowed, it will be specified in the country-specific recommendations on the Stability/Convergence Programme.

Considering the impact of adverse economic events

In addition to major structural reforms with a positive impact on the public finances, Regulation 1466/97 also allows for a departure from the adjustment path to the MTO is the case of adverse economic events. Articles 5 and 9 state:

"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."

In these cases, the conditions on the adjustment path to the MTO do not apply for the budgetary years concerned.

Regulation 1467/97 on the corrective arm, qualifies a severe economic downturn as a period of "negative annual GDP volume growth rate or from an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential", where this accumulated loss of output is to be reflected in the output gap. Although the two definitions are not the same, this can act as a guide as to how a period of severe economic downturn might be judged in terms of judging the adjustment path to the MTO.

1.3.2.3. 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 in the ex ante analysis.

Applying the expenditure benchmark

According to Regulation 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. This means that the Member State should remain at its MTO.

For Member States that have not attained their MTO:

- Annual expenditure growth should not exceed a rate 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 an appropriate adjustment towards the MTO
- Any discretionary reductions of government revenue items must be matched by either expenditure reductions or by discretionary increases in other revenue items or both.

Whether at the MTO or not, the Regulation specifies that excess expenditure growth over the medium-term reference is not counted as a breach of the benchmark if it is fully offset by revenue increases mandated by law. This provision is applicable to situations where Member States have revenue sources that are linked by law to certain expenditure items, so that when expenditure increases, the revenues automatically also increase to fund the higher expenditure. An example of this is the case where health/medical expenses are funded by a hypothecated tax which is automatically adjusted to cover these expenses when they increase (or decrease). Use of this exception should be based on detailed understanding and explanation of why a particular feature of a Member State's tax and spending system complies with this situation. Graph 1.2 in 1.1.2 summarises how the expenditure benchmark is applied.

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

Computing the expenditure benchmark

In order to apply the expenditure benchmark, the following figures need to be derived:

1) the medium-term rate of potential GDP growth
2) 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

Box 1.7: **The medium-term reference rate of potential growth and the convergence margins**

Expenditure benchmark reference rates of medium-term potential growth – 2012 vintage

	Medium-term reference rate of potential growth (%)	Convergence margin	Lower reference rate (%)
BE	1.2	1.0	0.2
BG	2.1	1.4	0.7
CZ	1.6	1.2	0.5
DK	1.1	0.9	0.2
DE	1.1	1.2	-0.1
EE	2.1	1.3	0.9
IE	0.6	1.4	-0.7
EL	-1.6	1.2	-2.8
ES	0.2	1.3	-1.1
FR	1.1	0.9	0.2
IT	0.0	1.1	-1.1
CY	0.2	1.2	-1.0
LV	1.4	1.5	0.0
LT	1.9	1.5	0.4
LU	1.1	1.2	-0.1
HU	0.1	1.1	-1.0
MT	1.8	1.3	0.6
NL	0.9	1.0	-0.1
AT	1.1	1.0	0.1
PL	3.7	1.3	2.5
PT	-0.1	1.2	-1.2
RO	2.5	1.4	1.1
SI	0.5	1.0	-0.5
SK	2.9	1.4	1.5
FI	0.8	0.9	-0.1
SE	1.9	1.0	1.0
UK	1.2	1.1	0.0

Countries at their MTO need to ensure that their net expenditure growth is at or below the medium-term reference rate of potential growth, while those that have not attained their MTO will need to limit it to the lower reference rate.

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

The reference medium-term rate of potential GDP growth is calculated over a 10-year horizon, incorporating 5 years of outturn data (t–5 to t–1), the outturn/forecast for the year in question (t), and 4 years of forecast data (t+1 to t+4). The actual figures are computed by the Commission, using Eurostat data, the Commission forecasts and forecasts made on the basis of the Output Gap Working Group agreed methodology. The medium-term rate of potential GDP growth is re-calculated every 3 years, at the same time as the MTOs are updated. The updated medium-term reference rates to be used for the ex ante assessment of the 2014 budgetary plans in the 2013 SCPs are presented in Box 1.7, while those for the in-year assessment of the 2013 budgetary plans in the 2013 are presented in annex 4.

The convergence margin is country-specific and is subtracted from the reference medium-term growth rate of potential GDP growth to obtain the reference rate for countries not at their MTO. This is set so that the lower increase in net expenditure relative to GDP is consistent with a tightening of the budget balance of 0.5% of GDP, when GDP grows at its potential rate. It is calculated based on the assumption that any decrease in the share of public expenditure not financed by additional revenue measures in the economy (which would occur if net expenditure grows more slowly than GDP) would then translate into an exactly proportional improvement of the structural balance (the coefficient being equal to the share of public expenditure in GDP times the shortfall of expenditure growth). The size of the convergence margin therefore depends on the size of the public 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 is recalculated every 3 years at the same time as the MTOs are updated, according to the methodology set out in Box 1.8.

In order to ensure that there is stability in policy setting, the same value of the medium-term reference rate of potential GDP growth and of the convergence margin should be used when assessing policy choices for any year t, for the ex ante assessment that occurred following the submission of the t-1 SCPs, the in-year assessment that occurs with the submission of the year t SCPs and for the ex post assessment that takes place in year t+1.

While potential GDP is measured in real terms, expenditure plans are typically set in nominal terms. Therefore, to convert the expenditure figures into real terms to allow for the comparison, a measure of inflation, the GDP deflator, is used. This choice in favour of the GDP deflator derives from two criteria. First, it has to be conceptually sound from an economic point of view so that the implementation of the expenditure benchmark is coherent with the aims of the preventive arm of the Pact. Since the benchmark itself is based on a potential rate of GDP growth, the decision to align growth rates of both net expenditure and revenues (where growth rate is proxied by GDP growth) and to use 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. When the Commission will assess Member States plans for years t to t+3 in the SCP of year t, the average GDP deflator from the Commission's Spring and in Autumn of the preceding year will be used.

Compliance with the expenditure benchmark requires that planned expenditure growth be compared with the appropriate benchmark growth rate (see Box 1.9).

Concluding the assessment on the expenditure benchmark

The conclusion of the assessment of compliance with the expenditure benchmark will state whether the information given in the SCP is consistent with net expenditure growth being at or below the appropriate benchmark level. In addition, the plans will be assessed against the Commission's forecasts, as well as the Member States' SCP forecasts.

Box 1.8: Calculating the convergence margin

This convergence margin is country-specific and serves to support the 0.5% of GDP annual improvement of the structural balance towards the MTO which is required under the preventive arm of the SGP.

The size of the convergence margin depends on the share of government primary expenditure in GDP (PG, in % of GDP): indeed, the higher this ratio PG, the larger the improvement of the balance (in terms of GDP) when the growth rate of net public spending (numerator) is limited below GDP (denominator) growth. The lower rate LR is thus derived from the benchmark reference rate RR (both expressed in percentage points) by the deduction of this convergence margin, as follows:

$$LR = RR - 50/PG.$$

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

Budget and year of ex ante assessment	Year of ex post assessment (during European Semester)	Deflators to use
2012	2013	Average of 2011 Spring and Autumn Commission forecasts
2013	2014	Average of 2012 Spring and Autumn Commission forecasts
2014	2015	Average of 2013 Spring and Autumn Commission forecasts
2015	2016	Average of 2014 Spring and Autumn Commission forecasts
T	t+1	Average of t-1 Spring and Autumn Commission forecasts

1.3.2.4. The ex ante analysis: an overall assessment

The overall ex ante assessment of the SCPs uses the structural balance as a reference and include an analysis of compliance with the expenditure benchmark. It acts as an assessment of the overall compliance of the Member State with the requirements of the preventive arm.

This assessment concludes that the Member State is compliant with the preventive arm if the assessment of compliance with both the change in the structural balance and the expenditure benchmark are positive. In the case where only one of these two conditions is met, judgement will be exercised.

1.3.3. The ex post analysis under the preventive arm

This section considers how compliance with the preventive arm on an ex post basis is judged. The ex post analysis is based on Articles 6 and 10 of Regulation 1466/97. These state that:

"As part of multilateral surveillance in accordance with Article 121(3) of TFEU, the Council and the Commission shall monitor the implementation of [stability]/[convergence] programmes, on the basis of

Box 1.9: **How is the net expenditure growth rate for year t computed on an ex ante basis?**

	Variable **(for t unless otherwise mentioned, in nominal terms)**	**Source**
+	Government expenditure aggregate	SCPs (table 2a, row 7)
–	Interest expenditure	SCPs (table 2a, row 9)
–	Government expenditure on EU programmes which is fully matched by EU funds revenue	SCPs (table 2c, row 1)
–	Gross fixed capital formation (for year t)	SCPS (table 2a, row 21)
+	Gross fixed capital formation averaged over t-3 to t	SCPs (table 2a, row 21) + ESTAT for past data
–	Cyclical unemployment benefit expenditure	SCPs (table 2c, row 2)
=	*modified* expenditure aggregate G_t	

Step 1 – The first step in the calculation requires the computation of *modified* expenditure aggregates for years t[1] and t-1, referred to as E_t and E_{t-1}, respectively.

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

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

Step 4 – The net expenditure growth is then deflated to be given in real terms, using the annual percentage change of the GDP deflator.

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

[1] Year t is the year of budgetary execution being assessed (either ex ante or ex post).

information provided by Member States and of assessments by the Commission and the Economic and Financial Committee, in particular with a view to identifying actual or expected significant divergences of the budgetary position from the medium-term budgetary objective, or from the appropriate path towards it."

The concept of "significant divergences" – or deviations – is key in the ex post assessments under the preventive arm of the Pact. Although deviations from the adjustment path are also considered under the ex ante analysis, on an ex post basis an observed significant deviation can lead to a Commission warning to the Member State in question which in turn starts the course of events that can lead to an interest-bearing deposit being required.

1.3.3.1. The legal requirements for the ex post analysis in the preventive arm

Regulation 1466/97 specifies how a deviation from the MTO or the adjustment path towards it will be measured; Articles 6(3) and 10(3) define when such a deviation is to be judged to be significant. The Regulation states that: "A deviation from the medium-term objective or from the appropriate path towards it shall be evaluated on the basis of an overall assessment with the structural balance as the reference, including an analysis of the expenditure net of discretionary revenue measures […].

The assessment of whether the deviation is significant includes the following criteria:

a) for a Member State that has not reached the medium-term budgetary objective, when assessing the change in the structural balance, whether the deviation is at least 0.5% of GDP in a single year or at least 0.25% of GDP on average per year in 2 consecutive years;
b) when assessing expenditure developments net of discretionary revenue measures, whether the deviation has a total impact on the government balance of at least 0.5% of GDP in a single year or cumulatively in 2 consecutive years."

The Articles further specify that:

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

The ex post analysis is therefore different depending on whether a country has reached its MTO, has overachieved its MTO, is on the adjustment path to the MTO or has departed from its MTO in t-1. Both the structural balance and the expenditure benchmark are taken into account in all cases except where the country has overachieved the MTO, when compliance with the expenditure benchmark is not taken into account on an ex post basis.

The starting point for the ex post analysis is whether the country in question achieved its MTO in t-1, based on the structural balance. The following conclusions are then possible:

(i) The Member State overachieved its MTO in t-1.
(ii) The Member State exactly achieved its MTO in t-1
(iii) The Member State did not achieve its MTO in t-1

For Member States that were not at their MTO in t-1, the ex post assessment will consider whether they were on an appropriate adjustment path to the MTO in that year. This will be based on a comparison of the change in the structural balance with the appropriate adjustment path and an assessment of compliance with the expenditure benchmark.

The actual structural adjustment is then compared with the appropriate adjustment path, and the assessment of a significant deviation looks at whether the difference between the two was equal to or more than 0.5% of GDP in the previous year, or resulted in an average deviation of 0.25% over two years. It is also for this reason that it is important to note any in-year deviation from the appropriate

Box 1.10: **Data sources for the computation of net expenditure growth rate for year t-1 on an ex post basis**

	Variable (for t-1 unless otherwise mentioned, in nominal terms)	Source
+	Government expenditure aggregate	SCPs (table 2a, row 7) for year t-1, AMECO for year t-2
–	Interest expenditure	SCPs (table 2a, row 9) for year t-1, AMECO for year t-2
–	Government expenditure on EU programmes which is fully matched by EU funds revenue	SCPs (table 2c, row 1) for year t-1, and the previous year's SCPs for t-2
–	Gross fixed capital formation (for year t-1)	SCPs (table 2a, row 21) for year t-1, AMECO for year t-2
+	Gross fixed capital formation averaged over t-4 to t-1	SCPs (table 2a, row 21) for the t-1 outturn and AMECO for all past data
-	Cyclical unemployment benefit expenditure	SCPs (table 2c, row 2, for year t-1
=	*modified* expenditure aggregate G_{t-1}	

adjustment path even if it is not significant – even a small deviation can contribute to an assessment of significant deviation in the following year by entering into the average.

The ex post analysis: Assessing the expenditure benchmark

As long as a country has not achieved its MTO, it needs to show compliance with the expenditure benchmark on an ex post basis. For those that achieved their MTO, non-compliance with the requirements of the expenditure benchmark will not lead to a conclusion of a significant deviation, as long as the MTO is maintained. However, compliance or non-compliance with the expenditure benchmark will provide guidance as to a possible future departure from the MTO.

Member States that overachieved 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. However, in that context, the ex post assessment of these countries will consider whether revenue windfalls are in part responsible for the overachievement of the MTO. Judging whether windfall revenues are responsible for the overachievement of the MTO involves the consideration of the observed revenue elasticity.

It is important to note that, as a significant deviation is judged both for one year, but also cumulatively over two, countries at their MTO could find that their non-respect of the expenditure benchmark contributes to an assessment of significant deviation in the next year, if they then depart from their MTO.

The values used for the reference rate for potential output, the deflator and the convergence margin for the ex post assessment of year t-1, will be those that were used to assess the SCP submitted in year t-2 to ensure stability of the guidance given across the years. In Spring 2013 and 2014, the respective ex post assessments of the 2012 and 2013 outcomes will be based on the reference rate for potential output and the convergence margin calculated in 2011. These figures are given in annex 4. 2015 is the first year when the ex post assessment will use the new reference rate and convergence margin set at the end of 2012 – these will apply for the ex post assessments of the 2014, 2015 and 2016 budgets which will take place under the 2015, 2016 and 2017 European Semesters respectively.

Unlike the reference rate and the convergence margin, the deflators are set annually. Table 1.1 explains how they are determined and annex 4 presents the figures to be used for the assessments of the 2012 outcomes and 2013 plans in the 2013 SCPs.

In order to show compliance with the expenditure benchmark, the appropriate expenditure aggregate is calculated from the information submitted in the SCPs. While the methodology was set out in Box 1.9, Box 1.10 sets out the data to be used for the ex post assessment.

The resulting net expenditure growth is then compared to the appropriate benchmark. If the net expenditure growth is below the benchmark, then the Member State complied with the expenditure benchmark.

If the net expenditure growth is higher than the benchmark, then the difference in the growth rates needs to be applied to the modified expenditure aggregate for the year t-2 and expressed as a share of GDP to see whether the difference corresponds to a significant deviation, in the following way:

Deviation = (Gt-2 x (difference in growth rate in percentage points))/Yt-1

If the resulting deviation is greater than 0.5% of GDP, it will be judged to be significant. If it is lower than 0.5% it will be added to any deviation from the previous year, to see whether the cumulative deviation is greater than 0.5% over two years.

Countries that are signatories of the TSCG have committed themselves to implement correction mechanisms at the national levels which will operate in the event of significant observed deviations – as defined in Regulation 1466/97 Articles 6(3) and 10(3) – from the agreed MTO or fiscal paths set in the calendar of convergence towards the MTO to be published by the Commission (see Box 1.12). Moreover, according to this Treaty, the European Commission has been tasked with proposing "common principles" underlying the design of the requested corrective mechanisms. The Commission's Communication on Common principles for the national correction mechanisms was published on 20 June 2012 and the principles it presents are given in Box 1.11.

Box 1.11: Common principles for the national correction mechanisms

The common principles presented in the Commission's Communication of 20/6/2012 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 concerned Member State under the Stability and Growth Pact.

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

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

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

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

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

(Continued on the next page)

Box (continued)

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.

1.3.3.2. The ex post analysis: an overall assessment

The overall ex post assessment of the SCPs uses the structural balance as a reference and includes an analysis of compliance with the expenditure benchmark. It acts as an assessment of the overall compliance of the Member State with the requirements of the preventive arm and, for countries not at their MTO, aims to identify any significant deviations from the MTO or the adjustment path towards it. This assessment of whether the deviation is significant will be based on an assessment of both the structural balance and the expenditure benchmark and in many cases judgement will be exercised due to the number of factors to be considered.

It follows from the Code of Conduct that the overall assessment will conclude on the significance of a deviation where:

- 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([17]); 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 indicates limited compliance with respect to the other condition.

If a euro area Member State is judged to have significantly deviated from the adjustment path to the MTO, the introduction of sanctions is possible. This is considered in section 1.4.

1.4. 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 address a warning under Article 121(4) of the Treaty to the Member State in question, in order to prevent the occurrence of an excessive deficit or if its budgetary policy risks jeopardising the proper functioning of EMU. A Council decision on a significant deviation from the adjustment path to the MTO then acts as the starting point of the procedure that may result in the imposition of sanctions, in the form of an interest-bearing deposit for euro area Member States. Graph1.3 sets out the various steps to be followed, while annex 7 provides details on the voting modalities.

([17]) In judging a deviation over two years, it is the difference between the appropriate change in the structural balance and that realised that is considered each year. In this way, a deviation from the level of the structural balance in year 1 does not have to be made up in year 2.

Box 1.12: **The calendar for convergence for signatories of the TSCG**

In order to comply with Art. 3(1)b of the TSCG, which states that *"[...]The Contracting Parties shall ensure rapid convergence towards their respective MTO. The time-frame for such convergence will be proposed by the European Commission taking into consideration country-specific sustainability risks.[...]"* countries that are signatories of the TSCG have agreed to submit a convergence path towards their MTO in their 2013 SCPs. The Commission will then evaluate these plans, based on the requirements of the SCPs and amend them if required.

The adjustment paths will be assessed against the following considerations:

(1) Member States in EDP should follow a structural adjustment path which will guarantee compliance with the fiscal effort as recommended by the Council in the EDP recommendations, until the excessive deficit is corrected;

(2) Member States that have not yet reached their MTO should implement a fiscal effort of *"0.5% of GDP as a benchmark"*. This benchmark fiscal effort would be modulated according to the following criteria:

- *Country-specific sustainability risks:* the Commission will examine whether the annual improvement of the structural effort is higher than 0.5% of GDP for Member States faced with a debt level exceeding 60% of GDP or with pronounced risks of overall debt sustainability.

- *Economic situation:* the assessment will take into account "*whether a higher adjustment effort is made in economic good times, whereas the effort might be more limited in economic bad times.*"

Compliance with the debt benchmark: the assessment will look at whether the plans are consistent with compliance with the debt benchmark, both during the transition period once a country leaves EDP (if applicable) and after.

