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Building a Strengthened Fiscal Framework in the European Union: A Guide to the Stability and Growth Pact

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

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INTRODUCTION

The Stability and Growth Pact (SGP) is a rule-based framework for the setting and assessing of national fiscal policies in the European Union. It aims to ensure that European Union countries pursue sound government finances, based on the principle that economic policies are a matter of shared concern for all Member States.

The SGP's origins are found in the Maastricht Treaty, which launched Economic and Monetary Union (EMU). In practical terms, EMU is based on four inter-related tenets: the single currency and the euro area; an independent monetary policy for the euro area conducted by the European Central Bank (ECB); a framework for fiscal policy, notably through limits on government debt and deficit; and the coordination of economic policy-making between Member States. While monetary policy, which aims to ensure price stability, is the exclusive competency of the ECB in the euro area, Member States have retained the full authority to set and implement fiscal policies within their respective countries. Because of the unique structure of European economic integration – specifically, a common monetary policy and decentralized fiscal policies – the architects of EMU established fiscal rules to ensure national fiscal policies would enable effective monetary policy necessary for price stability and economic growth while also avoiding potential negative spillovers. The Maastricht Treaty's budgetary provisions included both the basic requirements of economic cooperation fiscal surveillance – that is, the setting and monitoring of Member States' budgetary policies – as well as the principle of avoidance of excessive deficits and debt, as defined by reference values of 3% and 60% of GDP respectively. These provisions are implemented through the legal texts known as the Stability and Growth Pact.

The secondary legislation governing the SGP was adopted in 1997 and later reformed and supplemented in 2005 and 2011. New legislation, known as the Two Pack, which will complement the current framework for euro area Member States, will enter into force on May 30. Member States have taken additional commitments through the intergovernmental Treaty on Stability, Coordination and Governance (TSCG), which entered into force in January 2013, whose fiscal provisions mirror key elements of the SGP in national law.

While the Stability and Growth Pact has evolved since its initial adoption in 1997, the underlying framework of the Pact continues to serve as the basis of EU fiscal surveillance today. This framework consists of numerical rules to ensure sound budgetary planning, procedural rules which are followed when the numerical thresholds are breached, and institutional arrangements to coordinate budgetary policies.

The European Union at the time of EMU's launch in 1990 is very different than the EU we know today. Economic integration has been significantly deepened. The euro is a reality, serving as both a symbol and a tangible feature of the interdependence of Europe's economies. With the enlargement of Member States, the EU itself has become both a larger and more diverse union. The importance of national ownership and democratic legitimacy in rule-making has also been enhanced. Finally, a number of lessons have been learned from practical experience in the Pact's implementation, particularly weaknesses identified during the recent financial and economic crisis in Europe, that have served to make the Pact more effective. These factors have provided the impetus for the three periods of reform of the Stability and Growth Pact. Despite the significant enhancements to the rules over the years, the underlying principles and rationale of the SGP remain, reflecting their soundness.

This guide provides a non-technical overview of the SGP. It is organized into two sections. The first section provides a historical look at the evolution of the SGP's framework, from the Pact's origins in the Maastricht Treaty to the most recent Two Pack reforms. It discusses the changes that were made to the framework and the rationale behind the reforms and enhancements. The second section provides a description of the application of the SGP today, to provide the reader with an understanding of how the concepts discussed in the first section are implemented in practice. This guide is published alongside a "Vade Mecum on the SGP" which contains a detailed description of the operation of the SGP and is aimed primarily at technicians working on budgetary policies.

I. EVOLUTION AND REFORM OF THE STABILITY AND GROWTH PACT

I.1. THE STABILITY AND GROWTH PACT'S ORIGINS AND INITIAL FRAMEWORK

The need for fiscal coordination to accompany the introduction of the euro was acknowledged from the beginning of the establishment of the Economic and Monetary Union (EMU). ([1]) At its core, EMU is based on a single monetary policy which is the competency of the European Central Bank (ECB), while participating countries retain the full authority to set and implement fiscal policies. The architects of EMU realised that the interplay between monetary and fiscal policies and the increased interdependence of and spillovers among countries sharing a single currency meant that national fiscal policies could not be allowed to impose disproportionate costs on other participants. By imposing a common framework within which Member States would set budgetary policy, the possibility of negative impacts on other euro area countries – whether stemming from the inflationary impact of large deficits or the destabilising effect of unsustainability or insolvency – could be reduced. This is the role of the Stability and Growth Pact (SGP).

The SGP is the name given to the collection of secondary legislation that implements the Treaty requirements on budgetary surveillance. The first Treaty basis for the surveillance of budgetary policy was the Treaty on European Union, signed in Maastricht in 1992. While subsequent amendments found in the current Treaty for the Functioning of European Union (TFEU), henceforth also "Treaty," have complemented the original Maastricht design, including a specific article dedicated to the euro area (Article 136 TFEU, which is discussed in section I.3), the basis of budgetary surveillance remains unchanged. In particular, budgetary surveillance at the European level stems from two Articles. Article 121 TFEU states that "Member States shall regard their economic policies as a matter of common concern and shall co-ordinate them within the Council….," while Article 126 TFEU requires Member States to avoid excessive government deficits and debt based on specific reference values, and establishes a step-based process under the excessive deficit procedure (EDP) to ensure the correction of breaches of the reference values. Annex 1 replicates these articles.

The Treaty's reference values, as defined in the Treaty and the Protocol on the Excessive Deficit Procedure, are as follows:

• 3% of GDP government deficit, unless the excess is small, exceptional, and temporary;

• 60% of GDP government debt, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The SGP's initial framework consisted of two Council Regulations ([2]) which set out legally binding provisions to be followed by the European Institutions and the Member States. These Regulations were complemented by the Resolution of the European Council in Amsterdam (June 1997), which provides the political basis of the SGP, and a Code of Conduct which provides specifications on the implementation of the Stability and Growth Pact. 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 forms part of the preventive arm of the Pact, but does not contain additional operational requirements.

The SGP is divided into two arms, corresponding to the two establishing Regulations:

• The preventive arm implements the coordination of budgetary policy and aims to ensure that

([1]) The establishment of EMU comprised a three-stage process. Stage 1 (1990-1994) involved the completion of the single market through the liberalization of capital movements between Member States. Stage 2 (1994-1999) monitored the convergence of the economies of Member States based on four convergence criteria set within the Maastricht Treaty. Stage 3(1999 to present) was marked by the irrevocable fixing of the exchange rate and the introduction of the euro as the single currency, with a common monetary policy under the aegis of the ECB.

([2]) 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 and Council Regulation (EC) 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure.

Table I.1: **The specifications of the original 1997 SGP**

	Objective	Specification	Adjustment path	Enforcement mechanism
Preventive arm	Close to balance or in surplus	-	-	-
Corrective arm	Correct gross policy errors	Limits: • Deficit: 3% of • (Debt: 60% of GDP or sufficiently diminishing)	Defined within the EDP	At the very end of the procedure

budgetary policy leads to a sound medium-term budgetary position;

• The corrective arm is concerned with situations where the deficit or the debt breach the threshold values (of 3% and 60% of GDP respectively) set in the Treaty. It implements the step by step procedure outlined in Article 126 of the Treaty which applies in these cases. It is known as the Excessive Deficit Procedure.

Table I.1 outlines the main components of the original SGP, as it was set out in 1997. The next subsections consider these in more detail.

The preventive arm of the SGP in 1997

The preventive arm aims to ensure that all countries reach a sound public finance position over the medium term. The 1997 framework required all Member States to set a harmonized medium-term budgetary objective of close to balance or surplus. Setting a medium-term objective of close to balance or surplus meant that governments would either reduce or stabilise their debt over time and would aim to reach a position that ensured long-term public finance sustainability. The preventive arm of the Pact explicitly mentioned that the medium-term objective should enable countries to deal with normal cyclical fluctuations while keeping borrowing within 3% of the GDP over the cycle, linking the preventive arm with the corrective arm, and recognising the need to have a medium-term budgetary position strong enough to provide stabilisation over the cycle.

The original framework for the SGP also established the procedures for multilateral surveillance of Member States' budgetary positions. Each year, Member States were to outline their medium-term budgetary plans in Stability or Convergence Programmes (SCPs). Stability programmes were submitted by euro area Member States, while convergence programmes, which also contained monetary strategies, were submitted by non-euro area Member States.

Within the context of multilateral surveillance, the Commission and then the Council would consider whether a country's plans for its borrowing in the coming years were consistent with reaching a position of close to balance or surplus. If a country's plan was found to be inconsistent with the provision, the preventive arm allowed for the Council to issue an 'early warning' to the country, to avoid the country's borrowing turning into an excessive deficit.

The corrective arm of the Pact

The corrective arm of the Pact outlined the procedures to follow once a country's borrowing exceeded 3% of GDP. Although the Treaty also defines a threshold level for the debt, the 1997 specification of the corrective arm did not include specific criteria to judge whether a debt ratio above 60% was "sufficiently diminishing and approaching the reference value at a satisfactory pace", thus rendering the debt condition inoperational. ([3]) Following the steps set out in Article 126 of the Treaty, borrowing in excess of 3% of GDP would lead to a report by the Commission which would consider whether this excessive borrowing should result in an Excessive Deficit Procedure being opened against the country. This report considered whether the excessive borrowing should be considered as small, exceptional and temporary. If this was the case, the country would not be placed in EDP. The concept of "exceptional circumstances" was defined in terms of GDP retracting by 2% in a year.

