Part II

Evolving budgetary surveillance

SUMMARY

The global economic and financial crisis exposed weaknesses in economic and budgetary governance in the Economic and Monetary Union (EMU), which led to an overhaul of the existing framework.

In the budgetary area, a series of reforms were introduced, starting in 2010 with the institution of the European Semester and following with an in-depth reform of the EU economic governance, known as the Six Pack. (32) These reforms significantly strengthened the European budgetary framework. Nevertheless, the need for deeper budgetary integration among euro area countries became clear and set in motion a number of initiatives aiming to further strengthen the fiscal basis of EMU. End-May 2013 a reform package, known as the Two Pack, completed the framework. It will facilitate budgetary coordination among euro area countries and increase the transparency of Member States' budgetary decision-making. In introducing these changes, it is the first step towards fiscal union, in line with the Commission Blueprint's Roadmap towards a deep and genuine EMU. (33)

Concretely, the Two Pack consists of two EU regulations (34) applicable to euro area Member States only. To improve the existing framework for fiscal policy-making in the euro area as a whole, one text adds new provisions for the coordination of budgetary policy among euro area countries, the reinforcement of national fiscal frameworks and a tightened surveillance of those with excessive deficits. The second text integrates and simplifies the economic and budgetary surveillance that applies to euro area countries under financial strain, including those receiving financial assistance, into the EU framework. (35) The dual aims of increasing coordination and transparency run through both regulations, which simply differ by their target, as the first one concerns all Member States of the euro area while the second deals with the specific case of those facing financial difficulties.

The legal texts introduce a series of provisions according to three main axes. First, they close the circle of monitoring at euro area level, to create a rolling process of information flowing between the EU and the Member States, aiming to improve the ability of Member States to take policy decisions that contribute to the attainment of public finances that can underpin a healthy euro; by raising the awareness of belonging to a single currency area, where the budgetary decisions of each Member State may affect its partners, these new elements of the budgetary process should encourage more prudent budgetary decisions within a more collective approach to fiscal policy-making. Second, they increase the responsibility and accountability of national fiscal policy setting, giving independent institutions a prominent role in the process and increasing the information that governments should make available to both the EU and general public. Finally, they recognise the special position of countries under financial strain and create a decision-making process underpinned by principles of transparency and information sharing for protecting both the countries themselves and the euro area as a whole from the damage such a situation can cause. The sections that follow consider these three axes in order.

(32) The Six Pack reforms of 2011 are described in detail in European Commission (2011) (see part II "Evolving budgetary surveillance") and European Commission (2012a) (see part II.2 "The 2011 reform of the Stability and Growth Pact"). The legislation is available at: http://eur-lex.europa.eu/JOHtml.do?uri=OJ:L:2011:306:SOM:EN:HTML.
A complete guide to the operation of the SGP can be found at the following link: (http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp151_en.pdf), while a non-technical guide to its main features can be found at the following link: (http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/op150_en.htm).

(33) "Towards a Deep and Genuine Economic and Monetary Union Ex ante coordination of plans for major economic policy reforms", *Communication from the Commission to the European Parliament and the Council*, 20 March 2013, COM(2013) 166 final, available here: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0777:FIN:EN:PDF

(34) Regulation (EU) No 472/2013 of the European Parliament and of the Council 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; Regulation (EU) No 473/2013 of the European Parliament and of the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area; the legal texts are available at: http://eur-lex.europa.eu/JOHtml.do?uri=OJ:L:2013:140:SOM:EN:HTML.

(35) European Commission (2013a)

1. INTRODUCTION

On 30 May 2013, the Two Pack entered in force. Its two regulations apply only to the euro area as they address needs that are specific to the countries sharing the single currency. With the aim of protecting euro area Member States from the spillovers associated with imprudent budgetary outcomes, and based on the idea that those could be avoided with greater coordination and enhanced transparency, the Two Pack builds on the surveillance mechanisms reformed by the Six Pack to improve budgetary policy-making in euro area countries. The Two Pack is the subject of Chapter II.1, which explains its logic and its functioning.

In this context, the Two Pack constitutes the first step in translating the commitments of the Treaty on Stability Coordination and Governance in the Economic Monetary Union (TSCG) into EU law. This is relevant in that the TSCG complements the SGP by requiring Member States that signed it to introduce into national legislation key elements of the SGP, namely the country specific Medium-Term Budgetary Objective (MTO) and the adjustment path towards it.