Within one month of the adoption of a Commission warning, the Council will examine the situation in the Member State and adopt a recommendation under Article 121(4) on necessary policy measures. This recommendation will be based on a Commission recommendation and will set a deadline of no more than 5 months for the Member State to address the deviation. If the Commission judged that the situation was particularly serious and warranted urgent action, the deadline can be reduced to 3 months. On a proposal from the Commission, the Council shall make the recommendations it issues public. Following the Council recommendation, the Member State in question must report to the Council on action taken, within the deadline set. If the Member State fails to take appropriate action within this deadline, the Commission will immediately recommend that the Council adopt, by qualified majority, a decision establishing that no effective action has been taken. The Commission may recommend that the Council adopt a revised recommendation under 121(4) on the appropriate measures to be taken.

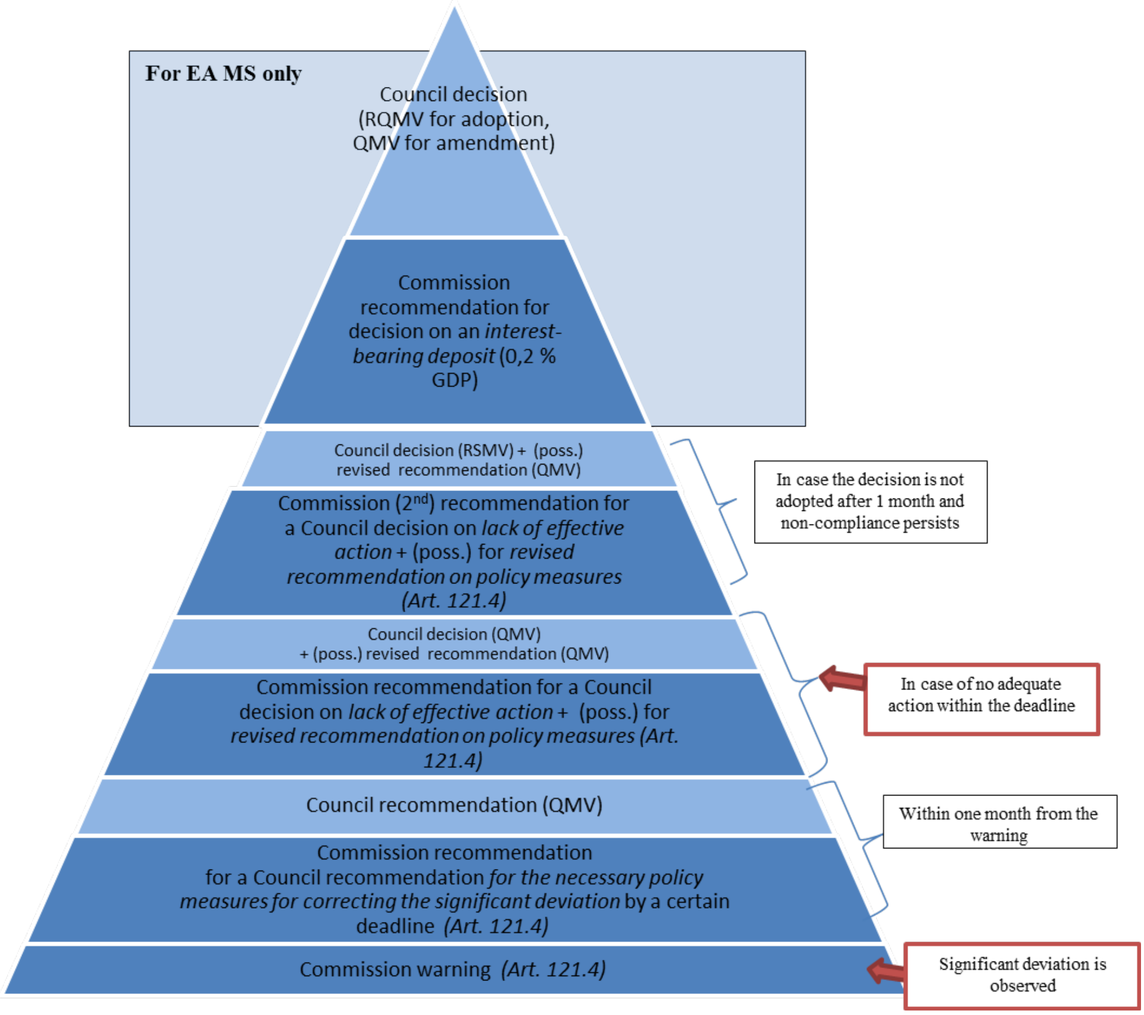
If the Council does not adopt the decision on no effective action and the lack of appropriate action by the Member State in question persists, the Commission will make a new recommendation for a Council decision on no effective action within one month of the previous one. This new recommendation will be subject to reverse simple majority voting in the Council, meaning that a majority of Member States should 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 decisions establishing a lack of effective action, 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 should submit a report to the European Council on all decisions taken.

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

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

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

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



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

2. THE CORRECTIVE ARM OF THE STABILITY AND GROWTH PACT

2.1. LEGAL BASIS, RATIONALE AND MONITORING

Compliance with the preventive arm of the Pact should ensure that countries are kept out of the Excessive Deficit Procedure (EDP) under all except the most unusual of circumstances. The EDP should therefore not 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 mistakes are rectified.

The objective of the corrective arm of the Stability and Growth Pact is to deal with gross errors of budgetary policy. The corrective arm implements the EDP. A peculiarity of the EDP is that the word "deficit" is used both specifically to refer to a situation of excessive general government borrowing, but also a government debt above 60% of GDP and 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 the 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 of the Pact implements the steps set out under Article 126 TFEU and Protocol 12 on the excessive deficit procedure. Its operation is set out in Council Regulation (EC) No 1467/97 and its subsequent amendments, and details relating to its implementation are further specified in the Code of Conduct.

The corrective arm contains a series of steps that are taken when Member States deficits or debt levels are judged to be excessive. In the case of the deficit, this corresponds to value greater than 3% of GDP. In the case of the debt, it corresponds to a debt in excess of 60% of GDP and insufficiently diminishing towards that level. In both cases, a breach of the numerical requirements does not necessarily mean that the Member State in question will be placed under an EDP, as other factors may be taken into account. Nevertheless, the presumption is that unless the breach is small or the circumstances under which it occurred are very unusual, exceeding the numerical values sets the Member State on a road where it should comply with Council recommendations to correct its budgetary excess or face increasing constraints and – in the case of euro area Member States and/or countries in receipt of the Cohesion fund – the possibility of sanctions.

The launch of an EDP brings with it Council recommendations for the Member State in question to take action and correct its deficit within the timeframe specified. The Commission and the Council monitor the action taken and either conclude that the country in question is taking effective action or they step up the EDP. Stepping up involves stricter requirements and stronger sanctions for euro area Member States. While the launch of an EDP can lead to a euro area Member State being required to lodge a non-interest bearing deposit, by the time the EDP has been stepped up to the final stages, euro area Member States will be required to pay a sanction that includes a part which is proportional to their excessive deficit for every year that they do not comply with the notice that they have been served.

2.1.1. Legal basis

The Treaty basis of the corrective arm of the SGP is Article 126 of TFEU and Protocol 12 to the Treaty. Article 126 (see Box 2.1) specifies that Member States will avoid excessive deficits and defines budgetary discipline in terms of compliance with specific bounds for government deficits and debt

Box 2.1: **Article 126 of TFEU**

1. Member States shall avoid excessive government deficits.

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

(a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, unless:
— either the ratio has declined substantially and continuously and reached a level that comes close to the reference value,
— or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

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

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

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

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

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

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

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

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

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

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

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

(Continued on the next page)

Box (continued)

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

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

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

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

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

levels. ([18]) It sets out the steps to be taken when one or more of the conditions are not complied with. The actual reference values against which the deficit and debt criteria are based, however, are defined in Protocol 12 (see Box 2.2).

Article 126 includes the provision of sanctions under step 126(11) for euro area Member States. However, since the entry into force of the Six Pack, sanctions are now applicable much earlier in the EDP, with the first financial sanctions for euro area countries being possible from the decision launching the EDP. This is based on Article 136 which applies only to euro area Member States (see Box 1.2). Article 136 specifies that in order to ensure the proper functioning of Economic and Monetary Union (EMU) the Council shall set out specific economic policy guidelines for the euro area and shall strengthen the coordination and surveillance of their budgetary discipline, in accordance with the relevant procedures from Articles 121 (multilateral surveillance) and 126 (the corrective arm of the SGP).

([18]) Protocol 15on 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 aoid an excessive deficit". As a reusult the reference values on the deficit and the debt are not directly binding on the United Kingdom.

Box 2.2: Protocol 12 on the Excessive Deficit Procedure

THE HIGH CONTRACTING PARTIES,

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

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

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

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

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

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

The actual implementation of the corrective arm of the Pact is governed by secondary legislation, based on Article 126(14) TFEU, in the form of Regulation (EC) 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, as amended by Regulation (EC) 1056/2005 of 27 June 2005 and Council Regulation (EU) 1177/2011 of the European Parliament and of the Council of 16 November 2011. ([19])

In addition, Regulation (EU) 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area added a system of effective preventive and graduated enforcement mechanisms to the Pact. This second Regulation complements the sanctions envisaged under Article 126(11) by an earlier and graduated system on the basis of Article 136 for euro area countries only.

([19]) The consolidated text is available here:
http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1467:20111213:EN:PDF.

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

The Code of Conduct foreseen under Regulation 1466/97 on the preventive arm has been complemented by specification on the implementation of the Excessive Deficits Procedure.

In addition, the Amsterdam European Council resolution on the SGP of 17 June 1997 ([20]) 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 technically form part of the corrective arm of the Pact, but do not contribute additional operational requirements.

Finally Council Regulation (EC) No 479/2009 of 25 May 2009 ([21]) 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.

Box 1.3 presented an overview of the key features of the TSCG. While this is an intergovernmental Treaty and is therefore outside the scope of European Union, the Contracting Parties have nevertheless committed themselves to voting as though reverse qualified majority voting (RQMV – see annex 7) applied on all votes concerning euro area Member States for deficit EDPs and to presenting economic partnership programmes when subject to an EDP.

2.1.2. Rationale behind the corrective arm of the SGP

The corrective arm of the SGP is centred on the fact that Member States should avoid excessive deficit and debt levels. It implements a step by step EDP which starts when a country is judged to have exceeded the 3% of GDP Treaty reference value for its general government deficit, or if its debt level exceeds 60% of GDP and is insufficiently diminishing towards that level.

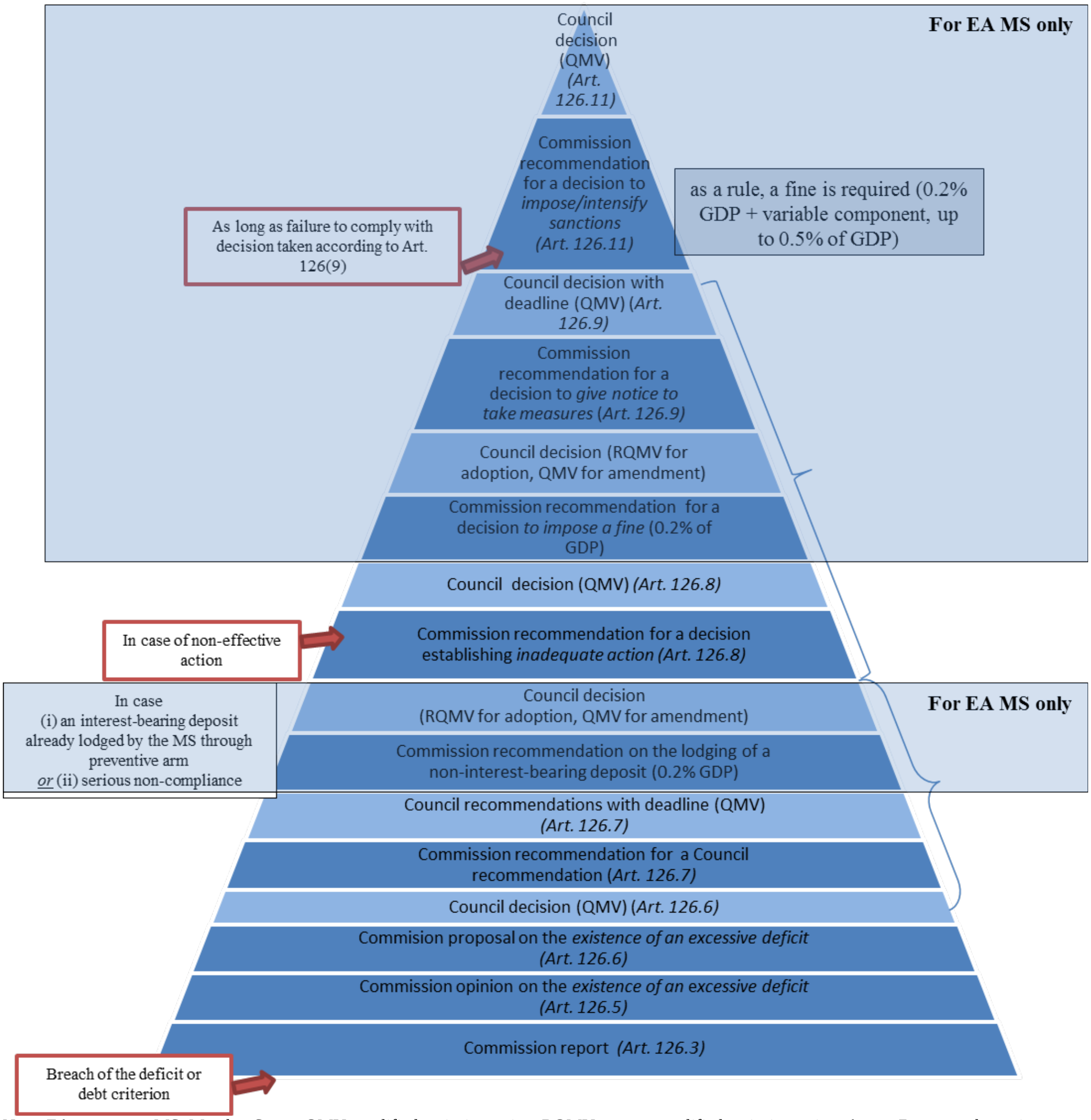
The rationale for having limits on the deficits and debt is based on the effect of the enhanced spillovers and interdependence between European Union but especially euro area countries. By constraining deficits to be at most 3% of GDP, the Treaty seeks to reduce the destabilisation and inflationary impact of large deficits, which render the role of monetary policy more difficult. The actual choice of the 3% is such that it is compatible with the free operation of the automatic stabilisers under normal conditions for a structural balance in balance or surplus and, under assumptions of 2% inflation and 5% nominal growth, would imply consistency with the 60% debt limit.

The limit on debt stems from the fact that debt levels that are too high can have important adverse consequences. Not only can public sector debt displace private investment, but the interest payment required to service the debt mean that government revenues need to be higher than they otherwise would be, acting as a break on growth. Moreover, increasing levels of debt lead to higher interest payments not just because there is more debt, but also because increasing debt also increases the risk of default and so governments face higher interest rates on the amount that they borrow. This can lead to the so-called snowball effect, where the effect of debt on interest rate drives debt levels up and these then drive interest rates higher resulting in a vicious spiral towards unsustainability.

The debt requirement was operationalized with the 2011 amendment of the SGP. At the time of its incorporation into the SGP a number of countries already had EDPs that were open and therefore had agreed fiscal consolidation paths. In order to ensure that these Member States had time to adapt their

([20]) Official Journal C 236 of 02.08.1997.
([21]) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:145:0001:0009:EN:PDF

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



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

structural adjustments to level needed to comply with the new benchmark, a transition period was introduced. For countries that were under EDP in November 2011, compliance with the debt criterion will therefore be judged according to the provisions for the transition period, for the three years after they correct their excessive deficit. During that period, they need to show that they are making sufficient progress towards compliance with the debt requirement, rather than actually be compliant with the formula that applies outside the transition period.

The operation of the corrective arm of the SGP is determined by a series of steps set out in Article 126 of TFEU, which are presented in more detail in the next subsection. Under this Article, financial sanctions become applicable to euro area countries at step 126(11), after the Member State in question has repeatedly failed to take the corrective action recommended by the Council. In addition any country in receipt of the Cohesion Fund can also be subject to specific provisions as eligibility for the Cohesion Fund is linked to avoidance of Excessive Deficits. A Council decision that the Member State has not taken effective action in response to its Article 126(7) recommendations can lead to a suspension of its commitments under the Cohesion Fund. In addition, Regulation 1173/2011, based on Article 136 and applicable only to the euro area, adds to the sanctions under Article 126 by including a series of early and increasing sanctions starting from when a country is placed under EDP. The reason for this is to ensure that sanctions have more power by being applicable at a time when Member States are able to react.

2.1.3. Monitoring and sanctions under the corrective arm of the SGP

A Member State can be placed in EDP following a breach of the deficit or debt conditions, on the basis of outturns, plans or forecast data. Once the breach has been identified, the Commission prepares a report according to Article 126(3) of the Treaty. In the report, the Commission considers whether or not an EDP should be launched, based on a consideration of all factors relevant to such a decision.

If however, the conclusion of the report is that an excessive deficit exists, the Commission prepares the recommendations for an Article 126(6) Council decision on the existence of an excessive deficit and Article 126(7) recommendations which issue the Member State in question with a time limit within which to correct its public finance situation and be compliant with both the deficit and the debt requirements. The recommendation should contain annual deficit targets set in both nominal and structural terms and linked by an underlying macroeconomic scenario.

Following the Council decision under 126(6) and the adoption of the Article 126(7) recommendations, the Member State must show that it has taken action to address its excessive deficit within six months – or three if the situation is judged to be particularly serious. It may also face the imposition of sanctions in the form of a non-interest bearing deposit if it is in the euro area.

The assessment of whether it is on track to correct its excessive deficit and/or has taken effective action can lead to either the abeyance of the procedure if the assessment is positive, or the stepping up if the assessment is negative. An EDP in abeyance may be activated again if the continuing monitoring of the situation shows that it is not on course to comply with the recommendations. However, 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 its deadline, by one year as a rule, if unexpected adverse economic events with a major impact on the public finances impede its ability to meet the EDP recommendations.

The stepping up of the EDP involves a Council decision, following a Commission recommendation under Article 126(8) that effective action has not been taken. This is the next trigger for the imposition of sanctions for euro area Member States – this time in the form of a fine that as a rule will correspond to 0.2% of GDP. All countries that are in receipt of the Cohesion Fund can also face a suspension of their commitments under the Cohesion Fund. Notice from the Council under Article 126(9) then follows for euro area Member States. This notice mirrors the Article 126(7) recommendations – it includes a time limit for the excessive deficit to be corrected and includes intermediate nominal and structural balance targets for every year, linked by an underlying macroeconomic scenario – although it also contains a series of measures that are conducive to the achievement of the targets according to a specific timetable. Non-euro area countries are issued with revised Article 126(7) recommendations following an Article 126(8) decision that effective action has not been taken.