Once an EDP was opened, the Member State in question would be issued with recommendations to bring the deficit back down to below 3% of GDP by a deadline. Following these recommendations, it was the role of the Commission to monitor and the Council to decide on whether a country had taken action to meet the timescale for reducing its deficit. If so, the EDP was then closed ("abrogated"). Otherwise, it was to be stepped up, leading first to more intrusive recommendations and finally, after persistent breaches, to the possible imposition of fines.

I.2. 2005 REFORM: ENHANCING ECONOMIC RATIONALE AND FLEXIBILITY

With eight years of operation, some of the shortcomings of the original Pact were evident. In addition, ten new economies – many of them at different stages of development compared to existing members – joined the EU in 2004. Their needs and particular circumstances were also taken into account in the 2005 revised version of the Pact. Finally, a lack of compliance with the rules became a major impetus for the reforms following events in 2003 involving the procedures of France and Germany.

The main innovations of the 2005 reforms were to (a) move away from uniform rules to more differentiation according to country specificities and to (b) better take into account the economic situation and developments. The 2005 reforms better specified some of the SGP provisions to ensure improved compliance, while also introducing more flexibility in their implementation. In particular, the previous nominalist approach which was based on the actual deficit respecting the 3% of GDP Treaty reference by a set deadline, was replaced with a focus on the concept of fiscal effort as measured by the structural deficit (meaning that the impact of the economic cycle was removed from the budget balance and one-off and temporary measures were also not taken into account).

Table I.2 summarises the changes, while the following subsections consider them in more detail. Innovations of the 2005 reform are in bold.

The preventive arm of the SGP

The main change to the preventive arm was the replacement of the horizontal requirement of achieving a budgetary position of close to balance or surplus in nominal terms by a country-specific objective set in structural terms. Thus, the medium-term budgetary objective (MTO) would be based on Member States' gross government debt level and on the magnitude of the fiscal challenge posed by population ageing, while ensuring a safety margin against breaching the 3% of GDP deficit reference value and allowing adequate room for budgetary manoeuvre. For countries in the euro, or in the European Exchange Rate Mechanism II (ERMII) ([4]) the MTO would have to be at least as tight as a structural deficit of 1% of GDP.

([3]) A requirement on the deficit was considered to be sufficient to ensure that the debt requirement would also be met. Based on the assumptions of the rate of growth and of inflation that seemed realistic at the time, nominal growth could be expected to be around 5% per year on average. A deficit of less than 3% would then lead to debt levels converging to 60% of GDP.

([4]) ERMII involves the fixing of exchange rates bands, relative to the euro, within which participating countries' currencies float. Countries joining the euro must participate in ERMII for at least two years prior to joining the euro.

Table I.2: **The changes to the SGP from the 2005 reform (bold)**

	Objective	Specification	Adjustment path + temporary deviations	Enforcement mechanism
Preventive arm	Close to balance or in surplus	**Country specific Medium–Term Objective (structural terms)** • **Safety margin against breaching the 3% of deficit limit** • **Rapid progress towards sustainability** • **Room for budgetary manoeuvre** **→ limit for euro area and ERMII countries = -1% of GDP**	**Annual adjustment: benchmark of +0.5% of GDP (structural terms), more in good times, less in bad times** **Possible temporary deviation for major structural reforms with verifiable impact on long-term**	-
Corrective arm	Correct gross policy errors	Limits: • Deficit: 3% of GDP • (Debt: 60% of GDP or sufficiently diminishing)	**Annual adjustment: at least +0.5% of GDP (structural terms)** **Possible deadline extension if (i) effective action has been taken and (ii) unexpected economic events beyond the control of the government with major unfavourable consequences for government finances (compared to forecasts underlying the recommendation)**	At the very end of the procedure

The move from nominal to structural targets in setting the medium-term objective was prompted by the need to better link the budgetary objective to the specificities of the countries and in particular their specific debt-to-GDP level and the challenge posed by ageing.

In addition, the appropriate path towards the MTO was defined for the first time as an annual adjustment of 0.5% of GDP (set in structural terms) being required as a benchmark, with more expected in good economic times, but less in bad times. The new explicit requirements of the adjustment path aimed to provide more precise guidance to Member States to ensure clear expectations and hence better adherence to the rules. Expressing this in structural terms and modulating the requirement in terms of the position of the economy meant that larger policy responses should not be required precisely when economies needed support.

Deviations from the MTO or the adjustment path towards it were also allowed to pay for structural changes with a verifiable long term (positive) impact on the public finances, including via higher potential growth. Special allowance was defined for certain types of pension reforms. The allowance of deviations was meant to strengthen the fundamentals – if the aim is to ensure a sustainable position, then reforms that clearly strengthen public finances may be allowed, even if they have some short-term costs – although in practice it was never invoked.

The corrective arm

The 2005 corrective arm was designed to better take into account the economic situation and developments. In deciding whether to place a country in EDP after a breach of the 3% limit, the concept of "exceptional circumstances" was broadened ([5]) and the factors to be used in the assessment of the existence of an excessive deficit – including the medium-term economic and budgetary positions – were defined. The 2005 reforms also introduced a benchmark of at least 0.5% of GDP per year in structural terms for the pace at which the countries were recommended to correct their excessive deficit.

By formulating the recommendations to correct an excessive deficit in structural terms, it was then possible to focus on the fiscal effort to be delivered by the concerned Member States to correct the situation. From the 2005 reform onwards, a country would not necessarily have its EDP stepped up if it was unable to reach its deadline for bringing its deficit back below the 3% nominal limit if adverse circumstances beyond its control prevented it from being able to do so. Instead, there was a new possibility to extend deadlines and ease the pressure on countries in difficult times, if they had delivered on the required fiscal effort as measured by the change in the structural balance. This was known as the concept of "conditional compliance".

The changes to the corrective arm emanated from the same logic of those to the preventive arm, namely that economic circumstances can have a significant impact on budgetary aggregates beyond the control of the government. The experience of 2003-04 was key – during those years, a number of countries found that their ability to meet their EDP targets was hampered by economic events, even though they had taken the measures that should have been sufficient under unchanged economic circumstances. The 2005 reforms therefore moved the structural balance to centre stage under both the preventive and the corrective arms, in recognition that governments should not be held accountable for outcomes that are beyond their control.

I.3. 2011 (SIX PACK) REFORM: SMARTER RULES, GREATER NATIONAL OWNERSHIP AND ENHANCED ENFORCEMENT

The recent economic and financial crisis in Europe underscored the importance of economic governance for the long-term economic growth and stability in the EU. Vulnerabilities in the Member States at the time of the onset of the crisis – including large private and public debt, divergent competitiveness and macroeconomic imbalances – highlighted weaknesses in the economic governance framework, including the EU architecture for ensuring sound public finance management. In particular, the underlying positions of many EU countries' budgets exposed the gaps within the SGP that had not been addressed during the 2005 reform.

Specifically, it became clear in the early years of the crisis that many Member States had not used the years of strong growth that preceded the crisis to sufficiently strengthen their budgetary positions and therefore enable them to undertake counter-cyclical fiscal expansions when the need arose. As the financial crisis turned into a sovereign debt crisis, the precarious debt position of some countries became a driver of global economic events and debt became a focal point. Additional important lessons of the crisis were that the unfolding of large macroeconomic imbalances could rapidly and drastically affect budgetary positions and that budgetary spillovers among euro area members might had been underestimated in the past.

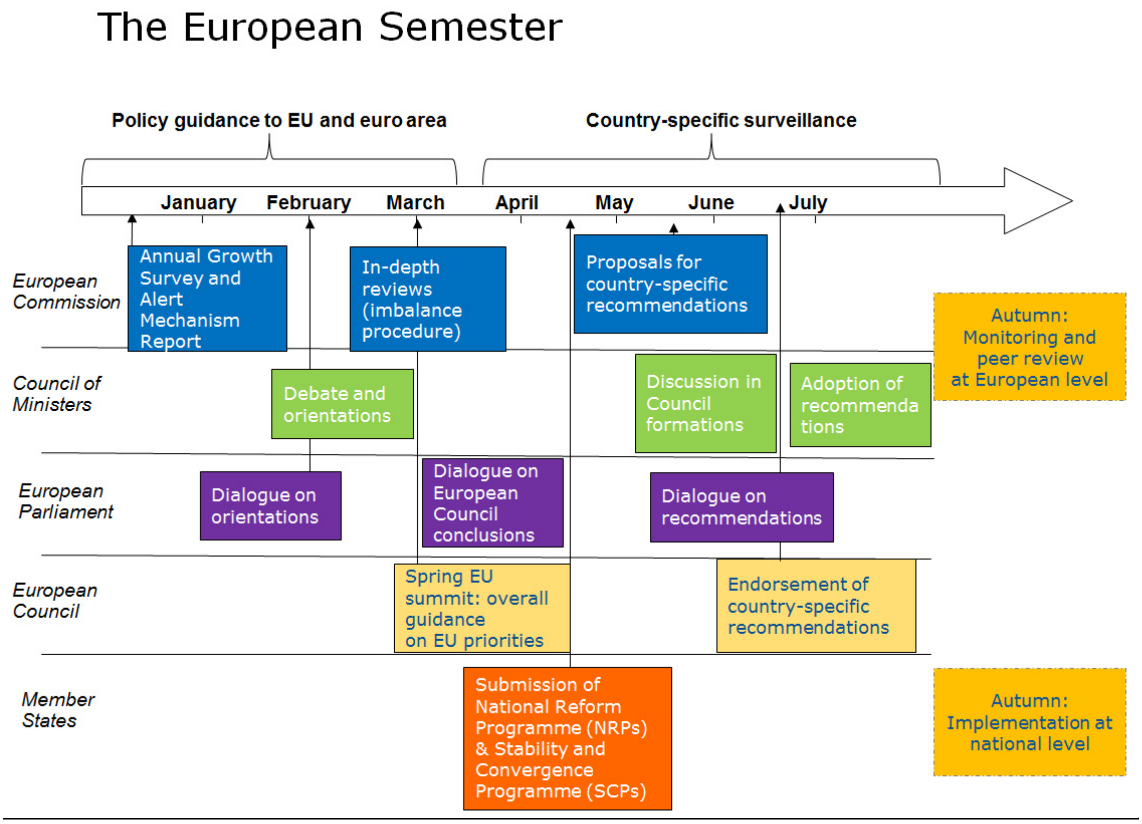
The crisis therefore served as an eye opener of what could go wrong if budgetary and macroeconomic positions were not sufficiently constrained, both for the countries directly concerned and also for the other members of the euro area which were affected due to the significant interdependencies among participants