The MTO is the key element of the preventive arm of the SGP, aimed at strengthening the public finances when conditions are favourable, to create enough fiscal space for the bad times. As the economy improves Member States will exit the Excessive Deficit Procedures (EDP) and attaining the MTO will move to centre stage in budgetary surveillance. Chapter II.2 discusses the MTO, considering both its role and the details for its computation.

2. TWO PACK

As part of its role of legislating for a significant strengthening of the coordination of the euro area's budgetary policies, the Two Pack is a first step in the translation into EU law of commitments made by the twenty-five signatories – including all members of the euro area – in the Treaty on Stability Coordination and Governance (TSCG). The TSCG, which entered into force on 1 January 2013, is an intergovernmental Treaty, meaning that it is agreed on between the signatory countries and that it is not rooted in EU law. 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. It is described in detail in Chapter II.5 of European Commission (2012) and an overview is given in Box II.2.1.

2.1. CLOSING THE MONITORING CYCLE

The experience of recent years has brought to the fore the importance of sound budgetary policy. For the euro area, the spillovers between countries require them to undertake their fiscal policy in a responsible manner, abiding by the rules that they set up, not just for their own benefit, but also for that of the other participants in EMU. Making sure that this occurs is a key aim of the Two Pack. To do so, it builds on the surveillance framework which exists at the EU level – i.e. the framework according to which Member States share information on their fiscal policies and the EU assesses whether those comply with commonly agreed rules (as part of the European Semester) – in order to increase the coordination between countries of the euro area.

To close what could be termed "the monitoring cycle", the Two Pack has introduced a continuous process of assessment of national fiscal policies, which will equip the EU with the information needed to establish whether euro area countries are compliant with their European budgetary obligations, and with the tools to take action where they are not. By the publication of this information, and as a result of the assessments undertaken, the information at the disposal of national stakeholders and governments on their fiscal policy will be enriched. This will aid the transparency of the budgetary policy – and therefore of the democratic process – as stakeholders will be better able to hold their law-makers to account. And governments in EMU will be guided throughout their budgetary year about the situation of the euro area and as to whether their policies are conducive to the budgetary targets that are in place to protect both them and their fellow euro area participants from the damage of imprudent policies. Excessive deficits should also be more promptly corrected.

Currently, monitoring under the preventive arm of the SGP is centred on the assessment of Member States' medium-term plans presented in the Stability Programmes (SCP) ([36]) every spring under the European Semester, and, one year later, the assessment of the actual budgetary outturns. The Two Pack introduces a coordinated assessment of Member States' draft budgetary plans in the autumn – an exercise enabled by the introduction of a common budgetary timeline in all the euro area – focusing on the measures to be adopted.

Starting in autumn this year, the Commission will publish opinions on each of the plans and their likely impact, made public for national parliaments and any other stakeholders. This will introduce an unprecedented degree of transparency. The opinions should act as early warnings on possible risks should a plan be judged negatively by the Commission. Not reacting adequately to this warning would be considered as an aggravating factor should those risks materialise.

The Two Pack also addresses the monitoring of the correction of excessive deficits under the Excessive Deficits Procedure (EDP). In the case of multiyear EDPs, having an in-depth up-to-date understanding of both the economic situation and the measures taken to correct the excessive deficit, takes on a particular importance. First, because, by definition, if such EDPs span a number of years, this is due to the seriousness of the challenges faced. Second, because an early slippage in the response can jeopardise the entirety of the correction strategy, possibly over a number of years. Third, because over time, the situation the Member States finds itself in will necessarily evolve and an adjustment in the response may

([36]) Euro area countries submit Stability Programmes, while non-euro area countries submit Convergence Programmes. They are therefore jointly referred to as Stability or Convergence Programmes (SCPs).

Box II.2.1: Overview of the Treaty on Stability Coordination and Governance (TSCG)

The TSCG contains six titles. The first two set out the aim of the Treaty and its relationship with the EU. Title III 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 medium-term budgetary objective (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 establish 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.

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 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 an 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 at increasing 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.

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. In this way, the Commission has proposed deadlines for reaching the MTO through the country-specific recommendations issued at the end of the European Semester ([1]) and the common principles according to which the national correction system should be set out ([2]) . 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 ([3]) .

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.

The Treaty is binding for the signatories which have ratified it, in its entirety for euro area Member States, while the others can, when ratifying it, select the provisions in Titles III and IV they would agree to be

([1]) The 2013 country-specific recommendations are available under http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index_en.htm.
([2]) The Commission published common 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.
([3]) 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 (see footnote 2).

(Continued on the next page)

Box (continued)

bound by ([4]) . Title V, nonetheless, applies to all Contracting Parties as from the date of entry into force of the Treaty.