Following notice under 126(9) or revised Article 126(7) recommendations, an assessment of whether a Member State is on track to correct its excessive deficit and/or has taken effective action can again lead to the abeyance of the procedure or a decision on non-effective action. The possibility of revising the notice or the recommendations and extending the deadline also remains, as long as the Member State in question 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 does not conclude that effective action has been taken, the procedure is stepped up to step 126(11) for euro area Member States with a Council decision to intensify sanctions. For as long as the Member State continues not to comply with its notice under 126(9) it can face an annual fine equal to 0.2% of its GDP in the preceding year plus a variable component determined by the magnitude of its excessive deficit, up to a total maximum of 0.5% of GDP. For non-euro area Member States, a repeat of steps 126(8) followed by new recommendations under 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.

The EDP is abrogated when the excessive deficit is corrected in a durable manner 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 and a qualified majority vote in Council.

2.2. THE LAUNCH OF AN EXCESSIVE DEFICIT PROCEDURE (EDP)

An EDP is launched by a Council decision based on a Commission proposal on the existence of an excessive deficit. The Commission proposal is based on a Commission report under Article 126(3) of the Treaty which considers the deficit and debt position of the Member State in question to see whether either or both of these positions merit the launch of an EDP. The writing of the report is itself triggered by a breach of the numerical deficit and debt criteria in the Treaty, on the basis of either outturn data, plans or forecasts.

Section 2.2.1 sets out the conditions under which the deficit and debt figures should trigger the writing of an Article 126(3) report. Section 2.2.2 describes what such a report contains, whether triggered by a breach of the deficit or debt condition. Section 2.2.3 then describes how the Article 126(7) recommendations are prepared, while section 2.2.4 describes the preparation of 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 usually the identification of a breach of either the deficit or debt criterion by the Commission. The breach in itself is just the first step; it triggers the writing of an Article 126(3) report which considers in detail a series of factors and concludes whether the breach of the criteria merits the launch of an EDP against the Member State in question.

The identification of a breach of the deficit or debt criterion can be based on either outturns, plans or forecast data. The launch of an EDP on the basis of forecast data can be based on either the Member State's plans – as outlined in their Stability or Convergence Programmes or in other announcements made by the government – or on the Commission's forecasts.

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 country will be found to be in breach of both. In these cases, the Article 126(3) report will consider both criteria and an EDP may be launched with both criteria as the justification, although a single EDP is launched.

It should be noted that special transitional arrangements apply to debt rule for countries that were in EDP in November 2011, when the latest amendments of the SGP, known as the Six Pack, entered into force. Countries that were in this situation need to show compliance with the debt benchmark according to the special transition arrangements for the three years after the correction of their excessive deficit. ([22]) 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 writing an Article 126(3) report on the basis of the deficit criterion.

2.2.1.2. Establishing non-compliance with the debt criterion

A Member State is non-compliant with the debt requirement if its general government debt is greater than 60% of GDP and is not sufficiently diminishing and approaching 60% of GDP at a satisfactory pace. The concept of "sufficiently diminishing" and the "satisfactory pace" are defined in Regulation 1467/97 as being fulfilled if *"the differential [of the debt] 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"*. This in turn is translated into a debt reduction benchmark which is set out in the Code of Conduct. The Regulation then specified that *"the requirement under the debt criterion shall also be considered to be fulfilled if the budgetary forecasts of the Commission indicate that the required reduction in the differential will occur over the three-year period encompassing the two years following the final year for which data is available". It further specifies that "the influence of the cycle on the pace of debt reduction"* should be taken into account.

A breach of the debt criterion is therefore judged by considering the debt reduction benchmark in three configurations: the backward looking version, the forward-looking one and by taking into account the impact of the cycle. Only if a country is in breach of all these conditions, is the debt criterion considered breached and an Article 126(3) report is written.

Judging compliance with the debt criterion is therefore done according to the steps set out in Graph 2.2. A Member State is in breach of the debt criterion if its debt is judged to be too high according to the following steps:

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:

$$bt > bbt = 60\% + 0.95/3\ (bt\text{-}1 - 60\%) + 0.95^2/3\ (bt\text{-}2 - 60\%) + 0.95^3/3\ (bt\text{-}3 - 60\%)$$

where bt equals the debt ratio in year t and bbt 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

$$bt\text{+}2 > bbt\text{+}2 = 60\% + 0.95/3\ (bt\text{+}1 - 60\%) + 0.95^2/3\ (bt - 60\%) + 0.95^3/3\ (bt\text{-}1 - 60\%)$$

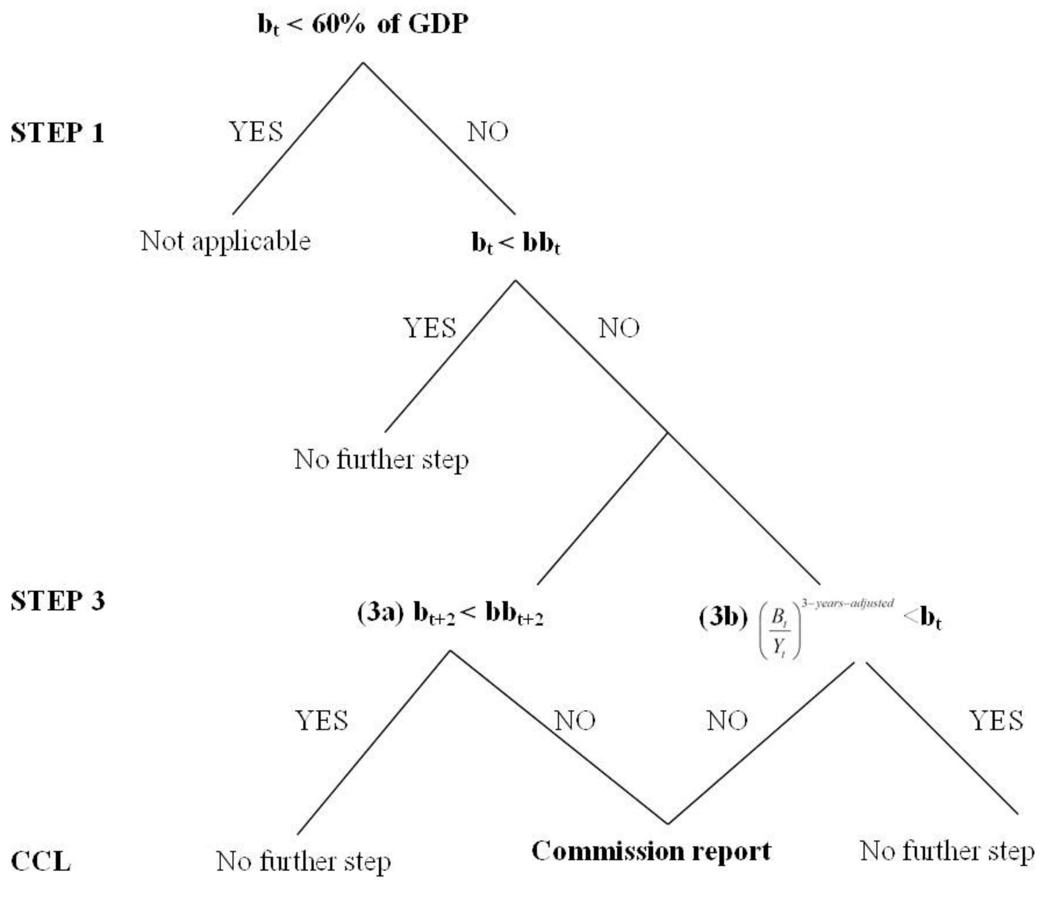
([22]) Denmark, Cyprus, Austria, Belgium, the Czech Republic, Italy, the Netherlands, Portugal, Slovenia, Slovakia, Poland, Romania, Lithuania, France, Latvia, Ireland, Greece, Spain, the United Kingdom and Hungary will enter the transition period when their EDPs are abrogated. Bulgaria, Germany and Malta are currently in their transition periods.

where bbt+2 stands for the forward-looking benchmark debt ratio; bt+1 and bt+2 stand for the debt forecast in year t+1 and t+2 as estimated by the Commission under the 'no-policy-change' assumption 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.

Graph 2.2: **The steps to follow to assess whether an EDP should be launched on the basis of the debt criterion.**



NB: while steps 1 and 2 are sequential, step 3a and 3b are parallel, i.e. if one of the two conditions 3a or 3b is fulfilled, there will be no further step.

The correction of the cycle

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

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

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

where B_t stands for debt, Y_t for GDP at current prices, y_t^{pot} for potential growth, p_t for the price deflator of GDP, C_t for the cyclical part of the budget balance. The cyclical components and potential growth are calculated according to agreed methodologies. ([23])

This methodology therefore:

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

- 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. 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

Countries that were in EDP on the date that the Six Pack amendments to the SGP were adopted – that is 8 of November 2011 – will be subject to transitional arrangements for the three years following the correction of their excessive deficit. During those three years, the debt requirement will be judged according to whether the Member State in question makes sufficient progress towards compliance.

The debt requirement was operationalized with the 2011 amendment of the SGP, known as the Six Pack. At the time of its incorporation into the SGP a number of countries already had EDPs that were open and therefore had agreed fiscal consolidation paths. In order to ensure that these Member States had time to adapt their structural adjustments to level needed to comply with the new benchmark, a transition period was introduced. It is important to note that countries still need to be moving towards compliance during this period. It is also important to note that the transition period does not begin with 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.

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

(i) First, the annual structural adjustment should not deviate by more than ¼ % of GDP from the linear structural adjustment ensuring that the least stringent condition consistent with the respect

([23]) 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.

of the debt benchmark is met by the end of the transition period (minimum linear structural adjustment);

(ii) Second, at any time during the transition period, the remaining annual structural adjustment should not exceed ¾ % of GDP. ([24])

This 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 allowing some room for manoeuvre during the transition period.

Compliance is then judged ex ante and ex post, with the ex ante assessment being undertaken on the basis of the plans submitted in the SCPs. The process is the following.

- Year 1: First year of the transition period

  -- *Ex-ante assessment*: the consolidation path set out in the S/CP is compared in years 1, 2 and 3 to the minimum linear consolidation path consistent with sufficient progress towards compliance, as defined by the conditions 1) and 2) mentioned above. No compliance triggers the preparation of a report under Art. 126(3).

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

- Year 2: Second year of the transition period

  --*Ex-ante assessment*: on the basis of the updated SCP in April of year 2, 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. No compliance triggers the preparation of a report under Art. 126(3).

  -- *Ex-post assessment of year 2*: 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 Art. 126(3) is 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, the projected debt ratios are compared to the debt benchmark account taken of the effect of the cycle and of the forward-looking dimension. No compliance triggers the preparation of a report under Art. 126(3).

  -- *Ex-post assessment of year 3*: based on fiscal notification for year 3, if the debt benchmark has not been respected, even after the effect of the cycle has been taken into account and account taken of the forward-looking dimension, a report based under Art. 126(3) is prepared.

A negative assessment of the 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).

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

2.2.2. The preparation of an Article 126(3) report

Non-compliance or risk of non-compliance with the deficit or the debt criterion leads to the Commission writing an Article 126(3) report which will conclude whether the Member State in question should have an EDP opened. The Report is submitted to the Economic and Financial Committee which has 2 weeks following its adoption by the Commission to formulate an opinion under Article 126(4).

The Article 126(3) presents an overall assessment of whether a country should be placed in EDP on the basis of its deficit and/or debt position.

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 (i) either 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 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. Article 126(3) specifies: "The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State." Regulation 1467/97 gives further details on the relevant factors to be taken into account, presenting a list that falls under three headings: developments in the medium-term economic position, developments in the medium-term budgetary positions and developments in the medium-term government debt position. However, the regulation states that this list is not exhaustive and that "The Commission shall give due and express consideration to any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess compliance with deficit and debt criteria and which the Member State has put forward to the Council and the Commission. In that context, particular consideration shall be given to financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between Member States in the context of safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances" (see Box 2.3)

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

- For a country with debt below 60% of GDP: the relevant factors are considered in the overall assessment, whatever the level of the deficit.
- For a country with debt above 60% of GDP: the relevant factors are only considered if the breach of the deficit criterion is small and temporary.

In addition, for countries whose deficit does not significantly exceed a level that can be considered close to the 3% of GDP reference value and whose debt ratio does not exceed the 60% of GDP reference value, *Box 2.3:* **The treatment of financial support in determining the existence of an excessive deficit**

In order to avoid that assistance provided to other EU Member States in the context of a coordinated, EU-wide policy, should result in a country being placed in EDP, debt-increasing operations will be 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 toward 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 entry into force of the 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 in which compliance with the criterion is assessed based on the notion of 'sufficient progress' towards compliance, 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 to be 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 under the second financial assistance programme for Greece which have a budgetary impact on lenders through the reduction of future expected income. These measures are the reduction of the GLF margin and interest rates, the transfer to Greece's segreagated account of the income equivalent to the Securities Market Programmes (SMP) profits and the cancelation of the EFSF guarantee fee. Payments made under the EfSM are not taken into account as the lending is not re-routed to EU Member States and therefore does not affect their debt.

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

special consideration is 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 is 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 (as defined in Article 1 of Regulation 479/2009). This impact stems from the fact that some revenue, which used to be recorded as government revenue, is diverted to a fully-funded pension fund classified in a sector other than general government. Moreover, some pensions and other social benefits, previously accounted for as government expenditure, will be paid by the pension scheme once the reform has been implemented. Thus, net costs do not include interest expenditure linked to the higher accumulation of debt due to forgone social contributions or other revenues. This consideration is part of a broader assessment of the overall features of the pension system created by the reform, namely whether it promotes long-term sustainability while not increasing risks for the medium-term budgetary position. In this way, countries that reform their pensions systems in way that improves the long-term sustainability of their public finances but introduces

Box 2.4: Rules in the 2011 reform of the SGP for systemic pension reforms

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

Such reforms were mostly carried out by new Member States. In response, the 2005 reform of the Pact considered their implications for the Maastricht deficit criterion. The reformed Pact made an allowance for deviating from the deficit threshold for 5 years, with the allowance gradually diminishing by the end of this transitory period. The 2011 reform of the SGP then changed the rules for taking systemic reforms into account when assessing compliance with the deficit criterion.

The new rules, which came into force by mid-December 2011, acknowledge the fact that the budgetary implications of systemic pension reforms can be drawn out over a longer period. They also take better account of the government's capacity to absorb higher deficits over this protracted period. The new rules

• make the allowance for maintaining a higher deficit permanent,
• provided that the government debt-to-GDP ratio does not exceed 60%, and
• provided that deficit does not significantly exceed what can be considered to be close to the 3% of GDP reference value.

The table below shows the various elements of these rules in detail.

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

<table>
<tr><th colspan="2" rowspan="2"></th><th>when launching EDP</th><th>when abrogating EDP</th></tr>
<tr><th>net costs of systemic pension reforms</th><th>net costs of systemic pension reform</th></tr>
<tr><td rowspan="4">former rules</td><td>government debt</td><td>No restriction</td><td>No restriction</td></tr>
<tr><td rowspan="2">government deficit</td><td>Remains close to the reference value</td><td>Has declined substantiallyand continuously</td></tr>
<tr><td>The excess is explained by reform costs</td><td>Has come close to the reference value</td></tr>
<tr><td>other criteria</td><td>Degressive scale</td><td>Degressive scale</td></tr>
<tr><td rowspan="4">new rules</td><td>government debt</td><td>Does not exceed 60% of GDP</td><td>Does not exceed 60% of GDP</td></tr>
<tr><td rowspan="2">government deficit</td><td>Does not significantlyexceed what can be considered close to the reference value</td><td>Has declined substantially and continuously</td></tr>
<tr><td>Excess is explained by reform costs</td><td>Has come close to the reference value</td></tr>
<tr><td>other criteria</td><td colspan="2">Fiscal sustainability is maintained</td></tr>
</table>

(Continued on the next page)

Box (continued)

For ongoing excessive deficit procedures the new rules imply that an EDP may be abrogated even if the government deficit ratio is above the 3% of GDP threshold if:

- its debt-to-GDP ratio does not exceed 60%,
- the net costs of a systemic pension reform explain the excess in the deficit and
- the deficit has come close to the reference value.

In addition to the above, the general rules for abrogation apply, i.e. an assessment is made whether the government deficit is reduced to below the reference value in a durable manner.

Furthermore, the net costs of the systemic pension reform must be determined. Council Regulation (EC) 1467/97 itself is not explicit in what constitutes the net costs of such a reform; it only refers – in a related paragraph – to the 'net costs of the publicly managed pillar'. The Code of Conduct defines these costs as direct costs stemming from the fact that some of the government's revenues has to be directed to the private pension pillar (adding to the costs of the reform), whereas some of the pension payments are, in fact, carried out by the private scheme instead of the public pillar (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 does not only allow for the acquisition of new pension rights but also enables the government to transfer some of the rights already accumulated (in the public pillar) to the new scheme.

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

short and medium-term costs, are able to deviate slightly from the 3% limit without being placed in excessive deficit. Box 2.4 explains how pension reforms are to be taken into account, in detail.

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

The same factors that may be taken into account for the opening of a deficit-based EDP, are also borne in mind in the overall assessment for a country in breach of the debt requirements. This in includes the possibility that any other factors deemed significant by the Member State in question should also be taken into account.

In the case of the debt, the relevant factors are taken into account whatever the magnitude of the breach – there are no exceptions. Pension reforms are considered along with the other relevant factors, but the exceptional treatment of systemic pension reforms as set out in section 2.2.2.1 is not applicable.

The revised Regulation (1467/97) has expanded the list of 'relevant factors', to be considered when assessing compliance with the deficit and debt criteria. Among these relevant factors the Regulation now mentions 'stock-flow adjustments'. These adjustments explain why the change in government debt differs from the government deficit and thus may have an impact on the compliance with debt criterion. Unlike the impact of the economic cycle on government debt, stock-flow adjustments are only considered when a report under Art. 126(3) is prepared. Therefore, they are part of a qualitative assessment after the quantitative debt-benchmark has already indicated a need for such a report. Recital 7 of the amended Regulation foresees that the assessment of the composition of the stock-flow adjustment on debt developments may be sufficient to exclude the establishment of an EDP on the basis of the debt criterion.

The components of the change in gross government debt

While government deficits/surpluses are normally the main driver of changing debt, other elements which are not recorded in the government balance can also impact the level of the debt. All the changes in debt unexplained by the deficit/surplus are grouped under the term stock-flow adjustments (SFA). Most importantly, SFA include changes in the stock of financial assets (for instance, the depletion of cash reserves). Table 2.1 presents different elements of SFA in more detail.