As a response to these weaknesses, an extensive reform of both the SGP and the broader economic governance framework was adopted in 2011. Six pieces of legislation ([6]) (referred to as the Six

([5]) The new conditions moved from a requirement of a negative output growth of 2%, to either a negative output growth or an accumulated loss of output due to protracted period of growth below potential.

([6]) See http://eur-lex.europa.eu/JOHtml.do?uri=OJ:L:2011:306:SOM:EN:HTML for 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

Graph I.1: **The European Semester**



Pack) reformed both the preventive and corrective arms of the SGP and established a new Macroeconomic Imbalances Procedure (MIP) aimed at preventing and correcting the building-up of economic imbalances in response to the pressure put on budgetary policy from the spillovers stemming from macroeconomic imbalances. Within the SGP, these reforms introduced a new graduated system of sanctions for euro area countries, applicable mainly to the corrective but also, for the first time, to the preventive arm; added an expenditure benchmark to complement the structural balance in assessing countries' fiscal positions and ensure expenditure growth was adequately matched with revenue measures; and operationalised the Treaty's debt criterion. Finally, for the first time, minimum requirements for national budgetary frameworks aimed at securing better adherence to the European rules were defined.

The 2011 Six Pack reforms followed a major change in the European surveillance system: the introduction of the European semester. Specifically, in the year prior to the entry into force of the Six Pack, the EU economic and

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

budgetary multi-lateral surveillance procedures were brought together in a new framework known as the European Semester. Whereas the different aspects of economic and budgetary surveillance had previously been treated separately, the European Semester synchronized the various surveillance processes in a coordinated and harmonized timetable. The European Semester aims to ensure that the surveillance of budgetary and economic policies take place in parallel and according to a timetable that allows the assessments made at European level to inform the national setting of policy in opportune time. The European Semester is launched with the publication of the European Commission's Annual Growth Survey (AGS) at the end of the calendar year. The AGS outlines budgetary, economic and social priorities for the European Union as a whole for the coming year. In March, EU Heads of State and Government adopt EU guidance, based on discussions of the AGS. This guidance should then be incorporated into Member States’ annual update of their medium-term plans: (i) National Reform Programmes (on economic and social policies, in line with the Europe 2020 strategy) and (ii) Stability or Convergence Programmes (on budgetary policy, in line with the SGP), which are sent to the Commission in April for it to present an assessment of each country's plan. Based on the Commission's analysis, the Council then adopts opinions in the form of country-specific recommendations for all Member States and for the euro area as a whole, which are endorsed by the European Council in June/July and conclude the European Semester. Graph I.1 outlines the European Semester schematically.

Tables I.3 and I.4 summarises the changes of the Six Pack reform, while the following subsections consider them in more detail. Innovations of the 2011 reform are in bold.

<u>The preventive arm</u>

Since prevention is better than correction, the core goal of the 2011 reforms of the preventive arm of the SGP was to make it more effective in order to prevent countries from reaching situations that are then painful and difficult to correct. To do so, an expenditure benchmark was introduced to complement the change in the structural balance in assessing progress toward the MTO.

In budgetary planning, keeping expenditure in check is essential: an analysis of tax and expenditure trends in the years before the onset of the crisis showed that increases in expenditures were a key reason for a persistence of weak underlying public finances, which left Member States with insufficient ability to support their economies when the crisis hit. Thus, the need was recognized to ensure that increases in expenditure were properly funded by revenue measures. The introduction of the new expenditure benchmark addresses this issue by requiring that expenditure growth be kept at (or below) a given country-specific level, unless any excess expenditure is funded through new discretionary revenue measures.

Also, while the structural balance, as previously discussed, remains a useful concept for analysing the underlying budgetary position, is not always an optimal tool for guiding Member State's policy choices in real time due to its reliance on unobserved data. Guidance that did not depend on statistical techniques (which are needed to correct for the impact of the cycle on borrowing when calculating the structural balance) but rather on easily observable data, such as revenues and expenditures, was perceived as a valuable addition to the structural balance to assess budgetary positions.

In addition, building on the 2005 reforms, which identified the pace at which a Member State should converge towards its MTO, the Six Pack specified the allowed limits for deviating from this path (known as "significant deviation"), in terms of both the new expenditure benchmark and the structural balance. When observed, this would then lead to defined steps including recommendations and a time limit to correct such a deviation. To increase the effectiveness of such recommendations, sanctions in the form of an interest-bearing deposit can be applied in the case of repeated non-compliance with the recommendations.

On the other hand, it was also recognized that some economic circumstances are so exceptional that the constraints on budgetary policy should be relaxed. To this end, the Six Pack introduced some additional elements of flexibility to the 2005 reforms in terms of the consolidation efforts

Table I.3: **Changes to the preventive arm from the 2011 reform (bold)**

	Objective	Specification	Adjustment path + temporary deviations	Enforcement mechanism
Preventive arm	Close to balance or in surplus	Country specific Medium–Term Objective (structural terms) • Safety margin against breaching the 3% of deficit limit • Rapid progress towards sustainability • Room for budgetary manoeuvre → limit for euro area and ERMII countries = -1% of GDP **Expenditure benchmark ensuring that expenditure net of discretionary revenue measures should grow in line with medium-term potential growth**	Annual adjustment: • benchmark of +0.5% of GDP (structural terms), more in good times, less in bad times • **>0.5% when debt >60% of GDP or pronounced risks of overall debt sustainability** Possible temporary deviation • for major structural reforms with verifiable impact on long-term sustainability (emphasis on pension reform) • **in case of unusual events outside the control of the country with a major impact on the financial position of the general government** **• in case of severe economic downturn in the euro area or the union as a whole**	**Procedure for correcting significant deviation** **Possible sanction (interest-bearing deposit of 0.2% of GDP as a rule) in case of repeated non-compliance**

Table 1.4: **Changes to the corrective arm from the 2011 reform (bold)**

	Objective	Specification	Adjustment path + temporary deviations	Enforcement mechanism
Corrective arm	Correct gross policy errors	Limits: • Deficit: 3% of GDP • Debt: 60% of GDP or sufficiently diminishing **→ Definition of sufficiently diminishing = respect of 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**	Annual adjustment: at least +0.5% of GDP (structural terms) Possible deadline extension if (i) effective action has been taken and (ii) unexpected economic events beyond the control of the government with major unfavourable consequences for government finances (compared to forecasts underlying the recommendation) **or 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**

required in cases of unusual events outside the control of the country with a major impact on the financial position of the general government, or in case of a period of severe economic downturn in the euro area or the union as a whole, provided this does not endanger fiscal sustainability in the medium-term.

The corrective arm of the Pact

The experience of the years before the crisis showed that the assumptions that debt would be sufficiently constrained by monitoring deficits were too optimistic, as the high debt levels that persisted in a number of countries had crippling effects once the crisis hit. Hence, the Six Pack legislation operationalized the concept of a "sufficiently diminishing" debt level, through a new debt reduction benchmark, in order to ensure a continuous decline of debt-to-GDP ratios towards the 60% of GDP Treaty reference value. With the 2011 reforms, an Excessive Deficit Procedure can now be launched against countries if their debt level exceeds 60% of GDP and is not diminishing quickly enough, even if their deficit is below the 3% of GDP Treaty reference value.

The 2011 reforms also greatly strengthened enforcement of the corrective arm by adding an early and gradual system of financial sanctions in the corrective arm for euro area Member States, addressing a gap that existed between the start of the EDP and the imposition of sanctions. Under the step-wise procedure based on Article 126 of the Treaty, sanctions can be imposed after a county has been found to be persistently non-compliant with the recommendations of its EDP. Given the number of steps and the time that elapses before a country reaches that stage, the result under the previous rules had been that only countries under very extreme budgetary pressure were likely to be candidates for the fines – a situation where the imposition of financial sanctions is usually counter-productive, rather than providing an impetus for earlier corrective action. As a result, sanctions were never applied. The imposition of early and gradual sanctions is therefore premised on the need to ensure that action is taken in the early rather than later stages of an EDP. The new sanctions provisions do, however, allow for the particular circumstances of a country to be taken into account. In this way, sanctions can be reduced or cancelled if justified by special circumstances.