([4]) 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

therefore be appropriate. For euro area Member States that are in EDP, the Two Pack addresses these needs through a system of reporting by the Member States and corresponding monitoring by the Commission. By enhancing the Commission's and Council's understanding of the situation that Member States under EDP are in, both at the launch and throughout the procedure, their ability to detect early possible risks that a Member State may not comply with the agreed path for correcting its excessive deficit is reinforced. This allows warnings, under the form of recommendations by the Commission, to be sent much earlier in the correction process.

In that respect, this closer monitoring of the correction of the excessive deficit increases the responsibility of the Commission in delivering timely guidance against the breach of EDP recommendations. In doing so it enhances the preventive role of the EU against the occurrence of slippages from EDP recommendations. With the stronger enforcement mechanisms applicable in the euro area since the changes under the Six Pack this is of particular importance; now that Member States are liable to financial sanctions all the way through the EDP it is important that any deviation of their policies from the recommendations under the EDP be flagged early on to allow them to take appropriate action and avoid the imposition of financial sanctions.

2.1.1. Enhancing budgetary coordination with an ex ante assessment of draft budgetary plans

A new phase in budgetary surveillance: the autumn assessment of Member States' draft budgetary plans

Under the preventive arm of the SGP, all Member States present annual updates of their medium-term budgetary plans in the form of SCPs by the end of April as part of the processes that come under the European Semester. The idea behind the introduction of this European Semester was to bring together the various mechanisms for providing Member States with early guidance as to their economic policies in a manner that allows them to be integrated into the national policy-setting. Accordingly, within the first six months of the year, Member States' plans are examined and assessed at the European level, before the national authorities prepare their budgets in the second half of the year.

Due to the Two Pack, euro area Member States will now submit draft budgetary plans to the Commission and to the Eurogroup, by 15 October, before the adoption of the budget, starting from October 2013. These draft budgetary plans should reflect the most important information of countries' draft budgets, presenting the measures they contain, in a format that will allow their assessment at European level. The purpose of this new exercise is to verify whether the measures contained in the draft budgets and the overall fiscal aggregates they lead to are consistent with the SGP rules and, where applicable, Council recommendations, and to analyse what Member States' budgetary plans imply for the fiscal stance of the euro area as a whole. It occurs between two European Semesters, by providing a follow-up to the recommendations in the previous spring and setting the scene for the next Semester.

The draft budgetary plans are meant to be synthetic documents presenting the main aspects of the budgetary situation of the general government sector and the detailed information on budgetary policy measures as planned in the draft budget for the next year. They are a detailed development of the SCPs for the year to come, focussing on the measures to be adopted to reach the targets set by either the preventive or the corrective arms of the SGP. The information to be included in these plans

Table II.2.1: **Process for the autumn assessment of draft budgetary plans**

	By when?	Who?	What?
	15 October	Each Member State	Submits its draft budgetary plan
Individual assessment of DBPS	*Normal process*		
	End-November at the latest	Commission	Adopts an Opinion on each DBP
	If Commission detects serious non-compliance with SGP obligations in a DBP		
	1 week of submission [indicative: 23 October]	Commission	Consults the Member State concerned
	2 weeks of submission [indicative: 30 October]	Commission	Adopts an Opinion requesting a revised DBP to be submitted within 3 weeks
	3 weeks of the date of Commission's Opinion at the latest [indicative: 21 November at the latest]	Member State concerned	Submits a revised DBP
	3 weeks of submission of revised DBP at the latest [indicative: 12 December at the latest]	Commission	Adopts a new Opinion on revised DBP
	No fixed deadline (in principle end-November)	Commission	Overall assessment of the budgetary situation and prospects in the euro area as a whole, on the basis of national DBPs and their interaction.

Source: Commission services

is set out in the Two Pack regulation and has been further elaborated on in a Code of Conduct,([37]) which includes template tables for the information to be submitted, in order to ensure homogeneity in the reporting and consistency across the assessment of the budgetary plans.

Table II.2.1 allows the comparison of the content of the draft budgetary plans and the SCPs. A number of differences are based on their different purposes; the SCPs are the vehicles for analysing policy-setting in a multiyear framework, while the draft budgetary plans are the documents that provide the information for judging whether the actual measures introduced are consistent with the budgetary targets for the next year.

The main differences between the two documents are the following:

(i) The draft budgetary plans contain information only on the forthcoming year, while the SCPs provide both outturn data and forecast data for at least three years.