The contribution of SFA to the evolution of gross government debt will be considered whenever an Art. 126(3) report is triggered based on the debt criterion. This assessment will not be quantitative in the sense

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

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

that it will not yield a recalculated debt benchmark. Nevertheless, an adjustment to the change in gross government debt will be applied to reveal whether developments in SFA justify the failure to meet the numerical debt benchmark. In particular, gross debt will be 'netted out' by the net acquisition of currency and deposits to prevent that the government's cash management activity comes into conflict with its obligation to meet the debt criterion.

2.2.2.3. The conclusion of the Article 126(3) report

Once consideration has been taken of the wider economic context and all relevant factors, the Article 126(3) report concludes whether the data should lead to the Member State being placed in EDP. Either way, the report is forwarded to the Economic and Financial Committee of the Council which has 2 weeks to formulate an opinion.

In addition, where the conclusion of the report is that the Member State should be placed in EDP, the Commission addresses an opinion to that effect to the Member State concerned and inform the Council accordingly. It also prepares a recommendation for a Council decision on the existence of an excessive deficit under Article 126(6) and a recommendation for a Council recommendation under Article 126(7) on the provisions to take to correct the excessive deficit.

2.2.3. Article 126(7) recommendations

The Commission recommendation for a Council recommendation under Article 126(7) to correct the excessive deficit contains an underlying analysis of the situation, 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.

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

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

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

Intergovernmental loans

A Member States should not be placed in EDP for breach of the debt criterion, including in the transition period, as a result of assistance provided to other EU Member States in the context of a coordinated, EU-wide policy. Box 16 describes how loans under the Greek loans facility, the EFSF, 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 reflects changes to the sustainability of fiscal policy, further adjustments to the gross debt figure is not recommended. The reason for this is that the more assets are considered to be netted out the further one departs from the concept of the original Maastricht debt criterion. Also, the valuation of most assets is difficult or sometimes even arbitrary and, by taking them into account, the 'well measurable' feature of the EDP definition of government debt would suffer as well.

The aim of the Article 126(7) recommendation is to present a credible path for the timely correction of the excessive deficit. According to Article 3(4) of the Regulation 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."*

Article 2(6) of Regulation 1467/97 specifies that the deadline for correction will be set, 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."*

To guide the choice between several possible EDP deadlines, the Code of Conduct 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."

These Articles require three quantitative budgetary objectives to be set in EDP recommendations:

(i) A <u>deadline</u> for the correction of the excessive deficit. As a rule, when the EDP is launched in year t, the excessive deficit should be corrected in year t+1. However, in case of special circumstances, a longer deadline could be set.
(ii) A <u>path</u> 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 would entail at least one intermediary nominal target (that of year t);
(iii) <u>Annual fiscal effort</u> of at least 0.5% of GDP, defined in structural terms, consistent with the nominal path towards the correction of the excessive deficit.

The Article 126(7) recommendations therefore present a path for the structural and nominal deficits. Depending on the magnitude of the structural adjustment to be made, and the urgency of the adjustment in terms of the fiscal risk the country displays and the feasibility of such an effort, the size of the annual adjustment, and as a result the timeline for the correction of the deficit is set.

The fiscal path set out in the recommendations has to also take into account the need to comply with the debt benchmark, hence including a fiscal trajectory leading to the debt complying with at least the forward-looking element of the debt benchmark at the end of the recommendation period. It should be noted that in case of debt-based EDPs, the general government balance recommended for the deadline year could be above -3% of GDP.

Along with the paths for both the nominal and structural deficits, and the underlying macroeconomic scenario that links them, a no-policy change trajectory of receipts and spending is given. This is because the change in the structural balance need not be equal to the magnitude of the measures that need to be taken by the Member State in question. In particular, the structural balance implicitly assumes that receipts and spending grow in line with potential GDP. In most countries, this is not the case, in some cases significantly so. For example, a country with no automatic indexation of tax thresholds will have revenue trends that are above the change in potential growth and will therefore need to take fewer policy measures than a country with indexation linked to the GDP deflator to achieve the same tightening in the structural balance, other things being equal. By making this distinction clear in the recommendation, the country in question should be guided to target the actual change in the structural balance even if the sum of the measures needed is different to this change (see Box 2.6).

In order to ensure that the assumptions underlying the recommendations are clear, the Staff Working Document prepared by the Commission that accompanies the Article 126(7) recommendations, will contain the Tables 2.2 and 2.3. The inclusion of these tables should help Member States understand what is required of them, and will form the basis of the ex post assessment of effective action. The references to terms α and β are explained in section 2.2.2.

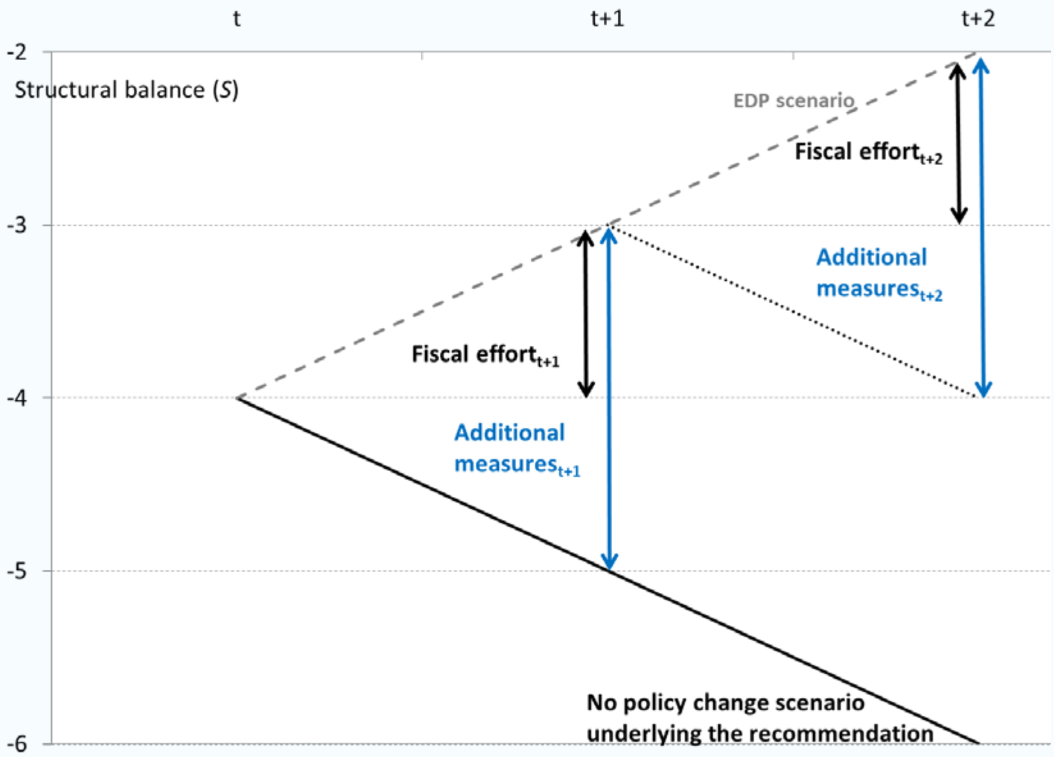
Table 2.2: **Information to include in the Staff Working Document on the underlying baseline scenario**

% of GDP	t	t+1	t+2
Revenues			
(enters β)			
Expenditure			
Structural expenditure (% of potential GDP)			
(enters α)			
Real GDP growth (%)			
Nominal GDP growth (%)			
(enters β)			
Potential GDP growth (%)			
(enters α)			
Discretionary measures with impact on current revenue			
(enters β)			
Structural balance			
General government balance			
p.m Revenue elasticity			
p.m Output gap (% of pot. Output)			

Table 2.3: **Information to include in the Staff Working Document on recommendations for the EDP**

% of GDP	t	t+1	t+2
Real GDP growth (%)			
Potential GDP growth (%)			
Structural balance			
General government balance			
p.m Output gap (% of pot. output)			

Box 2.6: **Reconciling the required change in the structural balance and the amount of additional measures**



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

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

In calculating the additional measures that need to be introduced to reach a given change in the structural balance, the impact of the measures on growth must be taken into account. This is not shown in the graphic

(Continued on the next page)

Box (continued)

as the aim is to illustrate the difference between the change in the structural balance and the amount of measures needed to reach it.

The Article 126(7) recommendation also establishes a maximum deadline of six months for effective action to be taken in order to correct the excessive deficit in a timely manner, unless the seriousness of the situation justifies a deadline for effective action of three months. Alongside the deadline for action, the recommendation also specifies the deadline by which the Member State should submit a report on the action taken on which the Commission will base its assessment of effective action.

2.2.4. Sanctions: non-interest bearing deposits

Following the Council's adoption of a decision under Article 126(6) establishing the existence of an excessive deficit, the Commission shall issue a recommendation for a further Council decision requiring the Member State to lodge a non-interest bearing deposit if the Member State 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 EDP. In these cases, the Commission shall issue its recommendation within 20 days of the Council's adoption of the Article 126(6) decision. The amount of the non-interest bearing deposit shall equal 0.2% of the previous year's GDP, as a rule. The deposit will be lodged with the Commission – if the country had already lodged an interest-bearing deposit, it will turned into a non-interest bearing one and any difference in the applicable amount will be returned to the Member State or made up by it.

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

While the default position is for the Commission to ask for a deposit equal to 0.2% of the previous year's GDP, the Commission may recommend that the Council reduce the amount or cancel the non-interest bearing deposit altogether. This can happen on the grounds of exceptional economic circumstances or following the reasoned request by the Member State concerned, addressed to the Commission within 10 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. PROCEDURES FOLLOWING A RECOMMENDATION UNDER ARTICLE 126(7)

This section considers the procedures that are followed after the adoption of Council recommendations under Article 126(7). Section 2.3.1 sets out the requirements on Member States following the launch of an EDP and section 2.3.2 describes how compliance with the recommendations under Article 126(7) is judged. Section 2.3.3 considers the cases in which the deadline can be postponed. 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

The Article 126(7) recommendations contain a deadline for the Member State to adopt the necessary measures to comply with the recommendation. Depending on whether the situation is deemed particularly serious or not, this deadline is either three or six months. Within this deadline, the Member State must report to the Council and the Commission on action taken in response to the Council's recommendation. 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 recommendations, as well as information on the measures already taken and on the nature of those envisaged to achieve the targets.

2.3.2. The assessment of compliance with the Article 126(7) recommendations

Following the expiry of the date for taking effective action and based on the Member State's report referred to in the previous section, the Commission examines it to see whether the Member State has complied with the Article 126(7) recommendations. This is done by assessing whether the Member State is forecast to meet all the nominal targets, according to the Commission forecasts. If some of the years covered by the EDP are not within the time horizon of the Commission forecasts, the assessment of compliance is preliminary and focuses on the credibility of the Member States' plans. According to the Code of Conduct, this preliminary assessment should consider whether the Member State concerned has publicly announced or taken measures that seem sufficient to ensure adequate progress towards the correction of the excessive deficit within the time limits set by the Council.

If the Commission considers that the Member State has acted in compliance with the recommendation (or notice) and that the EDP fiscal requirements are likely to be fulfilled, it informs the Council of its assessment and the procedure is held in abeyance (see section 2. 3.4). Otherwise, the procedure is either stepped-up (if no effective action is has been taken – see below) or a revised EDP recommendation is issued (if the assessment of effective action is positive but *"unexpected adverse economic events with major unfavourable consequences for government finances occurred"* (Art. 3(5) of Council Regulation (EC) 1467/97)).

2.3.2.1. The assessment of effective action following Article 126(7) recommendations

If the Member State is not compliant with the nominal targets, an assessment of effective action will be undertaken. The focus of this will be the structural adjustment, with the aim of determining whether the Member State has actually taken action of the magnitude required in its Article 126(7) recommendations. Multi-year EDPs issued after the 2011 SGP reform specify annual targets for both the nominal and structural balances; older EDPs specify average annual targets. This section considers the assessment of effective action for the new EDPs.([25]) The assessment of effective action in the case of existing EDPs with average annual targets is explained section 2.3.2.2. A numerical example of the assessment of effective action under the new recommendations is presented in annex 10.

Since the 2011 reform of the SGP, the recommendations under Article 126(7) include annual nominal and structural targets, which, on the basis of the forecast underpinning the recommendation, should be consistent with a minimum annual fiscal effort of 0.5% of GDP as a benchmark. The Code of Conduct specifies 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

([25]) This section provides an overview of the methodology currently in place, which will be reviewed in 2014.

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."

In brief, Member States that have improved their structural balance in line with the recommendations will be assessed as having taken effective action.

As a first step, the assessment of effective action revolves around the comparison between two elements, namely the required change in the structural balance (ΔS^{rec}) and the observed change in the structural balance (ΔS).

At first sight, monitoring the budgetary adjustment via changes in the structural balance may appear to be a purely mechanical exercise. However, the problem is that changes in the structural balance include two different components: one due to discretionary fiscal policy, the other resulting from forecasts errors linked to revisions in economic growth and its composition or of others shortfall/windfall on revenues compared to assumption at the time of the recommendation. Hence a simple comparison between the observed change in the structural balance and the required change in the structural balance should not lead to an unequivocal conclusion about effective action or the lack thereof. To disentangle policy errors from forecast errors, a correction of the observed change in the structural balance for effects outside the control of government (other than the normal operations of the cycle captured by the cyclical component) is undertaken.

For this purpose, the Commission implements a correction of the observed change in the structural balance.

Specifically, three budgetary aggregates are compared:

(i) The "recommended fiscal effort" (ΔS^{rec}), i.e. the annual change (improvement) in the structural balance prescribed in the Article 126(7) recommendation (Art. 126(9) notice);
(ii) The "observed fiscal effort" (ΔS), measured by the observed or forecast change in the structural balance;
(iii) The "adjusted fiscal effort" (ΔS^*), where the adjustment incorporates: (i) the impact of revisions in potential output growth compared to that underlying the growth scenario in the recommendation (α); (ii) the impact of revisions on the composition of economic growth or of other windfalls/shortfalls on revenue (β); and (iii) the possible impact of other unexpected events (on the general government financial situation([26]) (γ). See Annex 5—Computing the adjusted fiscal effort ΔS^* for details on computation of these parameters. Therefore,
$$\Delta S^* = \Delta S - (\alpha + \beta + \gamma)$$

The comparison between the two measures of actual fiscal effort and the required effort gives rise to four relevant cases (see Figures 2.3, 2.4 and 2.5):

(i) If the implemented effort, as measured by both ΔS and ΔS^*, is equal to or above the recommended effort $\Delta S^{rec,}$ there is a presumption that effective action has been taken. This would then have to be confirmed by a careful analysis.

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

(ii) If both ΔS and ΔS^* indicate a lower effort than recommended ΔS^{rec}, there is a strong presumption that no effective action has been taken. A presumption does not suffice to justify a formal conclusion that no effective action has been taken (Art. 126(8) TFEU). It should therefore be followed by a careful analysis which would have to demonstrate that the presumption of no effective action has turned to be groundless. The gap between ΔS^* and the required effort ΔS^{rec} should bear on the final judgment.

(iii) If ΔS is below the recommended effort ΔS^{rec} but ΔS^* indicates an effort equal to or above what was recommended, the concerned Member State has presumably taken effective action, although this would have to be confirmed by a careful analysis;

(iv) If ΔS is equal or above the recommended effort ΔS^{rec}, but ΔS^* indicates an effort below that recommended, the concerned Member State has presumably not taken effective action, although again this would have to be confirmed by a careful analysis. Note that this is a situation when, despite unexpected events playing a supporting role (potential output or windfall revenues higher than expected), the correction of the excessive deficit within the time limit set in the recommendation is still at risk. This appears an unlikely scenario but one that could nevertheless materialize, e.g. in case of a downward revision of the headline deficit used as a starting point when designing the EDP recommendation.

The above-specified assessment provides a first indication which needs to be confirmed by a careful analysis as required by the Code of Conduct. This careful analysis will spell out the reasons of possible shortfalls from the recommended effort and will in particular take into account whether expenditure targets have been met and the planned discretionary measures on the revenue side implemented. A quantification of the magnitude of the measures taken on the basis of a bottom-up assessment will form a central part of this careful analysis. The careful analysis will also refine the revenue effects of the changes in the composition of growth.

Conclusion

Following a conclusion (in particular on the basis of the Commission forecast exercises) that the achievement of a nominal target set in the recommendation is at risk, the assessment of effective action will address the following sequence:

--Step 1: Has the recommended structural adjustment been achieved once all the main factors outside the government control impacting it have been taken into account?; and

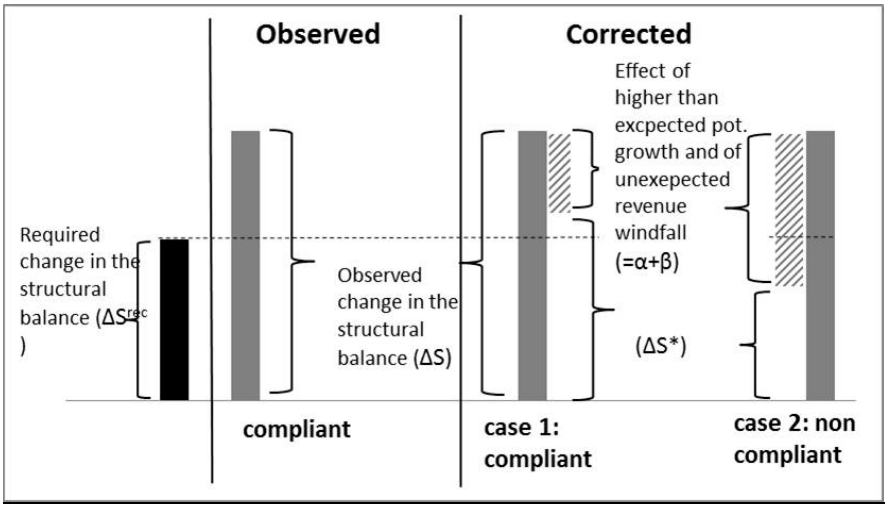
--Step 2: What does a careful analysis reveal about the expenditure and revenue developments compared to original plans in case of doubts?

The revised Code of Conduct requires a careful analysis of why the fiscal effort fell short of that recommended, looking in particular at whether:

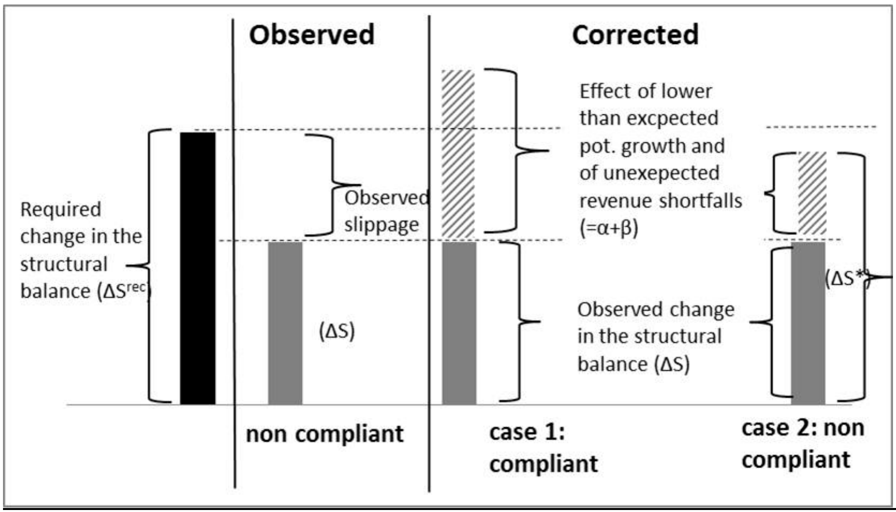
- the expenditure plans have been achieved,
- the discretionary revenue measures planned have been implemented,
- the composition of growth and its tax-richness.