A key innovation in the new sanctions procedures was the introduction of a new voting procedure (reverse qualified majority voting) for the new sanctions decisions. ([7]) Reverse qualified majority voting implies that the sanctions proposed by the Commission will be adopted, unless opposed by a (qualified) majority of countries. This is a reversal of the usual voting procedure whereby a majority have to vote in favour and therefore adds a level of automaticity to the sanctions. Annex 2 provides information on voting procedures. The imposition of sanctions, is however, still predicated at every stage by a prior Council decision on either the existence of an excessive deficit or of ineffective action – those decisions are still taken under qualified majority voting, as defined in the Treaty. ([8])

I.4. 2013 REFORM: THE TWO PACK AND THE FISCAL COMPACT: ENSHRINING EU RULES AT THE NATIONAL LEVEL

The economic and financial crisis that erupted in 2008 changed the perception about the need for coordination of budgetary policies of euro area Member States. This led to a number of initiatives which aim to strengthen the fiscal basis of EMU. In November 2011, on the day of the publication of the Six Pack reform in the Official Journal, the Commission presented its proposals for two further pieces of legislation, referred to as the Two Pack, targeted at euro area Member States. In parallel, twenty-five of the twenty-seven EU Member States pledged to deepen their commitment to the European budgetary framework and integrate it into their national frameworks by agreeing on an intergovernmental Treaty on Stability Coordination and Governance (TSCG) which was signed on March 2, 2012. Some of the elements of the TSCG were incorporated into the Two Pack during the negotiation process.

([7]) This applies to both the preventive and the corrective arms.

([8]) As section I.4.2 explains, euro area signatories of the Treaty on Stability, Coordination and Governance have committed themselves to replicating reverse qualified majority voting in all steps of deficit-based EDPs.

I.4.1. 2013: The Two Pack: Reinforcing monitoring and surveillance in the Euro Area

The 2013 reforms to the economic governance framework, the Two Pack, consist of two regulations which are applicable to euro area Member States.

• The regulation on enhanced monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area ([9]);

• The regulation on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability.([10])

The first Regulation complements the existing fiscal surveillance framework by adding new provisions for coordinating budgetary policy in the euro area and tightening surveillance of the euro area Member States in Excessive Deficit Procedure. The second Regulation on enhanced surveillance integrates the processes that apply to euro area countries under financial strain in the EU budgetary surveillance framework.

This section focuses on the regulation on enhanced monitoring (see Box I.1 for a summary of the main features of the other regulation). It should first be stressed that this new piece of legislation neither makes any quantitative changes to the SGP's budgetary rules nor adds any new numerical fiscal rules. Contrary to the previous reforms of the SGP described above, it does not amend the regulations defining the preventive and the corrective arms of the SGP. Rather, the principle innovation of the 2013 reform is to enhance coordination and surveillance in two ways.

First, the regulation completes the European semester for the euro area Member States by adding a new additional European assessment of draft budgetary plans in autumn for the euro area Member States. The assessment of the draft budgetary plans – which contain detailed figures for the year ahead – is introduced to allow a more practical approach to assessing not just countries' intentions in terms of policy planning (such as those reported in the stability programmes), but also to ensure that countries are adopting the specific measures necessary to achieve the objectives.

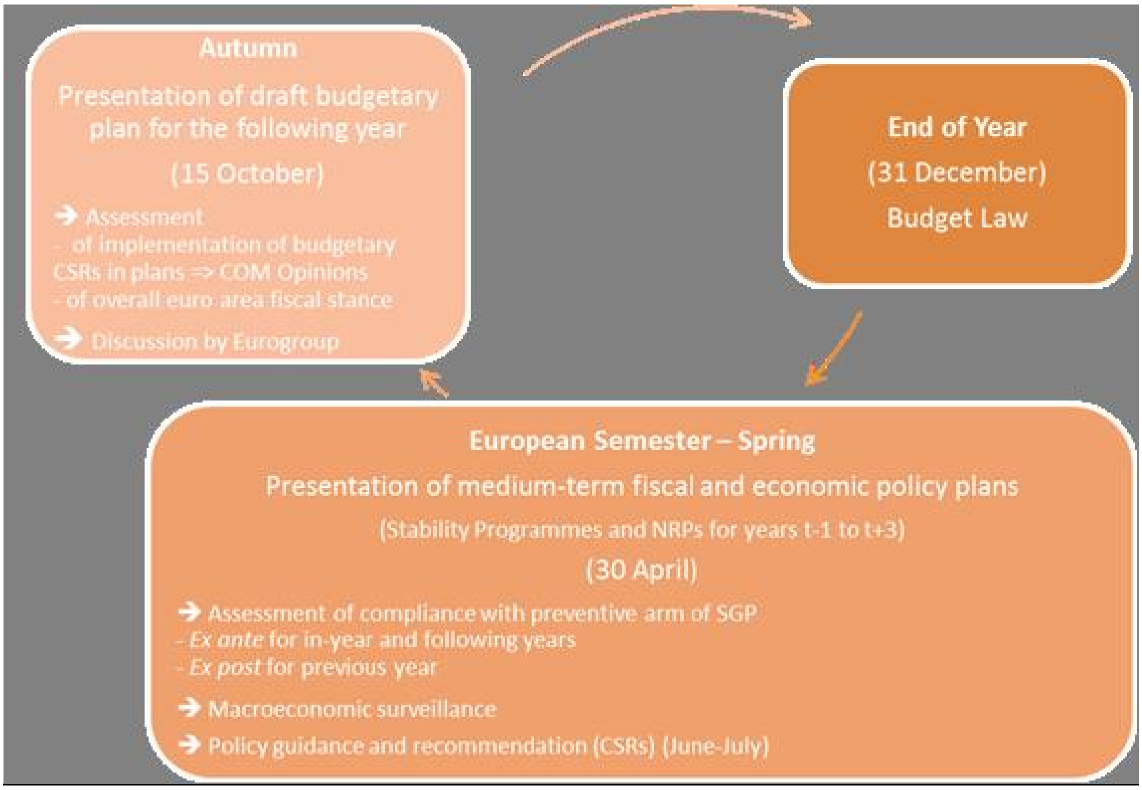
For this purpose, the Two Pack establishes a common budgetary timeline for euro area Member States. The latter will need to submit their draft budgetary plans to the Commission by October 15 every year, prior to the adoption of the budget. The Commission will then assess whether the draft budgetary plan is in line with the European requirements and issue an opinion. The Commission opinion will be based on the requirements of the SGP – in particular the country-specific recommendations issued under the preventive arm and the need to comply with the MTO requirements. For countries under an EDP, progress towards meeting the obligations stemming from the recommendations issued to the country will be a central aspect of the assessment. An important element of this assessment is that if the Commission identifies particularly serious non-compliance with the European budgetary policy obligations, it can ask for a new plan to be submitted.

The idea behind this provision is, again, that prevention is better than correction: it is easier to change a plan than to correct its effect by counter-measures. The Commission opinion will allow national parliaments to be better equipped to assess the proposed plans. It is important to recall

([9]) Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0011:0023:EN:PDF

([10]) Regulation (EU) No 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0001:0010:EN:PDF

Graph I.2: **The European monitoring cycle after the Two Pack**



that that violations of the SGP rules can be accompanied in most cases by the sanctions as discussed in the section above.

The fact that euro area Member States will be subject to a common timeline for submitting their draft budgetary plans will also allow the Commission to assess the fiscal stance of the euro area as a whole based on the resulting implementation of the draft plans. The Commission's overall assessment of these plans, their interaction and the resulting picture for the euro area will provide a basis for the Eurogroup to discuss the plans, understand their interaction and their impact on the area as a whole before such plans become law.

It is important to understand that the Two Pack, as already mentioned above, does not create new European fiscal rules. Since national processes are clearly key to the achievement of European goals, the Two Pack further builds on the Six Pack directive defining minimum requirements for the national budgetary frameworks by not only identifying minimum requirements for the national budgetary frameworks which would be instrumental in meeting the European rules, but also specifies desirable features for these frameworks. In this context, it foresees that any budgetary documents, and in particular the annual budgets and medium-term plans, should be based on independent macroeconomic forecasts. A tendency to base the plans in the SCPs on optimistic forecasts has meant that it has been difficult, in practice, for Member States to deliver the budgetary outturns that they presented. Thus, this requirement will support more robust information at the heart of the assessments of the draft budgetary plans, thus ensuring that national parliaments adopt budgets whose outcomes and impact are based on unbiased and realistic projections and planning. Also, recognising that

the independence of the institutions involved in the national process is an important guarantor of their effectiveness, it foresees the setting-up of independent body in charge of the monitoring of the national fiscal rules.