(ii) The draft budgetary plans should provide a higher level of detail on the budgetary measures than the SCPs. While SCPs are only required to provide no-policy change projections on the revenue side, the draft budgetary plans must provide no-policy change projections for both revenue and expenditure, as well as a break-down of expenditure by function and a description of measures taken.

([37]) Available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/130701_-_two_pack_coc_final_endorsed.pdf

(iii) The draft budgetary plans should be based on independent forecasts. The use of independent institutions is a key element of the Two Pack. It is also a requirement of the TSCG and builds on the minimum requirements on national budgetary frameworks introduced under the Six Pack. It is discussed in detail in Section II.1.2.

(iv) With a view to increase transparency on the macroeconomic impact of budgetary measures, the draft budgetary plans should include an analysis of the expected distributional impact of the measures and on their estimated impact on economic growth (the fiscal multipliers).

(v) The SCPs should provide information necessary for the medium-term aspects of the surveillance process. They define the MTO and the (possibly multiannual) path to reach it, together with any information (such as on structural reforms) necessary to assess any deviation from the MTO or the adjustment path towards it.

(vi) Unlike the draft budgetary plans, the SCPs should also contain elements on medium to long-term fiscal sustainability such as the projected path for the debt ratio as well as implicit liabilities related to ageing.

In parallel, the Two Pack also increases requirements in terms of information disclosure to the Commission.

The examination of the draft budgetary plans by the Commission: individual Opinions and an overall assessment

Following the submission of the draft budgetary plans (DBP), the Commission will assess each plan individually and analyse the overall budgetary stance of the euro area implied by the sum of these plans. Table II.2.2 presents the various aspects of the assessment and their timing.

For the country-specific assessments, the Commission will evaluate the content of each DBP against the requirements stemming from the SGP and, where applicable, the recommendations addressed to the respective Member State in the budgetary area, such as the Country Specific Recommendations (CSRs) issued in the context of the European Semester, as well as recommendations issued on the basis of Article

Table II.2.2: **The information required by the Two Pack to feature in the draft budgetary plans and comparison with the content of the Stability Programmes**

	Article 6(3) Reg 473/2013	Article 3(2) Reg 1466/97
Targeted budget balance	the targeted budget balance for the general government as a percentage of Gross Domestic Product (GDP), broken down by sub-sector of general government	the medium-term budgetary objective and the adjustment path towards that objective for the general government balance as a percentage of GDP
Unchanged policy projections	the projections at unchanged policies for expenditure and revenue as a percentage of GDP for the general government and their main components, including gross fixed capital formation	the planned growth path of government revenue at unchanged policy
Targeted expenditure and revenue path	the targeted expenditure and revenue as a percentage of GDP for the general government and their main components, taking into account the conditions and criteria to establish the growth path of government expenditure net of discretionary revenue measures under Article 5(1) of Regulation (EC) No 1466/97	the planned growth path of government expenditure, including the corresponding allocation for gross fixed capital formation, in particular bearing in mind the conditions and criteria to establish the expenditure growth under Article 5(1)
Detail on expenditure plans	relevant information on the general government expenditure by function, including on education, healthcare and employment, and, where possible, indications on the expected distributional impact of the main expenditure and revenue measures	
Detail on measures	a description and quantification of the expenditure and revenue measures to be included in the draft budget for the year to come at the level of each sub-sector in order to bridge the gap between the targets and the projections at unchanged policies; may be less detailed for measures with a budgetary impact estimated to be lower than 0.1% of GDP particular and explicit attention shall be paid to major fiscal policy reform plans with potential spillover effects for other euro area Member States	a quantification of the planned discretionary revenue measures a quantitative assessment of the budgetary and other economic policy measures being taken or proposed to achieve the objectives of the programme, comprising a cost-benefit
Debt and implicit liabilities	debt developments for the forthcoming year	the expected path of the general government debt ratio information on implicit liabilities related to ageing, and contingent liabilities, such as public guarantees, with a potentially large impact on the general government accounts
Consistency with other economic policy reco.	indications on how reforms and measures in the draft budgetary plan, including in particular public investment, address the current recommendations to the Member State concerned in accordance with Articles 121 and 148 TFEU and are instrumental to the achievement of the targets set by the Union's Strategy for growth and jobs	information on the consistency of the stability programme with the broad economic policy guidelines and the national reform programme
Forecasts	the main assumptions of the independent macro-economic forecasts and important economic developments which are relevant to the achievement of the budgetary targets an annex containing the methodology, economic models and assumptions, and any other relevant parameters underpinning the budgetary forecasts and the estimated impact of aggregated budgetary measures on economic growth	the main assumptions about expected economic developments and important economic variables which are relevant to the achievement of the stability programme, such as government investment expenditure, real GDP growth, employment and inflation an analysis of how changes in the main economic assumptions would affect the budgetary and debt position
Structural reform clause		analysis of major structural reforms which have direct long-term positive budgetary effects, including by raising potential sustainable growth if applicable, the reasons for a deviation from the required adjustment path towards the medium term budgetary objective.