To some extent these elements, in particular the composition of growth and its tax-richness, will also have been taken into account in the computation of $\Delta S^*$and in particular of β. However, where relevant, a more detailed analysis will be carried out, including highlighting possible reasons for divergences between the fiscal effort measured by the corrected change in the structural balance and the budgetary impact of the measures effectively implemented by the Member State concerned, i.e. divergences between the so-called top-down approach and the careful analysis, including a bottom-up approach centred on measures taken. In case of large differences between both approaches, the reasons for the divergence will be examined before a conclusive decision is reached.

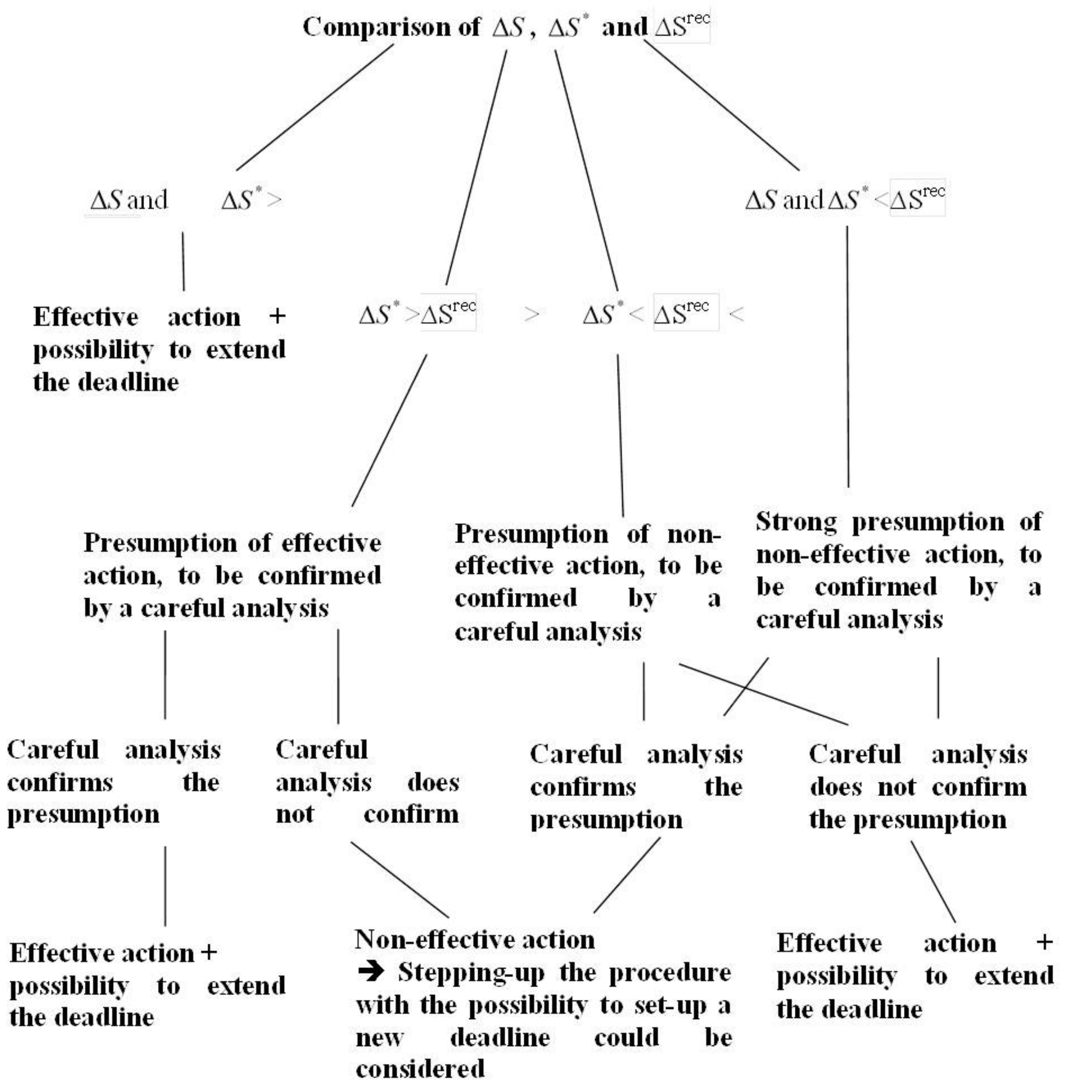
Graph 2.3: **Observed and corrected fiscal effort - The case of a positive unexpected event**



Graph 2.4: **Observed and corrected fiscal effort - The case of a negative unexpected event**



Graph 2.5: **The EDP decision tree for assessing effective action**



Definitions

Required fiscal effort = ΔS^{rec}

Observed change in the structural budget balance = ΔS

Corrected observed change in the structural budget balance = ΔS^*

$\Delta S = \Delta S^* + (\alpha + \beta + \gamma)$

Effect of revision of potential output growth compared to expectations at the time of the recommendations on $\Delta S = \alpha$

Effect of revision of revenue windfall/shortfall compared to expectations at the time of the recommendations on $\Delta S = \beta$

Effects of other unexpected events on ΔS (e.g. natural disaster, base effect linked to statistical revisions, etc..) $= \gamma$

2.3.2.2. The assessment of compliance for countries with pre-existing recommendations phrased in terms of average annual targets

While all the new Article 126(7) recommendations have annual nominal and structural targets most of the current EDPs have recommendations phrased in terms of average annual figures over a multiannual time period. In these cases, assessing compliance with the recommendations requires more judgment, particularly in assessing effective action before being close to the deadline. Without a specified path towards the correction, an apparent lack of effective action in early years of the consolidation path could be compensated by higher effort implemented by future budgets. However, lower effort in initial years compared to that recommended will normally be taken into account as an aggravating factor in case correcting by the deadline is at risk in the later years even if due to a deteriorated macroeconomic scenario in those years.

The assessment of effective action outlined in in section 2.3.2.1 will therefore be adjusted for the specificities of the average target effort. When assessing the structural effort, it is important to consider the structural effort made since the start of the EDP, rather than just in the previous year. Similarly, in computing the adjusted fiscal effort, the change in the estimates of potential output and revenues windfalls/shortfalls need to be relative to the year when the EDP was issued rather than relative to the previous year.

In addition, even if the circumstances permit it, it could also be decided not to postpone the deadline immediately, especially when the forecast is surrounded by large uncertainty. This could be the case in the early years of a multi-annual correction period.

2.3.3. Cases for postponing the deadline

In the presence of unexpected adverse economic event, if a Member State is judged to have taken effective action, the Commission will assess whether there is a need to issue a revised recommendation for a revised Council recommendation to end the excessive deficit under 126(7). This revised recommendation may extend the deadline for the correction of deficit, usually by one year, although it could 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.

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

- either the Commission considers that the Member States has acted in compliance with the Article 126(7) recommendation and it informs the Council accordingly and the procedure is placed in abeyance
- or the Commission considers that the Member States has taken effective action with regard to the Article 126(7) recommendation but that adverse unexpected events have intervened that render a new Article 126(7) recommendation necessary. It 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 2.3.3 should be followed.
- Alternatively, the Commission may conclude that effective action has been taken, but that despite adverse unexpected events being at play, there is no need for a revised recommendation. In those cases, no further action is taken and the procedure is put in abeyance.

2.3.3.1. A severe economic downturn in the euro area or EU as a whole

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

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

After the initial assessment of effective action, which is the only one specifically required by the SGP, Member States' compliance with the recommendation is subject to a continuous monitoring which does not embed specific milestones to take stock of the situation. ([27]) The regular Commission forecast exercises will be used as an occasion to check whether Member States are still on track with the correction of their excessive deficit.

The assessment of compliance will be based on the methodology set out in section 2.3.2. As in the first assessment, meeting the nominal target is sufficient to conclude compliance action. 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 be below the recommended one. This would lead to the procedure being stepped-up, even if the fiscal effort is delivered for that specific year is appropriate.

Once a country is in abeyance, it will eventually either correct its excessive deficit or see its EDP being stepped up following a decision of non-effective action. The correction of its excessive deficit will lead to the abrogation of the procedure, if this correction is found to be lasting. Section 2.6 sets out the procedures to be followed.

2.4. PROCEDURE FOLLOWING NON-EFFECTIVE ACTION TO EDP RECOMMENDATIONS

This section looks at the procedures that are followed once the Commission has concluded that a Member State has not taken effective action to its Article 126(7) recommendation. Such a conclusion will lead to the stepping up of the EDP for euro area Member States and to 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, when revised Article 126(7) recommendations can be issued irrespective of whether countries took effective action or not. This case was considered in section 2.3.3.2.

2.4.1. The issuance of a Council decision under 126(8) establishing non-effective action

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 ineffective action under Article 126(8). The Commission then issues a recommendation for a decision to give notice under Article 126(9) for euro area Member States, or for new recommendations under Article 126(7) for non-euro area Member States.

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

([27]) The draft regulation 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", foresees that for Member States in EDP, effective action would be assessed on a 6-month basis (resp. quarterly basis when the procedure reaches the stage of 126(9)).

2.4.2. The imposition of sanctions to euro area Member States: fines

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

The Council decision on the imposition of a fine shall be considered adopted, unless the Council decides to reject the Commission's recommendation within 10 days, using qualified majority voting.

While the default position is for the Commission to ask for a fine equal to 0.2% of the previous year's GDP, the Commission may recommend that the Council reduce the amount or cancel the fine altogether. This can happen on the grounds of exceptional economic circumstances or following the reasoned request by the Member State concerned, addressed to the Commission within 10 days of the Council's adoption of the Article 126(8) decision. 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, as Article 4(1a) of Council Regulation (EC) No 1084/2006 of 11 July 2006 establishing a Cohesion Fund and repealing Regulation (EC) No 1164/94 asserts the conditionality of Cohesion Fund assistance on an absence of an excessive deficit, any EU Member State that is a recipient of the Cohesion fund, could have its commitments under the Fund suspended following an Article 126(8) decision.

2.4.3. Commission recommendations for a decision giving notice under Article 126(9) for euro area Member States

This subsection looks at Commission recommendations for a Council decision givng notice under Article 126(9). This can follow a Council decision establishing non-effective action to Article 126(7) recommendation under Article 126(8) or a decision to issue revised notice under Article 126(9). Notice under Article 126(9) is only applicable to euro area Member States.

Following the adoption of an Article 126(8) decision establishing non-effective action to Article 126(7) recommendations, regulation 1467/97 requires that a Council decision to give notice to euro area Member States to take measures for deficit reduction according to Article 126(9) be taken within 2 months. The Commission therefore prepares a Commission recommendation for this notice within that timescale

Notice under Article 126(9) differs from the Article 126(7) recommendations in that there is an explicit requirement in Regulation 1467/97 for the notice to indicate measures conducive to the achievement of the budgetary targets.

The Commission recommendation for a decision giving notice under Article 126(9) follows the specifications set out for Article 126(7) recommendations which are presented in section 2.2.3, including due consideration to relevant factors. The recommendation for a decision givng notice also specifies measures that are conducive to the achievements of the budgetary targets and deadlines for the adoption of these measures.

Deadlines for adopting the recommended measures are explicitly mentioned as a specific timetable which will also bind the Member State to submit reports according to this timetable to show compliance with these requirements. Regulation 1467/97 specifies that any decision to intensify the procedure following non-compliance with the notice given under 126(9) should be taken within 4 months of the notice being issued.

2.4.4. Member States' reporting on action taken following notice under Article 126(9)

Member States submit reports to the Council and the Commission which set out measures taken, in line with the notice under 126(9). The reports, which are made public by the Member State, include the targets for government expenditure and revenue and for the discretionary measures on both the expenditure and the revenue side and information on the measures taken in response to the particular Council notice.

2.4.5. The assessment of compliance with the notice under Article 126(9)

Following the submission of the progress report, the Commission examines it to see whether the Member State has complied with the notice under Article 126(9). This is done by looking at whether the Member State is forecast to meet all the nominal targets, according to the Commission forecasts. If some of the years covered by the EDP are not within the time horizon of the Commission forecasts, the assessment of compliance is preliminary. According to the Code of Conduct, this preliminary assessment should consider whether the Member State concerned has publicly announced or taken measures that seem sufficient to ensure adequate progress towards the correction of the excessive deficit within the time limits set by the Council.

If a Member State is not compliant with the nominal targets, an assessment of effective action is undertaken according to the same methodology as described in section 2.3.2.1.

- A positive assessment of compliance with the nominal targets means that the EDP will be placed in abeyance.
- If a Member State is not compliant with the nominal targets but has taken effective action, and “unexpected adverse economic events” as defined in section 2.3.3.1 have occurred, it may be issued with revised notice and an extended deadline.

Similarly, the general waiver linked to a severe economic downturn in the euro area or in the Union as a whole set out in section 2.3.3.2 applies equally in the case of notice under Article 126(9).

2.4.6. Continuous monitoring of compliance with notice under Article 126(9) and the correction of the excessive deficit

Notice under Article 126(9) will include a series of deadlines with recommendations attached to them. Member States and the Commission will need to undertake the steps set out in sections II.4.4 to II.4.6. After the final deadline with explicit measures attached, Member States' compliance with the notice is subject to a continuous monitoring in line with that set out in section 2.3.4 for Member States under Article 126(7) recommendations.

2.5. PROCEDURES FOLLOWING NON-EFFECTIVE ACTION TO NOTICE UNDER ARTICLE 126(9)

This section looks at the procedures that are followed once the Commission has concluded that a Member State has not taken effective action to its notice under Article 126(9). Such a conclusion will lead to the stepping up of the EDP. The only possible exception to this is in the case of severe economic downturn in the euro area or the EU as a whole, when revised notice under Article 126(9) recommendations can be issued irrespective of whether countries took effective action or not. This case was considered in section 2.4.5.

2.5.1. The imposition of sanctions to euro area Member States: fines with a variable component

Where the Commission concludes, following the methodology set out in section 2.4.5 that effective action has not been taken, it issues a recommendation for a Council decision establishing ineffective action under Article 126(11), which should impose/intensify sanctions. Following an Article 126(11) recommendation the Commission will then issue a new recommendation for a decision giving notice under Article 126(9).

The Commission recommendation under Article 126(11) will, 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. However, fines can be supplemented by other sanctions specified under Article 126(11), namely:

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

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

2.6. ABROGATION OF THE EDP

The conditions for abrogating the EDP are included in the Code of Conduct. In particular, abrogation should be based on notified (i.e. observed) data and the EDP should only be abrogated if the correction of the deficit will be lasting. The "lasting condition" is assessed on the basis of the Commission forecasts indicating that the deficit will not exceed the 3% of GDP reference value over the forecast horizon and that the debt will be compliant with the debt benchmark in its forward-looking specification. ([28])

Therefore, an EDP can only be abrogated if both criteria – deficit and debt – are projecting to be met on the basis of the Commission forecast.

For the deficit criterion, compliance with the nominal requirement is absolute, apart from the possibility to take into account the cost of pension reforms according to the same methodology as set out under the Article 126(3) report. Irrespective of the structural effort implemented, a "durable correction" is deemed achieved if:

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

(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 or where the excess over the 3% threshold is fully explained by the net cost of the implementation of a multi-pillar pension system that includes a mandatory, fully funded pillar.

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

For the debt criterion, the requirement is as follows:

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

or,

(ii) the debt is above 60% of GDP but the orward-looking element of the debt benchmark assessed for the year t+2 is met, based on the Commission forecast.

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

Table 2.4 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.

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

Table 2.4 also confirms that this approach secures full consistency between EDPs opened on the basis of debt and deficit criteria.

Following the abrogation of the EDP, a Member State that had lodged a non-interest bearing deposit should have the deposit returned to it. The Council (on a Commission recommendation) will also abrogate all outstanding sanctions, but any fines imposed will not be reimbursed.

Table 2.4: **Decision matrix for the abrogation of deficit-based and debt-based EDPs, depending on the fulfilment of the forward-looking element of the debt benchmark**

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

ANNEX 1

Links to the relevant legislative texts

Regulation on the preventive arm of the SGP

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

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

Consolidated following Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1466:20111213:EN:PDF

Regulation on the corrective arm of the SGP

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

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

Consolidated following Council Regulation (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1467:20111213:EN:PDF

Other texts linked to the SGP or its application

Resolution of the European Council on the Stability and Growth Pact, Amsterdam, 17 June 1997
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997Y0802(01):EN:HTML

European Council Presidency conclusions of 22-23 March 2005, endorsing and including the ECOFIN Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact"
http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2005-03-23_council_presidency_conclusions_en.pdf

Council Regulation (EC) No 479/2009 of 25 May 2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:145:0001:0009:EN:PDF

Regulation (EU) No 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0001:0007:EN:PDF

Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0041:0047:EN:PDF

Code of Conduct: "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", of 3 September 2012
http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf

Annual growth survey 2013
http://ec.europa.eu/europe2020/pdf/ags2013_en.pdf

The macroeconomic imbalances procedure

Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0025:0032:EN:PDF

Regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0008:0011:EN:PDF

ANNEX 2
2012 Update of the Minimum Benchmarks

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

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

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

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

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

$$ROG = \frac{N_i}{(N_t + N_i)} P_{5\%}(country) + \frac{N_t}{(N_t + N_i)} P_{5\%}(EU\,27)$$

where P5% (country) represents the 5% percentile of the distribution of the country-specific output gap series and P5% (EU 27) the 5% percentile of output gap data for all countries. N_i and N_t stand for the number of country-specific and common annual observations available, respectively over a period of 25 years. N_t is set at 25.

The logic of this approach is to use the simplest and most direct statistical indicator which captures the idea of the representative output gap, i.e. a particularly low value of the output gap likely to be observed with a probability of 5%. The percentile is moreover computed after outlier values are deleted.([29])

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 order to compute the representative output gap, the current methodology eliminates exceptionally high negative output gaps with respect to the cross-country distribution of output gaps by trimming it at the 2.5% percentile (both at the bottom and at the top of the distribution), but does not eliminate country specific outliers. It results in particularly low representative output gaps in several Member States.

Since the crisis cannot be considered as a “normal cyclical fluctuation” the country-specific output gaps series have been trimmed for the most negative value for each Member State (between years 2009 and 2010).