Box I.1: Enhanced surveillance for financially fragile Member States

The Regulation on strengthening the monitoring and surveillance procedures for Member States experiencing severe difficulties with regard to their financial stability or for those in receipt of financial assistance will enable the Commission to better assess the risks threatening or faced by the Member State in question and thus, in some cases, address vulnerabilities even before a need for financial assistance arises. The Regulation encompasses three principle elements:

1- Enhanced surveillance. The Commission may put a country under enhanced surveillance in the case of a Member State experiencing severe difficulties with regard to its financial position and when these difficulties are likely to have adverse spillover effects on other euro area Member States. Enhanced surveillance includes an obligation on Member States to adopt measures to address the sources of instability, regular review missions and the provision of more detailed or disaggregated financial sector data if requested, and quarterly reporting by Commission to Eurogroup Working Group. If in the course of regular monitoring it is concluded that further measures are needed and the financial situation of the Member State has significant adverse effects on the financial stability of the euro area, the Council will have the possibility to recommend to the Member State concerned, on a proposal from the Commission, to seek financial assistance and prepare a macro-economic adjustment programme.

2- Procedures for adopting and monitoring macro-economic adjustment programmes. The Regulation sets out a clear procedure for preparing and adopting financial assistance under macro-economic adjustment programmes. Since financial support mechanisms including the ESM and EFSF, however, remain independent bodies, the request by the Member State to the institution and any decision to grant such assistance to the Member State remains with the Board of Governors of the relevant institution. Given the broad scope of programmes, including fiscal surveillance, Member States in a macro-economic adjustment programme would be exempt from the reporting of the Stability and Growth Pact and other economic reporting to avoid duplication of reporting obligations.

3- Post-programme surveillance. To help ensure that the countries concerned remain firmly on a safe track, countries would remain under special monitoring by the Commission as long as a minimum of 75% of the financial assistance received has not been repaid.

Second, the Two Pack will also enhance the monitoring requirements for countries under EDP: the later will need to submit detailed reports setting out their progress in complying with the recommendations every three or six months, depending on their EDP situation. This enhanced monitoring should allow an early detection of any risk to meet the deadline and hence allow the Member State to correct such a situation on the basis of a timely recommendation by the Commission. More detailed information on EDP provisions in the Two Pack is described in Box II.2 of section II.2.3.

I.4.2. The Two Pack and its links to the fiscal compact

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), signed by 25 EU Member States (all but the United Kingdom and the Czech Republic) entered into force in January 2013. It is binding for all euro area Member States that have ratified it, while other contracting parties will be bound only once they adopt the euro or earlier if they signal it. Specifically, countries outside the euro area can specify which elements of the Treaty they will be bound by. ([11]) The TSCG complements the SGP by committing the signatories to mirror key elements of the SGP, in particular of its preventive arm, in national law and by making further steps in the surveillance and coordination of budgetary policies.

([11]) For example, Denmark and Romania have stated that they commit themselves to being bound by Titles III, IV and V. For more information see: http://www.consilium.europa.eu/policies/agreements/search-the-agreements-database?command=details&lang=en&aid=2012008&doclang=EN

The TSCG contains six titles. Title III Article 3 of the TSCG is known as the Fiscal Compact and contains the provisions that are most closely linked to the SGP. The Fiscal Compact commits countries to incorporating the MTO and the adjustment path towards it – as defined in the SGP – into national law through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary process. The Fiscal Compact's provisions also increase the role of independent bodies, which are given the task of monitoring compliance with the national fiscal rules, including the operation of the national correction mechanism in case of deviation from the MTO or the adjustment path towards it.

These two elements—the incorporation of the MTO in national law and the role of independent bodies in monitoring compliance with national fiscal rules – are the most innovative aspects of the Fiscal Compact. The rationale behind these elements mirrors the rationale of the Two Pack, namely that evidence shows that national processes are key to the achievement of European goals and that the independence of institutions involved in the national process are an important guarantor of their effectiveness.

Beyond these aspects, the Fiscal Compact stresses the importance of adherence to the debt reduction benchmark introduced by the Six Pack and commits its signatories to support the proposals or the recommendations issued by the Commission under the deficit requirement unless a qualified majority of countries is opposed. This replicates the reverse qualified majority voting procedure explained in Annex 2, which was introduced in the Six Pack for voting on the additional sanctions in the SGP. The EDP is also strengthened through the requirement for countries placed in it to put in place a budgetary and Economic Partnership Programme (EPP) with a detailed description of structural reforms that will contribute to the lasting correction of the excessive deficit. Finally, the Fiscal Compact aims to increase coordination in debt issuance, and commits signatories to report on their public debt issuance plans to the Council and Commission on an ex ante basis.

As already mentioned, the Two Pack implements some provisions of the TSCG. In particular, under the Two Pack:

• Member States will have to establish (i) independent bodies (commonly called "fiscal councils") in charge of the monitoring of national numerical fiscal rules incorporating the MTO, and (ii) a corrective mechanism that should be automatically triggered in case of deviation from the MTO or the adjustment path towards it, except in the presence of exceptional circumstances.

• Member States in EDP will prepare an Economic Partnership Programme focussing on fiscal structural reforms which will help ensure a lasting correction of the excessive deficit.

• Member States will report on their national debt issuance plans to the Commission and the Council according to a harmonised framework.

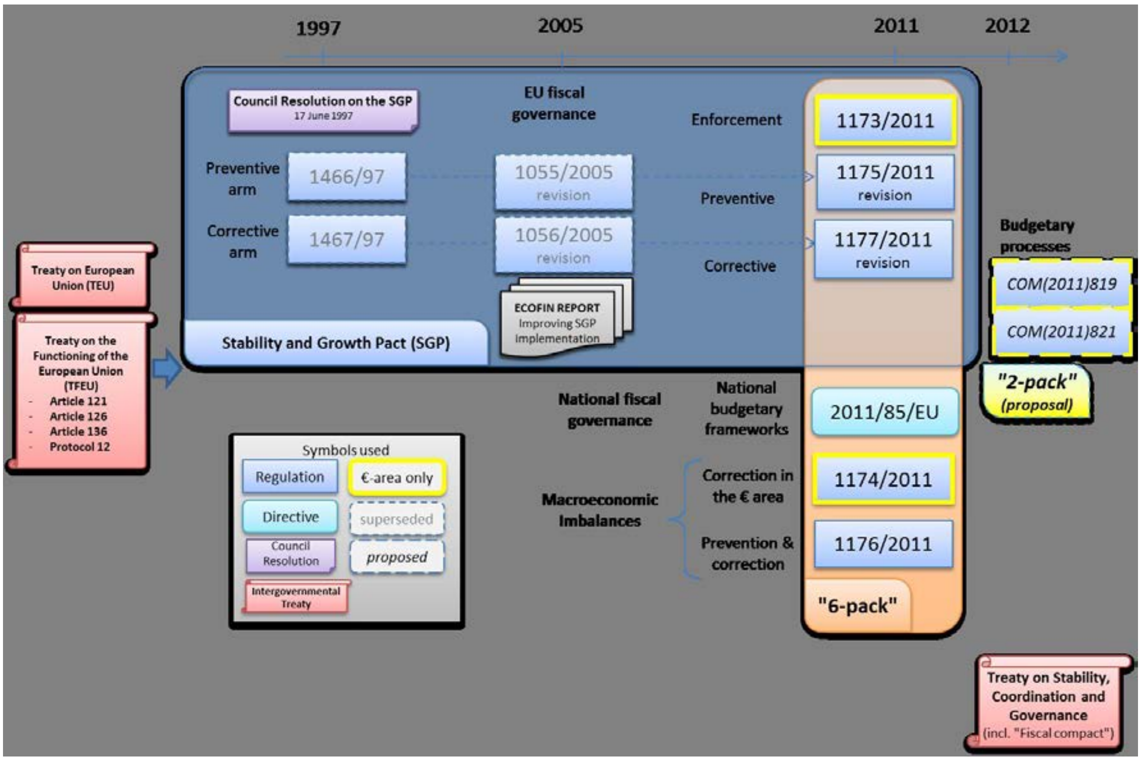
Interestingly, despite the intergovernmental status of the Treaty, EU bodies are assigned specific roles for the implementation of the Fiscal Compact, anchoring the provisions firmly within the overall EU context. Specifically, the Commission should propose a calendar for convergence towards the MTO and the common principles according to which the national correction system should be set out. ([12]) It will also present a transposition report of the fiscal compact rules in the national legal order, which can serve as the basis for taking any country that is found to be non-compliant to the Court of Justice of the European Union – although a Court action does not necessarily need to be based on this report.

The fourth title of the TSCG commits signatory countries to work jointly towards economic policy that fosters the proper functioning of EMU, including ex ante discussion and, where appropriate, coordination of economic policy reforms. ([13])

([12]) The Commission published such principles in COM(2012) 342 final: "Common principles on national fiscal correction mechanisms", http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0342:FIN:EN:PDF

([13]) The coordination of major economic reforms is identified as an immediate policy priority of the European Commission's vision for the deepening of EMU, set out in its Blueprint on deep and genuine EMU, published on 5 December 2012. See COM(2012) 777 Communication from the Commission "A blueprint for a deep and genuine economic and monetary union. Launching a European debate". http://ec.europa.eu/commission_2010-

Graph I.3: **A guide to the SGP's reforms over the years**



The final two titles of the TSCG are concerned with institutional issues. Title five institutes informal euro area summits and sets out their aims and broad rules. The national parliaments are given a forum for the discussion of budgetary issues. Finally, the ratification procedure and legal status of the TSCG is covered in title six, with a commitment to incorporate the substance of the TSCG into the legal framework of the EU within five years.