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

Table A2: the minimum benchmarks updated after the 2012 spring forecasts

Member States	Updated Minimum Benchmark based on semi-elasticities
BE	-1.7
BG	-1.7
CZ	-1.7
DK	-0.7
DE	-1.5
EE	-1.8
IE	-1.2
EL	-1.9
ES	-1.5
FR	-1.6
IT	-1.7
CY	-1.8
LV	-1.8
LT	-1.8
LU	-1.7
HU	-1.5
MT	-1.9
NL	-1.4
AT	-1.8
PL	-1.9
PT	-1.8
RO	-1.8
SI	-1.7
SK	-1.5
FI	-0.5
SE	-0.9
UK	-1.5

Annex 3

Tables to be supplied with the Stability and Convergence Programmes

Provision of data on variables in bold characters is a requirement.
Provision of data on other variables is optional but highly desirable.

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

Table 1a. Macroeconomic prospects

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

Table 1b. Price developments

	ESA Code	**Year X-1**	**Year X-1**	**Year X**	**Year X+1**	**Year X+2**	**Year X+3**
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator							
2. Private consumption deflator							
3. HICP[1]							
4. Public consumption deflator							
5. Investment deflator							
6. Export price deflator (goods and services)							
7. Import price deflator (goods and services)							
[1] Optional for stability programmes.							

Table 1c. Labour market developments

	ESA Code	**Year X-1**	**Year X-1**	**Year X**	**Year X+1**	**Year X+2**	**Year X+3**
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]							
2. Employment, hours worked[2]							
3. Unemployment rate (%)[3]							
4. Labour productivity, persons[4]							
5. Labour productivity, hours worked[5]							
6. Compensation of employees	D.1						
7. Compensation per employee					optional	optional	optional
[1]Occupied population, domestic concept national accounts definition.							
[2]National accounts definition.							
[3]Harmonised definition, Eurostat; levels.							
[4]Real GDP per person employed.							
[5]Real GDP per hour worked.							

Table 1d. Sectoral balances

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

Table 2a. General government budgetary prospects

	ESA Code	Year X-1	Year X-1	Year X	Year X+1	Year X+2	Year X+3
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13						
2. Central government	S.1311						
3. State government	S.1312						
4. Local government	S.1313						
5. Social security funds	S.1314						
General government (S13)							
6. Total revenue	TR						
7. Total expenditure	TE[1]						
8. Net lending/borrowing	EDP B.9						
9. Interest expenditure	EDP D.41						
10. Primary balance[2]							
11. One-off and other temporary measures[3]							
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)							
12a. Taxes on production and imports	D.2					optional	optional
12b. Current taxes on income, wealth, etc	D.5					optional	optional
12c. Capital taxes	D.91					optional	optional
13. Social contributions	D.61					optional	optional
14. Property income	D.4					optional	optional
15. Other [4]						optional	optional
16=6. Total revenue	TR						
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]							
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2						
17a. Compensation of employees	D.1						
17b. Intermediate consumption	P.2						
18. Social payments (18=18a+18b)							
***of which* Unemployment benefits[6]**							
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131						
18b. Social transfers other than in kind	D.62						
19=9. Interest expenditure	EDP D.41						
20. Subsidies	D.3						
21. Gross fixed capital formation	P.51						
22. Capital transfers	D.9						

23. Other[7]							
24=7. Total expenditure	TE[1]						
p.m.: Government consumption (nominal)	P.3						

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.
[2]The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).
[3]A plus sign means deficit-reducing one-off measures.
[4] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).
[5]Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.
[6] Includes cash benefits (D.621 and D.624) and in kind benefits (D.631) related to unemployment benefits.
[7] D.29+D4 (other than D.41) + D.5+D.7+P.52+P.53+K.2+D.8.

Table 2b. No-policy change projections [1]

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

[1]: The projections shall start at the time when the Stability or Convergence Programme is drafted (please indicate the cut-off date) and show revenue and expenditure trends under a 'no-policy change' assumption, as defined on p.15. Therefore, figures for X-1 should correspond to actual data for revenue and expenditure.

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

		Year X-1	**Year X-1**	**Year X**	**Year X+1**	**Year X+2**	**Year X+3**
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
1. Expenditure on EU programmes fully matched by EU funds revenue							
2. Cyclical unemployment benefit expenditure [1]							
3. Effect of discretionary revenue measures [2]							
4. Revenue increases mandated by law							

[1]: Please detail the methodology used to obtain the cyclical component of unemployment benefit expenditure. It should build on unemployment benefit expenditure as defined in COFOG under the code 10.5
[2]: Revenue increases mandated by law should not be included in the effect of discretionary revenue measures: data reported in rows 3 and 4 should be mutually exclusive.

Table 3. General government expenditure by function

% of GDP			
1. General public services	COFOG Code	**Year X-2**	**Year X+3**
2. Defence	1		
3. Public order and safety	2		
4. Economic affairs	3		
5. Environmental protection	4		
6. Housing and community amenities	5		

7. Health	6		
8. Recreation, culture and religion	7		
9. Education	8		
10. Social protection	9		
11. Total expenditure (=item 7=23 in Table 2)	10		
[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.	TE[1]		

Table 4. General government debt developments

% of GDP	ESA Code	**Year X-1**	**Year X**	**Year X+1**	**Year X+2**	**Year X+3**
1. Gross debt[1]						
2. Change in gross debt ratio						
Contributions to changes in gross debt						
3. Primary balance[2]						
4. Interest expenditure[3]	EDP D.41					
5. Stock-flow adjustment						
of which:						
- Differences between cash and accruals[4]						
- Net accumulation of financial assets[5]						
of which:						
- *privatisation proceeds*						
- Valuation effects and other[6]						
p.m.: Implicit interest rate on debt[7]						
Other relevant variables						
6. Liquid financial assets[8]						
7. Net financial debt (7=1-6)						
8. Debt amortization (existing bonds) since the end of the previous year						
9. Percentage of debt denominated in foreign currency						
10. Average maturity				-	-	-

[1]As defined in Regulation 3605/93 (not an ESA concept).

[2]Cf. item 10 in Table 2.

[3]Cf. item 9 in Table 2.

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

[5]Liquid assets (currency), government securities, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

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

[7]Proxied by interest expenditure divided by the debt level of the previous year.

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

Table 5. Cyclical developments

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

[1]A plus sign means deficit-reducing one-off measures.

Table 6. Divergence from previous update

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

Table 7. Long-term sustainability of public finances

% of GDP	2007	2010	2020	2030	2040	2050	2060
Total expenditure							
Of which: **age-related expenditures**							
Pension expenditure							
Social security pension							
Old-age and early pensions							
Other pensions (disability, survivors)							
Occupational pensions (if in general government)							
Health care							
Long-term care *(this was earlier included in the health care)*							
Education expenditure							
Other age-related expenditures							
Interest expenditure							
Total revenue							
Of which: property income							
Of which: from pensions contributions (or social contributions if appropriate)							
Pension reserve fund assets							
Of which: consolidated public pension fund assets (assets other than government liabilities)							
Systemic pension reforms[1]							
Social contributions diverted to mandatory private scheme[2]							
Pension expenditure paid by mandatory private scheme[3]							
Assumptions							
Labour productivity growth							
Real GDP growth							
Participation rate males (aged 20-64)							
Participation rates females (aged 20-64)							
Total participation rates (aged 20-64)							
Unemployment rate							
Population aged 65+ over total population							

[1]Systemic pension reforms refer to pension reforms that introduce a multi-pillar system that includes a mandatory fully funded pillar.
[2]Social contributions or other revenue received by the mandatory fully funded pillar to cover for the pension obligations it acquired in conjunction with the systemic reform
[3]Pension expenditure or other social benefits paid by the mandatory fully funded pillar linked to the pension obligations it acquired in conjunction with the systemic pension reform

Table 7a. Contingent liabilities

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

Table 8. Basic assumptions

This table should preferably be included in the programme itself; if not, these assumptions should be transmitted to the Council and the Commission together with the programme.

	Year X-1	Year X	Year X+1	Year X+2	Year X+3
Short-term interest rate[1] (annual average)					
Long-term interest rate (annual average)					
USD/€ exchange rate (annual average) (euro area and ERM II countries)					
Nominal effective exchange rate					
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)					
World excluding EU, GDP growth					
EU GDP growth					
Growth of relevant foreign markets					
World import volumes, excluding EU					
Oil prices (Brent, USD/barrel)					

[1]If necessary, purely technical assumptions.

ANNEX 4

The medium-term reference rate of potential growth and the convergence margin, to be used for the in-year and ex post assessment in 2013

	Medium-term reference rate of potential growth applicable in 2012 (%)	GDP deflator		Convergence margin for MS not at their MTO in 2012	Lower reference rate for 2012 (%) if MS not at their MTO
		2012 (for ex post)	2013 (for in-year)		
BE	1.4	2.1	2.1	1.0	0.4
BG	2.6	2.9	2.6	1.4	1.1
CZ	2.4	1.9	1.2	1.2	1.2
DK	0.9	1.9	1.5	0.9	0.0
DE	1.2	1.5	1.6	1.2	0.0
EE	2.3	2.6	3.0	1.2	1.0
IE	0.4	0.8	1.3	1.3	-0.8
EL	-0.2	0.3	-0.8	1.2	-1.4
ES	1.1	1.1	1.3	1.3	-0.2
FR	1.3	1.7	1.6	0.9	0.3
IT	0.3	1.9	1.9	1.1	-0.8
CY	1.5	2.4	1.8	1.2	0.3
LV	1.2	1.6	1.8	1.3	-0.1
LT	2.2	3.0	2.9	1.4	0.8
LU	1.8	2.2	3.2	1.1	0.6
HU	0.5	3.3	3.9	1.1	-0.6
MT	1.5	2.4	2.6	1.3	0.2
NL	1.4	2.1	1.5	1.0	0.4
AT	1.5	2.0	1.6	1.0	0.5
PL	3.8	2.6	2.2	1.2	2.6
PT	0.1	1.2	1.4	1.2	-1.1
RO	2.8	3.9	4.1	1.4	1.4
SI	1.7	1.5	1.3	1.0	0.6
SK	3.2	1.8	1.9	1.4	1.8
FI	1.4	2.6	2.0	0.9	0.5
SE	1.8	1.0	1.4	1.0	0.8
UK	1.2	2.6	2.2	1.1	0.1

ANNEX 5

Computing the adjusted fiscal effort

1/ The impact of revisions of potential output growth, α

1) Correcting for revisions of potential output growth, α

Traditionally, changes in the CAB are used as an indicator of discretionary fiscal policy. The following shows that this reading needs to be qualified in the presence of higher or lower than expected growth.

Ex-ante, an approximate of the expected change in the CAB in year t with respect to year t-1 is

$$\left.\frac{\Delta^d R_t^S - \Delta^d G_t^S}{Y_t^P}\right|_{E_{t-1}Y}$$

where $\Delta^d G_t^S$ the planned structural expenditure in period *t* and $\Delta^d R_t^S$ the planned structural revenues in period *t*. The ratio is conditional on the expected level of actual GDP $E_{t-1}Y_t$, as potential output is extracted from observed real GDP.

<u>Ex-post</u>, the ratio of structural expenditure to potential GDP in year *t* results from the implementation of expenditure plans, discretionary fiscal policy corrections and actual economic growth.

$$\left.\frac{G_t^S}{Y_t^P}\right|_{Y_t} = \left.\frac{G_{t-1}^S(1+E_{t-1}\omega_t^P + E_{t-1}\pi_t) + \Delta^d G_t^S}{Y_t^P}\right|_{Y_t}$$

$E_{t-1}\omega_t^P$ and $E_{t-1}\pi_t$ are expected potential output growth and expected inflation respectively.

The actual ratio is conditional on real GDP in year *t*. In contrast to the ex-ante case, it is not expected real GDP but the actual level observed ex-post. Hence, if actual real GDP in year *t* differs from the forecast, it will also affect potential output and the output gap compared to what was expected ex-ante. Both the denominator and the nominator of the ratio are affected.

In addition, lower or higher than expected growth not only affects potential output in year *t*, it also impacts on potential output of previous years.

Consequently, assuming that the tax system is proportional, the change in the CAB in year *t* with respect to year *t-1* is

$$\Delta CAB_t = \left.\frac{\Delta^d R_t^S - \Delta^d G_t^S}{Y_t^P}\right|_{Y_t} - \left.\frac{G_{t-1}^S}{Y_{t-1}^P}\left(\frac{(1+E_{t-1}\omega_t^P + E_{t-1}\pi_t)}{(1+\omega_t^P + \pi_t)} - 1\right)\right|_{Y_t}$$

The observed change in the CAB will exclusively reflect discretionary fiscal policy interventions only if structural expenditure follows potential output growth. However, given that expenditure plans are fixed in advance based on economic projections, inertia in the budgetary processes or adherence to plans will lead to a departure from the projected change in the CAB ex-ante. This effect may be called passive fiscal policy. In particular, if growth is overestimated $(1+E_{t-1}\omega_t^P + E_{t-1}\pi_t) > (1+\omega_t^P + \pi_t)$ a full implementation of expenditure plans results into a deterioration of the CAB, even in the absence of discretionary fiscal policy measures.

Simplifying the notation, the difference between ex-ante and ex-post changes in the CAB can be written as:

$$\left[\frac{\Delta^d BAL_t^S - G_{t-1}^S(E_{t-1}\omega_t + E_{t-1}\pi_t)}{Y_t^P} + \frac{G_{t-1}^S}{Y_{t-1}^P}\right]\Bigg|_{Y_t} - \left[\frac{\Delta^d BAL_t^S}{Y_t^P}\right]\Bigg|_{E_{t-1}Y_t} =$$

ex-post change in the CAB ex-ante change in the CAB

where $\frac{\Delta^d BAL_t^S}{Y_t^P}$ is the discretionary fiscal policy intervention $\frac{\Delta^d R_t^S - \Delta^d G_t^S}{Y_t^P}$.

Rearranging the difference between ex-post and ex-ante yields

$$= \frac{\Delta^d BAL_t^S|_{Y_t} - \Delta^d BAL_t^S|_{E_{t-1}Y_t}}{Y_t^P|_{Y_t}} + \left(\frac{\Delta^d BAL_t^S|_{E_{t-1}Y_t}}{Y_t^P|_{E_{t-1}Y_t}}\right)\frac{Y_t^P|_{E_{t-1}Y_t} - Y_t^P|_{Y_t}}{Y_t^P|_{Y_t}} - \frac{G_{t-1}^S}{Y_{t-1}^P}\Bigg|_{Y_t}\left(\frac{1+E_{t-1}\omega_t + E_{t-1}\pi_t}{1+\omega_t+\pi_t} - 1\right) \approx$$

$$\approx \frac{\Delta^d BAL_t^S|_{Y_t} - \Delta^d BAL_t^S|_{E_{t-1}Y_t}}{Y_t^P|_{Y_t}} + \left(\frac{\Delta^d BAL_t^S|_{E_{t-1}Y_t}}{Y_t^P|_{E_{t-1}Y_t}}\right)\frac{Y_t^P|_{E_{t-1}Y_t} - Y_t^P|_{Y_t}}{Y_t^P|_{Y_t}} - \frac{G_{t-1}^S}{Y_{t-1}^P}\Bigg|_{Y_t}\left((E_{t-1}\omega_t + E_{t-1}\pi_t) - (\omega_t + \pi_t)\right)$$

Hence, if expenditure plans and discretionary fiscal policy measures are fully implemented in volume terms, the difference between ex-ante and ex-post is a function of:

- the effect of the revision of growth on the output gap and, in turn, on the discretionary component of the budget (first term). A revision in the output gap entails that budgetary items, which ex-ante were thought to be cyclical, turn out to be structural or vice versa. Empirically, this term will tend to be fairly negligible;

- the effect of the revision of growth on the level of potential output and, via the assumption of adherence to plans, on the size of the discretionary correction expressed in percent of potential GDP (second term);

- the effect of the revision of growth on the level of potential output and, in turn, on the non-cyclical expenditure to potential GDP ratio (third term). Numerically, this term clearly dominates as the non-cyclical expenditure to potential GDP ratio is generally around 0.4-0.6, whereas discretionary corrections tend to be comparatively small.

2) The computation of the revenue gap, β

The recommendations under Art. 126(7), or the notice given under Article 126(9),are based on a fully-fledged macroeconomic forecast made under the usual no-policy change assumption. Among other things, this forecast implies an apparent revenue elasticity to GDP in year *t*, ε_t^{rec}, which is given by the following formula:

$$\varepsilon_t^{rec} = \frac{\left(\Delta R_t^{rec} - DM_t^{rec}\right) / R_{t-1}^{rec}}{\Delta Y_t^{rec} / Y_{t-1}^{rec}}$$

where R_t^{rec} is the forecast for the level of current revenues in year *t*, DM_t^{rec} is the level of discretionary revenue measures for year *t* that have been clearly specified and committed to by governments, ahead of the recommendation, relative to *t-1* and Y_t^{rec} is the forecast for the level of GDP in *t*.

In other words, the Commission forecast for revenue developments in year *t* is given by the following formula:

$$\Delta R_t^{rec} = \varepsilon_t^{rec} \left(\frac{\Delta Y_t}{Y_{t-1}}\right)^{rec} R_{t-1}^{rec} + DM_t^{rec}$$

This apparent elasticity can naturally depart from the elasticity used in the computation of the cyclically-adjusted balance (noted hereafter ε*, being close to one). In the short term, there could indeed be good reasons for the revenue elasticity to temporarily depart from its long term value (e.g. change in the composition of growth or in the tax collection rate), and indeed the Commission recommendation could be based on a revenue elasticity different from its long term value.

In sum, so-called "elasticity effects" [30] are not unusual in the short-run and the change in the structural balance as forecast at by the Commission at the time of the recommendation can already include these "elasticity effects" which explain an over/under shooting of the change in the revenue side of the structural balance with respect to discretionary revenue measures undertaken by the authorities..

Formally, this "elasticity effect" (or revenue windfall/shortfall) is given by the following formula:

$$\Delta R_t^{rec} - \Delta R_t^{rec}\Big|_{\varepsilon^*} = \Delta R_t^{rec} - \varepsilon^* \left(\frac{\Delta Y_t}{Y_{t-1}}\right)^{rec} R_{t-1}^{rec} - DM_t^{rec} = \left(\varepsilon_t^{rec} - \varepsilon^*\right) \times \left(\frac{\Delta Y_t}{Y_{t-1}}\right)^{rec} R_{t-1}^{rec}$$

Ex-post, based on actual data, the same distinction between long-term and apparent revenue elasticity can be drawn. Then, *ex-post*, the "elasticity effect" (or revenue shortfall/windfall) in year *t* is:

$$\Delta R_t - \Delta R_t\Big|_{\varepsilon^*} = \Delta R_t - \varepsilon^* \left(\frac{\Delta Y_t}{Y_{t-1}}\right) R_{t-1} - DM_t = \left(\varepsilon_t - \varepsilon^*\right) \times \left(\frac{\Delta Y_t}{Y_{t-1}}\right) R_{t-1}$$

The computation of the "revenue gap" then consists in taking into account possible forecast errors of the Commission as regards the "elasticity effects".