Part II of this guide provides a schematic presentation of the main concepts and processes under the SGP. It is therefore not a comprehensive guide – for detailed exposition, the reader can refer to the "Vade mecum on the Stability and Growth Pact" which is published alongside this guide. This part describes in turn the functioning of the preventive and corrective arms.

2014/president/news/archives/2012/11/pdf/blueprint_en.pdf. In addition, on 20 March 2013, the Commission issued a Communication "Towards a Deep and Genuine Economic and Monetary Union Ex ante coordination of plans for major economic policy reforms", as part of the consultation on this policy. See COM (2013) 166http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0166:FIN:EN:PDF

II. UNDERSTANDING THE SGP TODAY: THE CURRENT FRAMEWORK IN MORE DETAIL

II.1. THE PREVENTIVE ARM

The preventive arm of the Stability and Growth Pact aims to ensure sound budgetary policies over the medium term by setting parameters for Member States' fiscal planning and policies. The cornerstone of the preventive arm is that each Member State should reach a differentiated medium-term objective (MTO) for its budgetary position, defined in structural terms (i.e. cyclically-adjusted and net of one-off and temporary measures).

II.1.1. Defining the MTO and the Adjustment Path towards it

The MTO pursues a triple aim:

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

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

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

These three elements are considered in a formula that ensures that the resulting MTO is compliant with the aims set out in the SGP. Section 1.2.1.1 of the "Vade mecum on the Stability and Growth Pact" presents it in more detail.

Based on a commonly agreed methodology, MTOs are presented by Member States in their Stability and Convergence Programmes – which are submitted annually as part of the reporting requirements under the preventive arm of the Pact, see Box II.1 – and are updated every three years (or more frequently if a Member State has undergone a structural reform significantly affecting its public finances).

MTOs are defined in structural terms, meaning that they represent the cyclically adjusted general government budget balance, net of one-off and other temporary measures. One-off and temporary measures are measures having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position, such as: the sales of nonfinancial assets; receipts of auctions of publicly owned licenses; short-term emergency costs emerging from natural disasters; tax amnesties; revenues resulting from the transfers of pension obligations and assets. The cyclical adjustment methodology takes out the effect that the position in the economic cycle has on the budget balance, to give an estimate of what the balance would be in normal economic times. In this way, MTOs aim to capture the underlying position of the budget balance and be a guide to its medium-term dynamics.

The legislation specifies that euro area and ERMII 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 (TSCG) (see section 1.4.2) 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 which case the -1% of GDP limit remains applicable.

The preventive arm defines an appropriate annual improvement in the structural balance as follows:

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

Box II.1: Stability and Convergence Programmes

Stability programmes are submitted by euro area Member States, while convergence programmes, which also include monetary policy planning, are submitted by non-euro area Member States. Guidelines on the content and format of the Stability and Convergence programmes are given in the Code of Conduct, which provides a model summarising quantitative information in a standardised set of tables. Stability and Convergence Programmes contain the following:

• A medium-term objective (MTO), the adjustment path towards the MTO (the year-by-year target figures until it is achieved) and the expected path of the debt ratio;

• The underlying economic assumptions (growth, employment, inflation and other important economic variables);

• A description and assessment of policy measures to achieve the programme objectives;

• An analysis of how changes in the main economic assumptions would affect the budgetary and debt position;

• If applicable, the reasons for a deviation from the required adjustment path towards the medium term budgetary objective.

• Information covering a multi-annual timeframe including: one year of budgetary execution, the current budgetary year, and plans for the three following years.

Member States' programmes should be based on the most likely macrofiscal scenario or on a more prudent scenario. The macroeconomic and budgetary forecasts shall be compared with the most updated Commission forecasts and, if appropriate, those of other independent bodies. Significant differences between the chosen macrofiscal scenario and the Commission's forecast must be described with reasoning, in particular if the level or growth of external assumptions departs significantly from the values retained in the Commission's forecasts.

Once the Two Pack (see section 1.4.1) enters into law, the forecasts contained in the Stability programmes (i.e. those submitted by euro area countries) will have to be based on independent macroeconomic forecasts that should be produced or endorsed by an independent institution – where the concept of independence is defined in the regulation.

• Member States with debt in excess of 60% of GDP or with pronounced risks of overall debt sustainability should plan for an annual improvement that is higher than 0.5% of GDP.

• All Member States should undertake a greater adjustment in good economic times, while the effort may be more limited in bad economic times.

It is possible to temporarily deviate from this adjustment in case of:

• Major structural reforms with verifiable impact on long-term sustainability, including pension reforms.

• Unusual events outside the control of the country with a major impact on the financial position of the general government.

• A severe economic downturn in the euro area or the union as a whole.

II.1.2. Surveillance process

As part of the 2011 Six Pack reforms to strengthen fiscal surveillance, the analysis of progress towards attainment of the MTO under the preventive arm of the SGP is judged by an assessment of the structural budget balance, complemented by an analysis of the growth rate of expenditure net of discretionary revenue measures, known as the expenditure benchmark.

The expenditure benchmark requires that any additional expenditure plans are adequately financed through equivalent permanent revenue measures. In particular, the rate of growth of an expenditure aggregate, which corresponds to the expenditure which needs to be financed by the government (see below) – net of discretionary revenue measures – is compared with a medium-term growth rate of potential GDP, which is assumed to represent the medium-term growth rate of government revenue.

The expenditure benchmark, which identifies expenditures which are under the control of the government and need to be adequately financed, applies to an expenditure aggregate that excludes interest spending, expenditure on European Union programmes fully matched by European Union fund,s 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. This is to enable countries with peaks in investment due to large projects to face more stable requirements for the rest of their expenditure. 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 is defined as an average over time and in terms of potential – rather than actual – growth to ensure that the application of the expenditure benchmark does not lead to procyclicality

According to the preventive arm of the Pact, for Member States that have attained their MTOs:

• The structural balance should remain stable

• Annual expenditure growth must 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 over time.

For Member States that have not attained their MTO:

• The structural balance should improve by 0.5 % as a benchmark

• Annual expenditure growth must 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 set so as to ensure an appropriate adjustment towards the MTO.

The expenditure benchmark should not, however, be seen as limiting the level or type of public expenditure. All that is required is that any expenditure growth be funded by equivalent discretionary revenue measures. It should be stressed that any excess of expenditure growth over the benchmark growth rate should be matched by revenue measures rather than revenues. In this way, during a boom, any excess expenditure cannot be funded out of the additional revenues generated by the rapidly growing economy. Excess expenditure must instead be funded through new measures. Thus, when the boom gives way to a recession, the country in question has put in place measures that allow the expenditure programmes to be paid for.

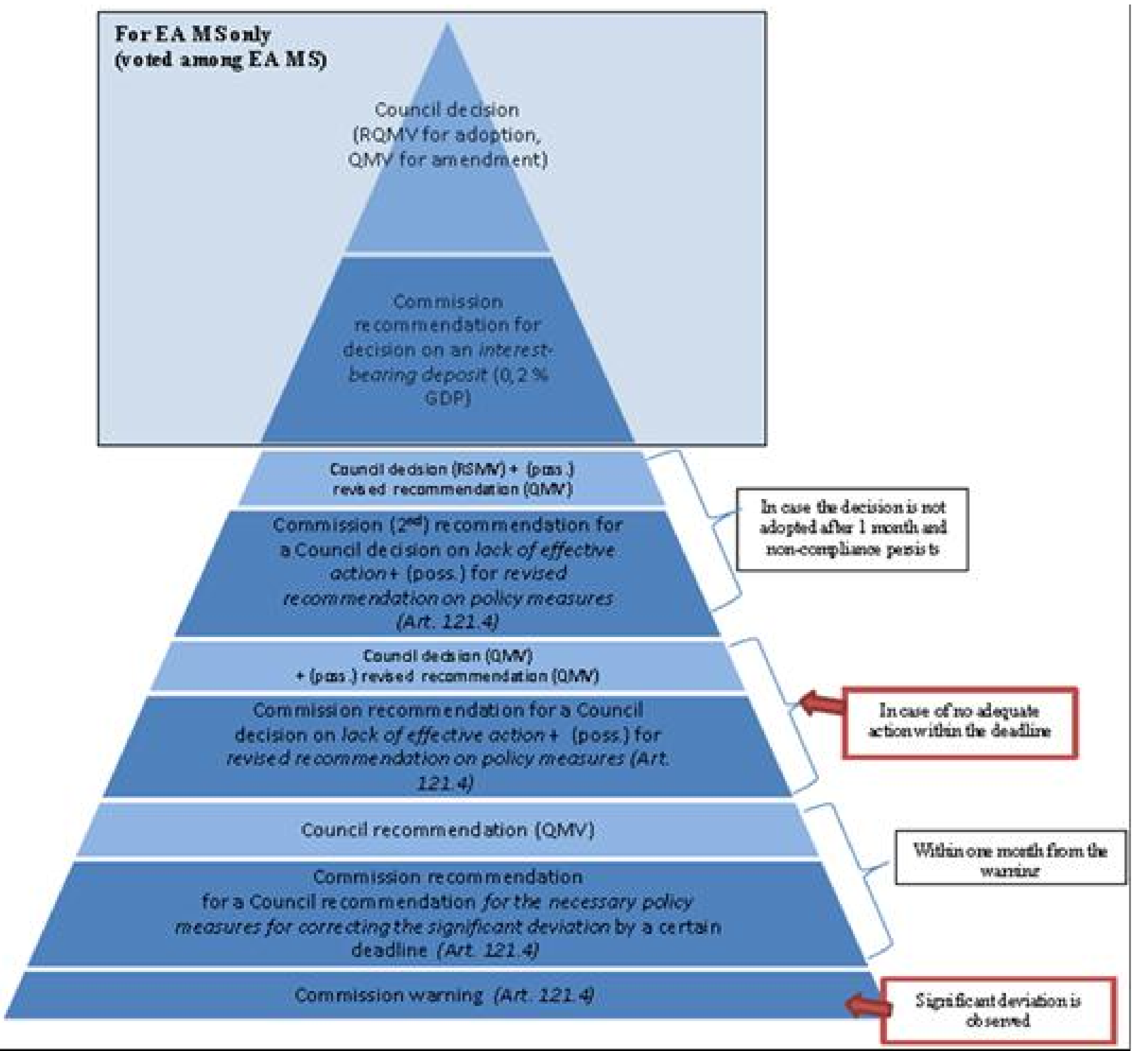
As part of multilateral fiscal surveillance, the Commission conducts both an ex ante assessment of the plans for the current and forthcoming budgetary years based on Member State's Stability or Convergence Programmes. It also conducts an ex post assessment based on notified data.

The ex post assessment includes identifying significant deviations of the budgetary position from the medium-term budgetary objective, or from the appropriate path towards it.

For a Member State that has not reached its MTO, the identification of a significant deviation is based on an overall assessment which takes into account whether the structural balance or the expenditure benchmark has deviated from the required adjustment of 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.

If the Commission finds evidence of significant deviation from the MTO or the adjustment path towards it, it will address a warning to the Member

Graph II.1: **Actions in the case of significant deviation from the adjustment path to the MTO**



State concerned, which is followed by a Council recommendation within one month on how to return to the adjustment path towards the MTO. This can be followed, if the Member State does not comply with the recommendations by, a Council decision on lack of effective action and, possibly, a revised recommendation on policy measures. In such cases by a euro area Member State, the Council or the Commission will impose a sanction equal to an interest-bearing deposit of 0.2% of GDP. Graph II sets out the stages in the procedures under the preventive arm, leading to the imposition of sanctions.

II.2. THE CORRECTIVE ARM

The corrective arm of the SGP is concerned with situations where countries' deficit or debt levels are too high. It is also known as the Excessive Deficit Procedure (EDP). A potentially confusing peculiarity of the EDP is that the word "deficit" is used to refer to situations where either the Treaty's deficit or the debt requirements are breached. The corrective arm contains a series of steps that are followed when a country's deficit exceeds 3% of GDP or its debt is higher than 60% of GDP and insufficiently diminishing towards that level. In both cases, a breach of the numerical requirements does not automatically mean that the Member

State in question will be placed under an EDP, as other relevant factors may be taken into account.

The EDP's step-by-step procedure is outlined in detail in Art. 126 of the Treaty. It is graphically presented in Graph II.2. The procedure begins with the identification of a breach of the deficit or debt criterion which leads to the writing of an Article 126(3) report by the Commission. This considers in detail a series of factors and concludes whether the breach of the criterion merits the launch of an EDP against the Member State in question.

II.2.1. The Deficit Requirement

A Member State is non-compliant with the deficit requirement if its general government deficit is greater than 3% of GDP. The Treaty – and by extension the SGP – provides two exception clauses with regard to the opening of an Excessive Deficit Procedure on the basis of the deficit criterion. Member States are deemed to have complied with their deficit commitment if at least one of the two following conditions is met:

• the deficit has declined substantially and continuously and has reached a level close to 3% of GDP;

• the excess is only exceptional and temporary, and the deficit value is still close to 3% of GDP.

A deficit above 3% of GDP is considered exceptional when it results either (i) from an unusual event outside of the Member State's control and with a major impact on its public finances, or (ii) from a severe economic downturn. A severe economic downturn is defined 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. An event outside of the Member State's control includes such circumstances as a natural disaster. 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 Commission report under Article 126(3) TFEU also takes into account whether the government deficit exceeds government investment expenditure and takes into account all other relevant factors. Relevant factors include, but are not limited to:

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

• the developments in the medium-term budgetary position (in particular, the record of adjustment towards the medium-term budgetary objective, the level of the primary balance and developments in primary expenditure, both current and capital, the implementation of policies in the context of the prevention and correction of excessive macroeconomic imbalances, the implementation of policies in the context of the common growth strategy of the Union and the overall quality of public finances, in particular the effectiveness of national budgetary frameworks);

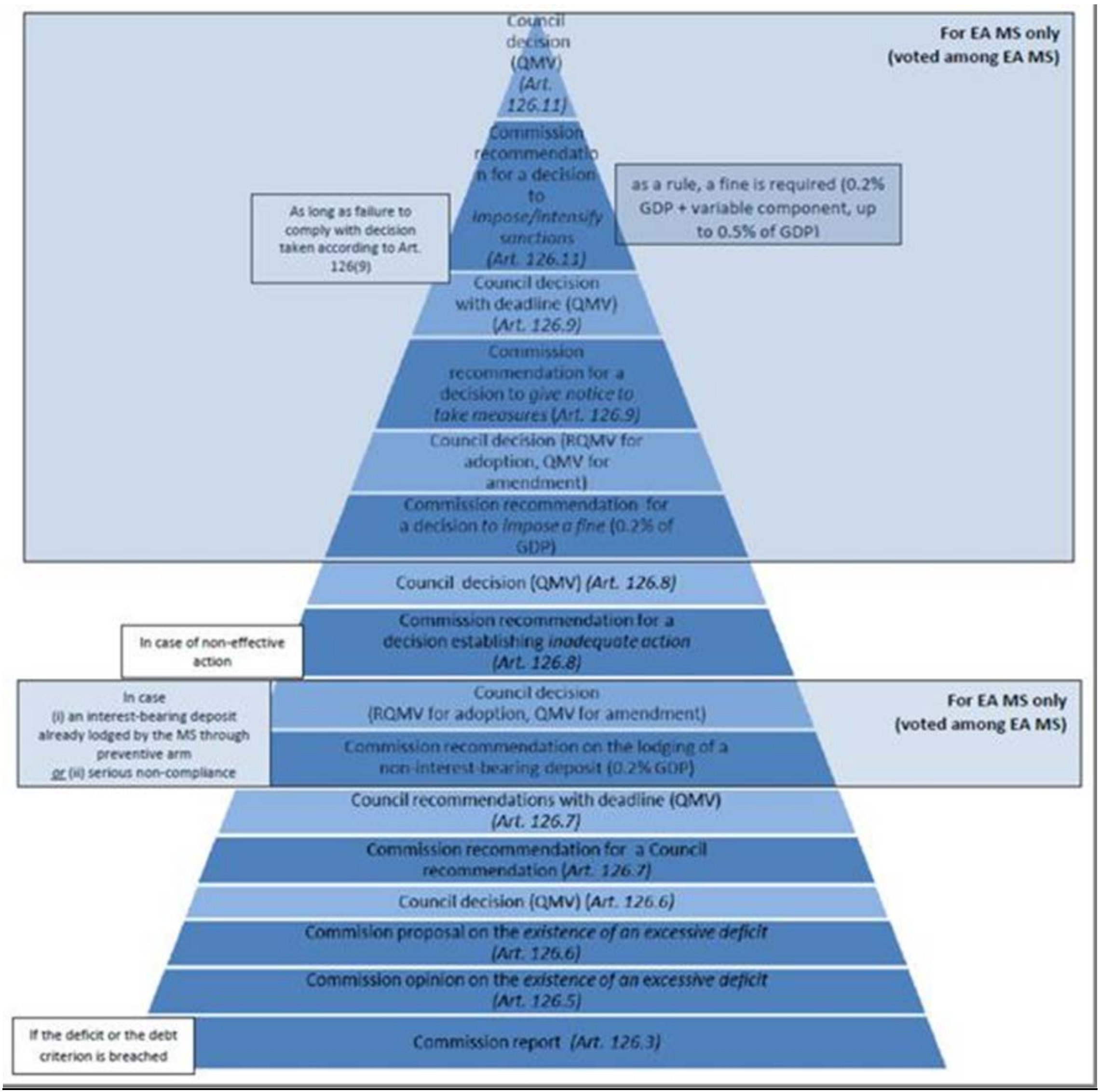
• the developments in the medium-term government debt position, its dynamics and sustainability (in particular, risk factors including the maturity structure and currency denomination of the debt, stock-flow adjustment and its composition, accumulated reserves and other financial assets, guarantees,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

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 always considered in the overall assessment. For these countries 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.

• 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.