[30] If the "elasticity effects" are positive (i.e. if the revenue elasticity is above its long-term value), the change in the structural balance would then over-estimate the "true" fiscal effort (in terms of measures undertaken). On the contrary, if the "elasticity effects" are negative (i.e. if the revenue elasticity is below its long-term value), the change in the structural balance would under-estimate the "true" fiscal effort (in terms of measures undertaken).

$$RG_t = \underbrace{\left(\Delta R_t - DM_t - \varepsilon^* \left(\frac{\Delta Y_t}{Y_{t-1}} \right) R_{t-1} \right)}_{\text{actual windfall / shortfall}} - \underbrace{\left(\Delta R_t^{rec} - DM_t^{rec} - \varepsilon^* \left(\frac{\Delta Y_t}{Y_{t-1}} \right)^{rec} R_{t-1}^{rec} \right)}_{\text{windfall / shortfall underlying the recommendation}}$$

$$= \underbrace{\left(\varepsilon_t - \varepsilon^* \right) \times \left(\frac{\Delta Y_t}{Y_{t-1}} \right) R_{t-1}}_{\text{actual elasticity effect}} - \underbrace{\left(\varepsilon_t^{rec} - \varepsilon^* \right) \times \left(\frac{\Delta Y_t}{Y_{t-1}} \right)^{rec} R_{t-1}^{rec}}_{\text{elasticity effect underlying the recomendation}}$$

Finally, in order to compute the adjusted fiscal effort, the "revenue gap", expressed at current prices, needs to be converted into a ratio where the denominator takes the form of a nominal potential output. β then can be written as follows:

$$\beta = \frac{RG_t}{Y_t^* \left(Y_t^{nom} / Y_t^{real} \right)}$$

where GDP_t^* stands for the potential output (at constant prices) and Y_t^{nom} / Y_t^{real} is the ratio of GDP at current prices over the GDP at constant prices (this ratio being precisely the price deflator of the GDP). $Y_t^* \left(Y_t^{nom} / Y_t^{real} \right)$ can then be seen as a nominal potential output.

Annex 6

Calculating the Minimum Linear Structural Adjustment (MLSA) for the application of the debt criterion in the transition period

If no additional adjustment is made during the transition period, the debt-to-GDP ratio is assumed to evolve according to effect that the economic cycle given a constant structural balance. We compute the gap to the debt benchmark at the end of the transition period and if this gap is positive the Member State needs to implement a structural adjustment. As we will see, the structural adjustment we chose to calculate is linear – constant over the transition period – and is proportional to the size of the gap to the debt benchmark.

Consider a Member State leaving the Excessive Deficit Procedure at year 0. Its transition period covers year 1 to year 3, during which it implements a constant annual structural adjustment of *adj*. During years 4 and year 5, its debt-to-GDP ratio then evolves freely, driven by a constant structural balance. Finally, the macroeconomic scenario during those five years is given either by the Commission forecasts or by the SCPs projections.

Let $b_1^*, \dots, b_5^*$ be the debt-to-GDP ratios from year 1 to year 5 if the adjustment *adj* was equal to zero – the baseline scenario – and $b_0, b_1, \dots, b_5$ the debt-to-GDP ratios from year 0 to year 5 where the adjustment *adj* that is implemented from year 1 to year 3 is strictly positive.

The gap to the debt benchmark at the end of year 3 under the baseline scenario is assumed positive

$$G_3^* = \min(b_3^* - bb_3^* \,;\, b_5^* - bb_5^*; b_3^{*,3-year-adjusted} - bb_3^*) > 0$$

The known parameters of the equation are the initial debt ratio b_0, *the nominal g*rowth rates $g_1, \dots, g_5$, the initial structural balance s,, the cyclical components of the general government balance $cb_1, \dots, cb_5$, the one-off and other temporary measures $o_1, \dots, o_5$ and the stock-flow adjustments $sfa_1, \dots, sfa_5$. *These pa*rameters allow us to compute the debt-to-GDP ratios in the baseline case where the structural balance remains constant: $b_i^* = \frac{b_{i-1}}{1+g_i} - s_0 - cb_i - o_i + sfa_i$

Alternative case is computed where the structural balance is adjusted each year by an additional *adj* during the transition period:

$$s_1 = s_0 + adj$$
$$s_2 = s_0 + 2adj$$
$$s_3 = s_0 + 3adj$$

In this scenario, the structural balance remains constant afterwards to take into account the forward-looking element of the debt reduction benchmark.

$$s_5 = s_4 = s$$

In the first year of the transition period the difference between the debt-to-GDP ratio in the baseline case and the debt-to-GDP ratio in the case of an adjustment is only due to the adjustment:

$$b_1^* - b_1 = \left(\frac{b_0}{1+g_1} - s_0 - cb_1 - o_1 + sfa_1\right) - \left(\frac{b_0}{1+g_1} - (s_0 + adj) - cb_1 - o_1 + sfa_1\right)$$
$$= adj = adj \times e_1$$

where $e_1 = 1$.

In the following years the difference stems from two sources: the adjustment and the initial level of debt. Thus

$$b_2^* - b_2 = \left(\frac{b_1^*}{1+g_2} - s_0 - cb_2 - o_2 + sfa_2\right) - \left(\frac{b_1}{1+g_2} - (s + 2adj) - cb_2 - o_2 + sfa_2\right)$$
$$= 2adj + \frac{b_1^* - b_1}{1+g_2} = adj \times e_2$$

The same logic applies for years 3, 4 and 5 :

$$b_3^* - b_3 = 3adj + \frac{b_2^* - b_2}{1+g_3} = adj \times e_3$$
$$b_4^* - b_4 = 3adj + \frac{b_3^* - b_3}{1+g_4} = adj \times e_4$$
$$b_5^* - b_5 = 3adj + \frac{b_4^* - b_4}{1+g_5} = adj \times e_5$$

Note for notational purposes that the sequence e is defined by

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

The goal is to solve the following equation for *adj*:

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

The resolution of this equation is done in three steps: first we calculate the adjustment that closes the backward-looking gap to the debt benchmark; second we calculate the adjustment that closes the forward-looking gap to the debt benchmark; and third we calculate the adjustment that closes the cyclically adjusted gap to the debt benchmark.

The minimum adjustment *BLadj* leading to respect of the backward looking element is given by:

$b_3 = bb_3$

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

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

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

Second, the minimum adjustment *FLadj* allowing respect of the forward-looking element of the debt criterion is given by:

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

Thirdly the 3-year adjusted debt at the end of the transition period is

$$b_3^{3-year-adjusted} = \frac{\prod_{i=1}^{3}(1+g_i)}{\prod_{i=1}^{3}\left(1+g_i^{pot}\right)(1+p_i)} \times b_3 + \frac{\sum_{i=1}^{3} cb_i \prod_{j=1}^{i}\left(1+g_j\right)}{\prod_{i=1}^{3}\left(1+g_i^{pot}\right)(1+p_i)} = \alpha b_3 + \beta$$

Thus, the minimum adjustment *CYCLadj* allowing respect of the cyclical element of the debt criterion is given by

$$CYCLadj = \frac{\alpha b_3^* \ + \beta - bb_3^*}{\alpha e_3 - \frac{0.95^3}{3} e_0 - \frac{0.95^2}{3} e_1 - \frac{0.95}{3} e_2}$$

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

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

If the adjustment implemented in year 1 differs from the MLSA, then one needs to calculate the remaining linear structural adjustment for years 2 and 3, following the same logic as before but with an initial level of debt b1 at the end of year 1 and a transition period lasting only two years.

ANNEX 7

Voting modalities under the SGP

In all voting under the SGP, the Member State concerned does not vote. For the corrective arm of the Pact, non-euro area Member States do not participate in the voting on euro area countries. This is also the case in the preventive arm, for the vote establishing lack of effective action to the Council recommendations following a Commission warning and for the vote to impose an interest-bearing deposit on euro area countries.

Unless otherwise specified, all votes are taken under qualified majority voting (QMV). The Nice Treaty definition of a qualified majority is currently applicable. This considers that a qualified majority is reached when 2/3 of concerned Member States weighted according to Protocol 36 to the Treaty, and representing 62% of the population, are in favour of a proposal. From 1 November 2014, the Lisbon definition of a qualified majority will apply, although until the end of the transition period in 2017, any Member State can request that the Nice definition be used. The Lisbon definition considers that a qualified majority has been reached when 55% of Member States participating in the decisions comprising at least 65% of population of these States are in favour of a proposal.

The exceptions to the use of qualified majority voting are the following:

Reversed simple majority voting (RSMV) – whereby an unweighted majority of Member States is need to reject of Commission proposal for a Council decision – is used to vote on a Council decision establishing a lack of effective action to Council recommendations following a Commission warning in the preventive arm, the second time such a decision is recommended by the Commission.

Reversed qualified majority voting (RQMV) – whereby a qualified majority of Member States is needed to reject a Commission proposal for a Council decision – is used:

- To impose sanctions in the form of an interest-bearing deposit under the preventive arm
- To impose or convert the interest-bearing deposit into a non-interest bearing deposit under the corrective arm, following an Article 126(6) decision
- To impose a fine under the corrective arm, following an Article 126(8) decision on a lack of effective action
- It should be noted that the imposition of a fine with a variable component following an Article 126(11) decision on a lack of effective action to notice under Article 126(9) is decided using normal QMV.

The euro area Contracting Parties of the TSCG have committed themselves to voting on in line with the Commission's proposals or recommendations where the Commission considers that a euro area country is in breach of the deficit criterion as long as there is no qualified majority against the recommendations. This is a behavioural, rather than a legal, commitment, and mimics the use of RQMV.

Annex 8
The Fiscal Compact

ARTICLE 3

1. The Contracting Parties shall apply the rules set out in this paragraph in addition and without prejudice to their obligations under European Union law:
(a) the budgetary position of the general government of a Contracting Party shall be balanced or in surplus;
(b) the rule under point (a) shall be deemed to be respected if the annual structural balance of the general government is at its country-specific medium-term objective, as defined in the revised Stability and Growth Pact, with a lower limit of a structural deficit of 0,5 % of the gross domestic product at market prices. The Contracting Parties shall ensure rapid convergence towards their respective medium-term objective. The time-frame for such convergence will be proposed by the European Commission taking into consideration country-specific sustainability risks. Progress towards, and respect of, the medium-term objective shall be evaluated on the basis of an overall assessment with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures, in line with the revised Stability and Growth Pact;
(c) the Contracting Parties may temporarily deviate from their respective medium-term objective or the adjustment path towards it only in exceptional circumstances, as defined in point (b) of paragraph 3;
(d) where the ratio of the general government debt to gross domestic product at market prices is significantly below 60 % and where risks in terms of long-term sustainability of public finances are low, the lower limit of the medium-term objective specified under point (b) can reach a structural deficit of at most 1,0 % of the gross domestic product at market prices;
(e) in the event of significant observed deviations from the medium-term objective or the adjustment path towards it, a correction mechanism shall be triggered automatically. The mechanism shall include the obligation of the Contracting Party concerned to implement measures to correct the deviations over a defined period of time.

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

3. For the purposes of this Article, the definitions set out in Article 2 of the Protocol (No 12) on the excessive deficit procedure, annexed to the European Union Treaties, shall apply.
The following definitions shall also apply for the purposes of this Article:
(a) "annual structural balance of the general government" refers to the annual cyclically-adjusted balance net of one-off and temporary measures;
(b) "exceptional circumstances" refers to the case of an unusual event outside the control of the Contracting Party concerned which has a major impact on the financial position of the general government or to periods of severe economic downturn as set out in the revised Stability and Growth Pact, provided that the temporary deviation of the Contracting Party concerned does not endanger fiscal sustainability in the medium-term.

ARTICLE 4

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

ARTICLE 5

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

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

ARTICLE 6

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

ARTICLE 7

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

ARTICLE 8

1. The European Commission is invited to present in due time to the Contracting Parties a report on the provisions adopted by each of them in compliance with Article 3(2). If the European Commission, after having given the Contracting Party concerned the opportunity to submit its observations, concludes in its report that such Contracting Party has failed to comply with Article 3(2), the matter will be brought to the Court of Justice of the European Union by one or more Contracting Parties. Where a Contracting Party considers, independently of the Commission's report, that another Contracting Party has failed to comply with Article 3(2), it may also bring the matter to the Court of Justice. In both cases, the judgment of the Court of Justice shall be binding on the parties to the proceedings, which shall take the necessary measures to comply with the judgment within a period to be decided by the Court of Justice.

2. Where, on the basis of its own assessment or that of the European Commission, a Contracting Party considers that another Contracting Party has not taken the necessary measures to comply with the judgment of the Court of Justice referred to in paragraph 1, it may bring the case before the Court of

Justice and request the imposition of financial sanctions following criteria established by the European Commission in the framework of Article 260 of the Treaty on the Functioning of the European Union. If the Court of Justice finds that the Contracting Party concerned has not complied with its judgment, it may impose on it a lump sum or a penalty payment appropriate in the circumstances and that shall not exceed 0,1 % of its gross domestic product. The amounts imposed on a Contracting Party whose currency is the euro shall be payable to the European Stability Mechanism. In other cases, payments shall be made to the general budget of the European Union.

3. This Article constitutes a special agreement between the Contracting Parties within the meaning of Article 273 of the Treaty on the Functioning of the European Union.

Annex 9
A numerical example of the expenditure benchmark

This section looks presents a calculation of the expenditure benchmark, in line with the methodology outlined in Box 10 in section 1.3.2.3.2. The table at the end of this annex presents the data used for the calculation of the expenditure benchmark for an indicative country following the 2012 Autumn forecasts.

As Box 10 set out, the first data that enters the calculation is the government expenditure aggregate. This comes from the SCPs and is given in line 1. Interest expenditure (line 2), government expenditure on EU programmes fully matched by EU funds revenue (line 3), gross fixed capital formation for the year in question (line7) and cyclical unemployment benefit expenditure (line 9) are also obtained from the SCPs. These items will be subtracted from the government expenditure aggregate, while the average annual gross fixed capital formation for years t-3 to t (line 8) will be added. The table shows how the average is computed from the nominal figures for the four years in question, using the information from lines 4 to 7. The modified expenditure aggregate is then given in line 14. This is then corrected for discretionary revenue measures (given in line 12) and revenue measures mandated by law (13), in the countries where these latter apply. Both these figures are given in the SCPs, and it is important to check that it the increment of these figures relative to the previous year that is used. Care should be taken to check the reliability of these figures in line with guidance given in Box 10.

The change in the net nominal expenditure is then computed in line 16 using the formula from Box 10. Note that in doing this, the corrected expenditure net of revenue measures in year t (line 15) is compared to the corrected expenditure for year t-1 that is not net of revenue measures (line 14). This is because the revenue measures from lines 12 and 13 are given on an incremental basis over the previous year. The nominal change is then converted to real terms using the deflator in line 17. The real terms change is given in line 18 according to the formula: real*deflator = nominal. The figure given in line 18 is then the real change in the net expenditure aggregate which can be compared to the appropriate benchmark figure to judge compliance with the expenditure benchmark.

In the example given in the table, the country had an MTO of 0 for 2011 and 2012 and a structural balance of -3.5% in 2011, -3.5% in 2012, -3.2% in 2013 and -2.8% in 2014. It was therefore not at its MTO at the time of the exercise and as it is a member of the euro zone and therefore subject to a minimum MTO of -1%, would not be forecast to be at its MTO for the remaining years of this indicative exercise. Lines 21 and 22 give the benchmark rate for the country in question depending on whether it is at its MTO, or not, respectively. The table shows that the applicable lower benchmark rate is 0.24%.

If line 18 is at or below the level given in line 22, the country (that is not at its MTO) is compliant with the expenditure benchmark for a given year. Otherwise it is not compliant. A country at its MTO will be judged by comparing line 18 to line 21. Line 23 calculates the excess of the growth in expenditure over the benchmark rate, and coverts into the national currency using the figure for the net expenditure aggregate. Using the figure for nominal GDP given in line 24, this difference of net expenditure growth relative to the benchmark rate is given as a share of GDP in line 25.

The figure in line 25 gives the excess (if it is positive) of net expenditure growth over the benchmark rate to be used to assess whether the deviation is significant or not. If the figure exceeds 0.5pp of GDP over 1 year, it is judged to be significant. As the significance of deviation is judged both in each year and over two years, line 26 gives the average over two consecutive years. If this is over 0.25, the deviation is judged to be significant over two years.

			2011	2012	2013	2014
1		**General government expenditure**	2.751	2.876	3.036	3.142
2		**Interest expenditure**	0.201	0.215	0.229	0.235
3		**Government expenditure on EU programmes fully matched by EU funds revenue**	0.098	0.124	0.147	0.159
4		*Gross fixed capital formation t-3*	*0.139*	*0.136*	*0.132*	*0.164*
	5	*Gross fixed capital formation t-2*	*0.136*	*0.132*	*0.164*	*0.177*
	6	*Gross fixed capital formation t-1*	*0.132*	*0.164*	*0.177*	*0.184*
7		**Gross fixed capital formation t**	0.164	0.177	0.184	0.199
8		**Annual average gross fixed capital formation t-3 to t**	0.143	0.152	0.164	0.181
9		**Cyclical unemployment expenditure**	0.000	-0.001	0.000	0.000
	10	*Discretionary measures current revenue*	*0.000*	*0.042*	*-0.019*	*-0.024*
	11	*Discretionary measures capital transfers received*	*0*	*0*	*0*	*0*
12		**Total discretionary revenue measures**	0.000	0.042	-0.019	-0.024
13		**Revenue measures mandated by law**		0.000	0.000	0.000
14		**Corrected expenditure aggregate* (nominal)** *= (1) –(2) – (3) – ((7) – (8)) – (9)*	2.430	2.513	2.640	2.730
15		**Corrected expenditure aggregate net of (15) and (16)* (nominal)** *= (14) – (12) – (13)*	2.430	2.471	2.659	2.754
16		**Net public expenditure annual growth in % (nominal)**		1.68	5.83	4.30
17		GDP deflator (% change) computed according to agreed methodology for 2012 and 2013 - for 2014, AF12		2.41	2.56	2.35
18		**Net public expenditure annual growth in % (real)**		**-0.72**	**3.19**	**1.90**
19		MTO announced in SCP of year t	0	0	NA	NA
20		Structural balance (% of potential GDP)	-3.54	-3.54	-3.20	-2.83
21		Applicable benchmark rate when already at MTO (structural balance in t-1 ≥ MTO on year t)		1.51	1.51	1.51
22		Applicable lower benchmark rate when MS needs to progress towards MTO		**0.24**	**0.24**	**0.24**
23		Deviation in year t (in national currency) *= ((18)-(22))*(14 from the previous year)/100* if negative, it is an over-compliance with the benchmark		-0.02	0.07	0.04
24		GDP (nominal in national currency)	6.5	6.7	7.0	7.3
25		**Deviation in year t (in % GDP)** *= (23)/(24) *100* **if positive, it is an over-compliance with the benchmark**		**-0.34**	**1.06**	***0.60***
26		**Average deviation in t-1 and t (in % GDP)** *= average of (25) for t-1 and t*			**0.36**	**0.83**

ANNEX 10

A numerical example of an assessment of effective action to an Article 126(7) recommendation or Article 126(9) notice

This annex presents an example of an assessment of effective action following an Article 126(7) recommendation or notice under Article 126(9), by considering the case of Spain in November 2012. At that time, Spain's response to the (revised) recommendations issued by the Council in July 2012 was being assessed. As the Article 126(7) recommendation was issued recently, it included annual targets for the deficit and the structural balance and effective action therefore follows the methodology set out in section 2.3.2.1. Tables A14a and A14b below present the main variables used when assessing whether Spain had taken effective action.