Graph II.2: **Steps of the EDP**



II.2.2. The Debt Requirement

A Member State is non-compliant with the debt requirement if its general government debt is greater than 60% of GDP and is not approaching 60% at a satisfactory pace. The concept of a "satisfactory pace" is given as corresponding to a decrease in the difference between the debt level and the 60% of GDP threshold of 5% per year over 3 years. Consideration is also given as to whether the country has taken a policy response that sets its debt on an appropriate diminishing path over the next two years, even if the reduction in the debt has not yet been observed. In addition, an assessment is made of whether the position of the economic cycle is the cause of the debt benchmark being breached. If neither of these are the case, then the debt requirement is considered to be breached and an article 126(3) report is written by the Commission. The article 126(3) report will then take a series of relevant factors (see above) into account in the overall assessment of whether an EDP should be launched, whatever the magnitude of the breach.

Box II.2: The EDP for euro area Member States after the Two Pack

With the entry into force on May 30 of the Two Pack, Member States in EDP will be subject to closer monitoring. This includes increased and graduated reporting to ensure that Member States subject to an EDP secure a timely and durable correction of excessive deficits, and to allow an early detection of possible risks and appropriate action in response to cases where a Member State is not on track to correct its excessive deficit by the deadline set by the Council.

The Regulation requires that "The Member State subject to closer monitoring shall without delay carry out a comprehensive assessment of in-year budgetary execution for the general government and its sub-sectors. The financial risks associated to government-owned entities and government contracts shall also be covered by the assessment to the extent that they may contribute to the existence of an excessive deficit."

Member States entering EDP will also be required to present Economic partnership programmes (EPPs) to the Commission and to the Council, which describe the policy measures and structural reforms that are needed to ensure an effective and lasting correction of the excessive deficit. The implementation of the programme, and the annual budgetary plans consistent with it, are monitored by the Commission and by the Council.

Additional regular reporting on budgetary execution and measures taken is also required within the Regulation in order to enrich the assessment of effective action and to be able to detect early any risk to a time correction. This includes a regular report every six months if under 126 (7) of the Treaty or every three months if under 126(9) of the Treaty. This reporting includes information on: the in-year budgetary execution, the budgetary impact of discretionary measures taken on both the expenditure and the revenue side, targets for the government expenditure and revenues, as well as information on the measures adopted and the nature of those envisaged to achieve the targets. An audit of public accounts or any other information determined necessary to judge whether a risk of non-compliance with the deadline to correct the excessive deficit exists may be requested by the Commission.

If risks of non-compliance by the deadline set by the Council are assessed, the Commission will address a recommendation to the Member State concerned for the full implementation of the measures recommended or the adoption of further measures within a timeframe consistent with the deadline for the correction of its excessive deficit. This recommendation, together with the Member State's response, will inform the Commission's assessments to the Council as to whether a Member State has taken effective action with regards to their EDP recommendations.

II.2.3. Existence of an Excessive Deficit-Recommendations and time limit for correction

If the conclusion of the article 126(3) report is that an excessive deficit exists and that an EDP should be launched, the Commission prepares recommendations for the Council. By qualified majority voting the Council then issues a decision on the existence of the excessive deficit (under Article 126(6)) as well as concrete recommendations for the Member State concerned (under Article 126(7)) to correct such a situation. Euro area Member States that have already been sanctioned under the preventive arm or whose breach of the threshold values is especially serious, may also face the imposition of a stricter sanction in the form of a non-interest-bearing deposit of 0.2% of GDP as a rule, this deposit being lodged with the Commission.

The Article 126(7) recommendation aims at presenting a credible path for the timely correction of the excessive deficit and is based on annual deficit targets set in both nominal and structural terms. 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 improvement in the structural balance, 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."

The EDP recommendations contain:

(i) A deadline 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. In the EDPs launched during the economic crisis, the deadlines were typically much longer than one year.

(ii) A path towards the correction of the excessive deficit with intermediary annual targets for the general government balance. All budgetary targets are given in both nominal and structural terms and

and linked by an underlying economic forecast..

II.2.4. Assessing the response of Member States: effective action

After the adoption of the Council recommendations, the Member State has six months (three months for serious cases) to show that it has taken "effective action" to address its excessive deficit. Once the deadline has passed, the Commission and the Council assess the action the Member State has taken. The assessment takes into account whether the Member State concerned has achieved the annual budgetary targets initially recommended by the Council and whether it is on course to continue to meet these and – if not – it will assess the underlying improvement in the structural balance and the impact of revisions and forecasting errors on this variable. If the Commission considers that the Member State is on course to meet the targets, it will inform the Council accordingly – the procedure is then referred to as being in abeyance.

A Member States which has taken effective action to address its excessive deficit, but where this has not resulted in the nominal targets being met, may see an extension of its deadline for correction and a revision of the recommendations to reflect the change in circumstances. A country that is neither on course to meet the nominal targets nor has taken measures that would have led to compliance in the absence of external events, will see its EDP being stepped up. The only exception to this is in the case of a severe downturn in the euro area or EU as a whole – in this case revised recommendations are possible despite a lack of a response by countries under EDP.

II.2.5. Stepping up of the EDP and sanctions

The stepping up of the EDP involves a Council decision (under Article 126(8)) based on a Commission recommendation, that effective action has not been taken. At this stage, all Member States—regardless of whether euro area Member States or not—that are in receipt of the Cohesion Fund may face a temporary suspension of this financing. ([14]) At the same time, if the Member State concerned is one outside of the euro area, it will then receive a new recommendation by the Council under Article 126 (7) TFEU. Euro area Member States will receive revised more intrusive recommendations (known as notice under Article 126(9) which may include a new timeline of concrete measures to address the excessive deficit. For a euro area Member State, the assessment of non-effective action may result also in the imposition or strengthening of sanctions in the form of a fine of 0.2% of GDP. With continued non-compliance (as determined by a decision under Article 126(11)), the fine for euro area Member States may be increased to include a variable component and imposed annually as long as the country in question continues to fail to take "effective action." ([15]) ([16])

([14]) This is defined in Article 4 of Council Regulation (EC) No 1084/2006 of 11 July 2006 establishing a Cohesion Fund and repealing Regulation (EC) No 1164/94 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32006R1084:EN:NOT

([15]) This is defined in Article 12 of Regulation 1467/97 as updated in 2011 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0033:0040:EN:PDF

([16]) It should be noted that the provision for a transition period for the debt benchmark means that the EDP that were open

II.2.6. The abrogation of EDPs

An EDP can be abrogated when the excessive deficit is corrected in a sustainable manner. This is assessed by looking at both the outturn and the forecast data for the deficit and by considering the debt dynamics on a forward-looking basis, based on current policy. An EDP can only be abrogated if the deficit respected the 3% of GDP Treaty reference in the last year for which outturn data exists, the Commission forecasts indicate it will remain under this threshold over the forecast horizon and the current policy shows that the debt is compliant with the debt benchmark on a forward-looking basis. ([17])

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.

in November 2011, should be abrogated on the basis of the deficit criterion only.

([17]) Countries introducing eligible pension reforms can have their EDPs abrogated despite being above these thresholds, as along as the excess is fully explained by the reforms and is small.

ANNEX I
The legal basis and other relevant texts for the SGP

Box AI.1: **Article 121 TFEU – the basis of the preventive arm**

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.

Box AI.2: Article 126 of TFEU – the basis of the corrective arm

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.

(Continued on the next page)

Box (continued)

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

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

— to require the Member State concerned to publish additional information, to be specified by the Council, before issuing bonds and securities,

— to invite the European Investment Bank to reconsider its lending policy towards the Member State concerned,

— to require the Member State concerned to make a non-interest-bearing deposit of an appropriate size with the Union until the excessive deficit has, in the view of the Council, been corrected,

— to impose fines of an appropriate size.

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

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

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

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

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

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

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

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

Box AI.3: **Protocol 12 on the Excessive Deficits Criterion**

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.

Box AI.4: **Article 136 of TFEU – the basis of the sanctions under the preventive arm and the additional sanctions under the corrective arm, and of the two regulations in the Two Pack**

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).

Box AI.5: **Secondary Legislation and other relevant texts**

Council Regulation (EC) 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, as amended by Council Regulation (EC) 1055/2005 of 27 June 2005 and Regulation (EU) No 1175/2011 ☐ th

Council Regulation (EC) 1467/97 on speeding up and clarifying the implementation of the Excessive Deficit Procedure, as amended by Council Regulation (EC) No 1056/2005 of 27 June 2005 and Regulation (EU) No 1177/2011 ☐ the corrective arm of the Stabilit

Council Regulation (EC) 479/2009 on the application of the Protocol on the EDP

Regulation (EU) No 1173/2011 on the effective enforcement of budgetary surveillance in the euro area – sanctions regulation

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

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", on 3 September 2012

Resolution of the European Council on the Stability and Growth Pact, Amsterdam, 17 June 1997- established the political basis of the SGP. It contains commitments by Member States, the Commission and the Council on how to implement the SGP.

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"

Treaty on Stability, Coordination and Governance in the economic and monetary Union

ANNEX II

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 Nice 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:

Reverse 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.

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

• To impose sanctions in the form of an interest-bearing deposit under the preventive arm

• To impose or convert the interest-bearing deposit into a non-interest bearing deposit under the corrective arm, following an Article 126(6) decision

• To impost a fine under the corrective arm, following an Article 126(8) decision on a lack of effective action

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 recommendations on all aspects of EDPs on the basis of the deficit criterion for euro area countries, as long as there is no qualified majority against the recommendations. This is a behavioral, rather than a legal, commitment, and mirrors the use of RQMV.

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