Table A14a – Baseline scenario underlying the recommendation addressed to Spain in July 2012

% of GDP	2011	2012	2013	2014
Revenues	35.1	35.9	35.7	34.7
Current revenues	35.3	36.1	35.9	34.9
Discretionary measures with impact on current revenue (EUR bn)[31]	9.7	9.3	-1.8	-4.7
Expenditure	44.0	42.2	41.8	41.1
Real GDP growth (%)	0.7	-1.9	-0.3	1.1
Nominal GDP growth (%)	2.1	-1.0	0.3	2.5
Potential GDP growth (%)	0.1	-0.8	-0.9	-0.9
Structural balance	-7.0	-4.3	-4.1	-5.1
General government balance	-8.9	-6.3	-6.1	-6.4
p.m CAB methodology revenue elasticity	1.1	1.1	1.1	1.1
p.m Apparent revenue elasticity		0.9	-0.2	0.5
p.m Output gap (% of pot. Output)	-4.2	-5.3	-4.7	-2.8

Table A14b – EDP scenario underlying the recommendation addressed to Spain in July 2012

% of GDP	2011	2012	2013	2014
Real GDP growth (%)	0.7	-1.9	-2.1	-1.1
Potential GDP growth (%)	0.1	-0.8	-0.9	-0.9
Structural balance	-7.0	-4.3	-1.8	0.1
General government balance	-8.9	-6.3	-4.5	-2.8
p.m Output gap (% of pot. output)	-4.2	-5.3	-6.5	-6.8

Alongside the change in the structural balance, the key variables for the assessment of effective action are the parameters α (revisions in potential growth) and β (revisions in windfall/shortfall revenues). The estimation of these parameters is given in tables A14c and A14d, respectively.

Table A14c – Detailed calculations for the parameter α

	Pot. growth assumptions underlying the July recommendation (%) (1)	**Pot. growth (2012 COM AF) (%) (2)**	**Forecast error (%) (3)=(2)-(1)**	**Structural expenditure (% of pot. GDP) (2012 COM forecast) (4)**	**Correction coefficient α (% of nominal pot. GDP) (5)=[(3) x (4)]/100**
2012	-0.8	-1.0	-0.2	40.1	-0.1
2013	-0.9	-1.3	-0.3	38.9	-0.1
2014	-0.9	-1.3	-0.3	40.1	-0.1

[31] Measures clearly specified and committed to by governments ahead of the recommendation.

Table A14c shows that the correction of the change in the structural balance due to revisions in potential output growth (parameter α) has an effect of 0.1 percentage point in all three years covered by the EDP recommendation, explained by a downward revision of potential output growth of 0.2, 0.3 and 0.3 percentage points in the three years between the time of the (revised) EDP recommendation and the time of the assessment of effective action.

Table A14d – Detailed calculations for the parameter β

CAB methodology revenue elasticity $\varepsilon^*=1.09$	**Change in current revenues (yoy) (EUR bn)**		**Discretionary revenues measures (EUR bn)**		**Nominal growth assumptions (%)**		**Current revenues in t-1 (EUR bn)**		**Revenue gap (EUR bn)**	**Correction coefficient β**
	July reco. (1)	*2012 AF (1')*	*July reco. (2)*	*2012 AF (2')*	*July reco. (3)*	*2012 AF (3')*	*July reco. (4)*	*2012 AF (4')*	*(5)=[(1')-(2')- ε*x (3') x (4')]- [(1)-(2)- ε*x (3) x (4)]*	*=(5) expressed in % of nominal pot. GDP*
2012	5.5	-0.8	9.3	18.0	-1.0	-1.2	378.4	380.3	-14.3	-1.3
2013	-2.0	8.2	-1.8	10.7	0.3	0.4	383.9	379.5	-2.7	-0.2
2014	-0.2	-0.6	-4.7	-6.7	2.5	2.3	381.9	387.7	2.5	+0.2

ANNEX 11
Parameters underlying the Commission's cyclical adjustment methodology

	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	0.94	-0.15	-0.06	-1.15	49.05	50.70	-0.029	-0.582	0.553
BG	0.82	-0.02	-0.18	-1.02	37.75	38.10	-0.068	-0.390	0.322
CZ	0.86	-0.02	-0.14	-1.02	39.91	43.77	-0.057	-0.448	0.391
DK	0.90	-0.22	-0.10	-1.22	55.75	54.34	-0.057	-0.665	0.607
DE	0.89	-0.31	-0.11	-1.31	44.00	46.45	-0.047	-0.609	0.562
EE	0.74	-0.06	-0.26	-1.06	37.63	36.99	-0.096	-0.393	0.297
IE	1.00	-0.23	0.00	-1.23	35.20	41.14	-0.001	-0.506	0.505
EL	0.92	-0.05	-0.08	-1.05	39.93	48.06	-0.034	-0.507	0.473
ES	1.00	-0.16	0.00	-1.16	38.14	41.13	-0.002	-0.478	0.476
FR	0.89	-0.11	-0.11	-1.11	49.90	54.11	-0.056	-0.603	0.546
IT	1.09	-0.04	0.09	-1.04	45.14	48.77	0.040	-0.507	0.547
CY	0.95	-0.04	-0.05	-1.04	40.27	43.47	-0.019	-0.453	0.434
LV	0.73	-0.06	-0.27	-1.06	35.08	38.26	-0.094	-0.404	0.310
LT	0.77	-0.05	-0.23	-1.05	32.92	36.13	-0.074	-0.379	0.305
LU	1.06	-0.08	0.06	-1.08	41.87	41.09	0.026	-0.444	0.471
HU	0.88	-0.04	-0.12	-1.04	44.97	50.33	-0.053	-0.522	0.470
MT	0.86	-0.04	-0.14	-1.04	39.48	43.74	-0.054	-0.457	0.403
NL	0.88	-0.31	-0.12	-1.31	45.25	47.37	-0.053	-0.618	0.566
AT	0.87	-0.08	-0.13	-1.08	48.49	50.77	-0.062	-0.551	0.488
PL	0.78	-0.12	-0.22	-1.12	38.78	43.79	-0.086	-0.491	0.404
PT	0.92	-0.07	-0.08	-1.07	41.08	46.42	-0.034	-0.498	0.463
RO	0.84	-0.04	-0.16	-1.04	32.97	36.78	-0.053	-0.382	0.329
SI	0.91	-0.08	-0.09	-1.08	43.46	46.49	-0.040	-0.502	0.461
SK	0.77	-0.06	-0.23	-1.06	34.23	38.62	-0.078	-0.410	0.332
FI	0.75	-0.29	-0.25	-1.29	53.13	51.08	-0.132	-0.658	0.526
SE	0.85	-0.26	-0.15	-1.26	53.99	53.13	-0.082	-0.671	0.589
UK	1.02	-0.04	0.02	-1.04	40.36	45.60	0.007	-0.475	0.482

Glossary

Automatic stabilisers Features of the tax and spending regime which react automatically to the economic cycle and reduce its fluctuations. As a result, the budget balance in percent of GDP tends to improve in years of high growth, and deteriorate during economic slowdowns.

Bottom up fiscal effort A quantification of the fiscal impact of measures introduced, obtained by summing up the impact of the individual measures.See *Top down fiscal effort.*

Broad Economic Policy Guidelines (BEPGs) Annual guidelines for the economic and budgetary policies of the Member States. They are prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN).

Budget balance The balance between total public expenditure and revenue in a specific year, with a positive balance indicating a surplus and a negative balance indicating a deficit. For the monitoring of Member State budgetary positions, the EU uses *general government* aggregates. See also *structural budget balance*, *primary budget balance*, and *primary structural balance*.

Budgetary sensitivity The variation in the budget balance in percentage of GDP brought about by a change in the output gap. In the EU, it is estimated to be 0.5 on average.

Close-to-balance requirement A requirement contained in the 'old' *Stability and Growth Pact*, according to which Member States should, over the medium term, achieve an overall *budget balance* close to balance or in surplus; was replaced by country-specific *medium-term budgetary objectives* in the reformed *Stability and Growth Pact*.

Code of Conduct Policy document setting down the specifications on the implementation of the *Stability and Growth Pact* and the format and content of the *Stability* and *Convergence programmes*.

Convergence programmes Medium-term budgetary and monetary strategies presented by Member States that have not yet adopted the euro. They are updated annually, according to the provisions of the *Stability and Growth Pact*. See also *stability programmes*.

Crowding-out effects Offsetting effects on output due to changes in interest rates and exchange rates triggered by a loosening or tightening of fiscal policy.

Cyclical component of budget balance That part of the change in the *budget balance* that follows automatically from the cyclical conditions of the economy, due to the reaction of public revenue and expenditure to changes in the *output gap*. See *automatic stabilisers*, *tax smoothing* and *structural budget balance*.

Cyclically-adjusted budget balance See *structural budget balance*.

Defined-benefit pension scheme A traditional pension scheme that defines a benefit, i.e. a pension, for an employee upon that employee's retirement is a defined benefit plan.

Defined-contribution pension scheme A scheme providing for an individual account for each participant, and for benefits based solely on the amount contributed to the account, plus or minus income, gains, expenses and losses allocated to the account.

Demand and supply shocks Disturbances that affect the economy on the demand side (*e.g.* changes in private consumption or exports) or on the supply side (*e.g.* changes in commodity prices or technological innovations). They can impact on the economy either on a temporary or permanent basis.

Direct fiscal costs (gross, net) of a financial crisis The direct gross costs are the fiscal outlays in support of the financial sector that increase the level of public debt. They encompass, for example, recapitalisation, purchase of troubled bank assets, pay-out to depositors, liquidity support, payment when guarantees are called and subsidies. The direct net costs are the direct gross cost net of recovery payments, such as through the sale of acquired assets or returns on assets. Thus, the net direct fiscal costs reflect the permanent increase in public debt.

Discretionary fiscal policy Change in the *budget balance* and in its components under the control of government. It is usually measured as the residual of the change in the balance after the exclusion of the budgetary impact of *automatic stabilisers*. See also *fiscal stance*.

Economic and Financial Committee (EFC) Formerly the Monetary Committee, the EFC is a Committee of the Council of the European Union set up by Article 134 of TFEU. Its main task is to prepare and discuss (ECOFIN) Council decisions with regard to economic and financial matters.

Economic Policy Committee (EPC) Group of senior government officials whose main task is to prepare discussions of the (ECOFIN) Council on structural policies. It plays an important role in the preparation of the *Broad Economic Policy Guidelines*, and it is active on policies related to labour markets, methods to calculate cyclically adjusted budget balances and ageing populations.

ESA95 / ESA79 European accounting standards for the reporting of economic data by the Member States to the EU. As of 2000, ESA95 has replaced the earlier ESA79 standard with regard to the comparison and analysis of national public finance data.

European Financial Stability Facility is a company owned by Euro Area Member States created following the decisions taken in May 2010 by the Council. EFSF is able to issue bonds guaranteed by euro area Member States to lend to euro area Member States in difficulty, subject to conditions negotiated with the European Commission in liaison with the European Central Bank and International Monetary Fund and to be approved by the Eurogroup.

European semester is the yearly cycle of economic policy coordination which takes place over the first 6 months of the year. The European Commission undertakes a detailed analysis of EU Member States' programmes of economic and structural policies and the European Council and the Council of ministers provide policy advice before Member States finalise their draft budgets.

Excessive Deficit Procedure (EDP) A procedure according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in order to assess and/or correct the risk of an excessive deficit in each Member State. Its application has been further clarified in the *Stability and Growth Pact*. See also s*tability programmes* and *Stability and Growth Pact*.

Expenditure rules A subset of *fiscal rules* that target (a subset of) public expenditure.

Fiscal consolidation An improvement in the *budget balance* through measures of *discretionary fiscal policy*, either specified by the amount of the improvement or the period over which the improvement continues.

Fiscal governance Comprises all arrangements, procedures, rules and institutions that underlie the conduct of budgetary policies of general government.The terms fiscal governance and fiscal frameworks are used interchangeably in thedocument.

(Numerical) Fiscal rule A permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance, such as the government budget deficit, borrowing, debt, or a major component thereof. See also *expenditure rules*.

General government As used by the EU in its process of budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure*, the general government sector covers national government, regional and local government, as well as social security funds. Public enterprises are excluded, as are transfers to and from the EU Budget.

Government contingent liabilities Obligations for the government that are subject to the realization of specific uncertain and discrete future events. For instance, the guarantees granted by governments to the debt of private corporations bonds issued by enterprise are contingent liabilities, since the government obligation to pay depend on the non-ability of the original debtor to honour its own obligations.

Government implicit liabilities Government obligations that are very likely to arise in the future in spite of the absence of backing contracts or law. The government may have a potential future obligation as a result of legitimate expectations generated by past practice or as a result of the pressure by interest groups. Most implicit liabilities are contingent, i.e., depend upon the occurrence of uncertain future events.

Indirect taxation Taxes that are levied during the production stage, and not on the income and property arising from economic production processes. Prominent examples of indirect taxation are the value added tax (VAT), excise duties, import levies, energy and other environmental taxes.

Integrated guidelines A general policy instrument for coordinating EU-wide and Member States economic structural reforms embedded in the Lisbon strategy and which main aim is to boost economic growth and job creation in the EU.

Interest burden *General government* interest payments on public debt as a share of GDP.

Maastricht reference values for public debt and deficits Respectively, a 60 % *general government* debt-to-GDP ratio and a 3 % *general government* deficit-to-GDP ratio. These thresholds are defined in a protocol to the Maastricht Treaty on European Union. See also *Excessive Deficit Procedure*.

Medium-term budgetary framework An institutional fiscal device that lets policy-makers extend the horizon for fiscal policy making beyond the annual budgetary calendar (typically 3-5 years). Targets can be adjusted under medium-term budgetary frameworks (MTBF) either on an annual basis (flexible frameworks) or only at the end of the MTBF horizon (fixed frameworks).

Medium-term budgetary objective (MTO) According to the reformed *Stability and Growth Pact*, *stability programmes* and *convergence programmes* present a *medium-term objective* for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risks to the sustainability of public finances, and is defined in structural terms (see *structural balance*).

Minimum benchmarks The lowest value of the structural budget balance that provides a safety margin against the risk of breaching the *Maastricht reference value for the deficit* during normal cyclical fluctuations. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks. They are a lower bound for the *medium-term budgetary objectives (MTO)*.

One-off and temporary measures Government transactions having a transitory budgetary effect that does not lead to a sustained change in the budgetary position. See also *structural balance*.

Output gap The difference between actual output and estimated potential output at any particular point in time. See also *cyclical component of budget balance*.

Pension fund A legal entity set up to accumulate, manage and administer pension assets. See also *private pension scheme*.

Potential GDP The level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate. See also *output gap*.

Primary budget balance The *budget balance* net of interest payments on *general government* debt.

Primary structural budget balance The *structural budget balance* net of interest payments.

Private pension schemes The insurance contract specifies a schedule of contribution in exchange of which benefits will be paid when the members reach a specific retirement age. The transactions are between the individual and the insurance provider and they are not recorded as government revenues or government expenditure and, therefore, do not have an impact on government surplus or deficit.

Pro-cyclical fiscal policy A *fiscal stance* which amplifies the economic cycle by increasing the *structural primary deficit* during an economic upturn, or by decreasing it in a downturn. A neutral fiscal policy keeps the *cyclically-adjusted budget balance* unchanged over the economic cycle but lets the *automatic stabilisers* work.

Public debt Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by public institutions in the Member State, except that part of the debt which is owed to other public institutions in the same Member State.

Public investment The component of total public expenditure through which governments increase and improve the stock of capital employed in the production of the goods and services they provide.

Significant divergence/deviation A sizeable excess of the budget balance over the targets laid out in the *Stability or Convergence programmes*, that triggers the *warning* procedure of the *Stability and Growth Pact*.

'Snow-ball' effect The self-reinforcing effect of public debt accumulation or decumulation arising from a positive or negative differential between the interest rate paid on public debt and the growth rate of the national economy.

Sovereign bond spread The difference between risk premiums imposed by financial markets on sovereign bonds for different states. Higher risk premiums can largely stem from (i) the debt service ratio, also reflecting the countries' ability to raise their taxes for a given level of GDP, (ii) the fiscal track record, (iii) expected future deficits, and (iv) the degree of risk aversion.

Stability and Growth Pact (SGP) Approved in 1997 and reformed in 2005 and 2011, the SGP clarifies the provisions of the Maastricht Treaty regarding the surveillance of Member State budgetary policies and the monitoring of budget deficits during the third phase of EMU. The SGP consists of two Council Regulations setting out legally binding provisions to be followed by the European Institutions and the Member States and two Resolutions of the European Council in Amsterdam (June 1997). See also *Excessive Deficit Procedure*.

Stability programmes Medium-term budgetary strategies presented by those Member States that have already adopted the euro. They are updated annually, according to the provisions of the *Stability and Growth Pact*. See also C*onvergence programmes*.

Stock-flow adjustment The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between the net borrowing (flow) and the variation in the stock of gross debt. It includes the accumulation of financial assets, changes in the value of debt denominated in foreign currency, and remaining statistical adjustments.

Structural budget balance The actual *budget balance* net of the *cyclical component and one-off and other temporary measures*. The structural balance gives a measure of the underlying trend in the budget balance. See also *primary structural budget balance*.

Sustainability A combination of budget deficits and debt that ensure that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

Tax elasticity A parameter measuring the relative change in tax revenues with respect to a relative change in GDP. The tax elasticity is an input to the *budgetary sensitivity*.

Top down fiscal effort A quantification of the fiscal impact of government policy, obtained by looking at the overall change in the structural balance. This may differ from the *bottom* up measure due to the incomplete coverage of the latter, second-order economic effects or different assumptions about the non-policy change assumption.

List of Abbreviations

Member States

BE	Belgium
BG	Bulgaria
CZ	Czech Republic
DK	Denmark
DE	Germany
EE	Estonia
EI	Ireland
EL	Greece
ES	Spain
FR	France
IT	Italy
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
DG ECFIN	Directorate-General Economic and Financial Affairs
ECB	European Central Bank
ECOFIN	Economic and Financial 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(95)	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 of Economic Co-operation and Development

pp	Percentage points
SCPs	Stability and convergence programmes
SFA	Stock Flow Adjustments
SGP	Stability and Growth Pact
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance in the Economic and Monetary Union

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