Source: Commission services

121(4) Treaty on the Functioning of European Union (TFEU) (in case of significant deviation from the preventive arm requirements of the SGP), or on the basis of Article 126 TFEU for countries subject to an EDP.

Based on this assessment, the Commission will issue an Opinion. In order to allow the national budgetary authorities, and in particular the national parliaments, to take this independent assessment into account and so to maximise its policy relevance, the Commission is committed to delivering it as early as possible and, at the latest, on 30 November. The Commission's Opinion will be an independent voice that contributes to the debate on euro area countries' budgets which are, and will remain, decided at the national level.

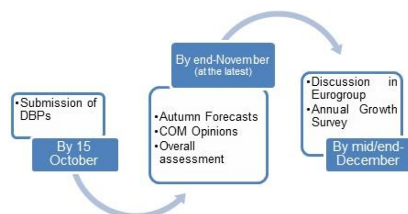
In the case where the Commission finds a DBP in serious non-compliance with the country's obligations under the SGP, the Two Pack introduces a specific procedure requiring the submission of a new draft budgetary plan. Such non-compliance could arise if a Member State clearly misses targets recommended by the Council under Article 121(4) in the context of the preventive arm of the SGP, or under the EDP, or when it entails an obvious breach of one of the Treaty reference values for the deficit and the reduction of the debt. Similarly, plans whose implementation would put at risk the financial stability of the Member State concerned or risk jeopardising the proper functioning of the euro area as a whole would lead to the same conclusion.

In such cases, the Commission will consult the Member State concerned and require that a revised draft budgetary plan be submitted within three weeks. This special procedure, which is intended to be used only in exceptional cases, is designed so that no more than five weeks separate the submission of the first draft of the plans and its revised version. The Commission Opinion requesting new plans aims to prevent gross policy errors which would result in the Member State falling under the reinforced sanctions mechanism associated with breaches of the SGP. Once the new plans are submitted, a new assessment and Opinion are issued.

The Commission's assessments of the DBP serve another role too – they feed into subsequent examinations of the budgetary outcomes. If the Commission Opinion on these plans is that the implementation of some of aspect would not be in line with the SGP, this would be considered as an early warning. If the budgetary outcomes then prove in breach of the SGP, the implementation of plans which had received a negative opinion would be considered as an aggravating factor. In this way, they would be treated more strictly than countries whose breach could not be predicted in advance.

The Commission will present its opinion to national and the European Parliament if called to do so.

Graph II.2.1: **Timeline for the autumn assessment of the fiscal stance**



Source: Commission services

For the assessment of DBP for the euro area as a whole, the Commission intends to provide a comprehensive overview of the fiscal outlook for the forthcoming year, on the basis of an aggregated evaluation of all draft budgetary plans. Graph II.2.1 sets out how this will contribute to the policy debate. This will facilitate a discussion on the most appropriate policy mix in the euro area, while putting individual policy choices in euro area perspective. This overall assessment should also be taken into account by the upcoming Annual Growth Survey, which constitutes the general guidance that the Commission delivers to Member States for the setting of their economic policy goals in the forthcoming year, launching the European Semester.

2.1.2. Improving the efficiency of the excessive deficit procedure

The years since the onset of the crisis saw an unprecedented number of EDPs being opened, many of them spanning a number of years. In contrast, EDPs opened prior to the crisis were usually much shorter. These longer procedures inevitably implied changes in countries' circumstances over the years concerned.

Box II.2.2: **The regular reporting under the EDP provided for by the Two Pack and specified by the delegated Regulation**

The Two Pack contains a provision for the precise format and content of the regular reporting introduced under for countries under EDP to be determined by a delegated act of the Commission (Article 10.3). The delegated Regulation in question was adopted by the Commission on 27 June 2013, specifying that the regular reports should include the following information:

For the general government and its sub-sectors:

- Actual balances, debt developments, and updated budgetary plans for the period of correction for the general government and its sub-sectors;

- Description and quantification of the fiscal strategy in nominal and structural terms (cyclical component of the balance, net of one-off and temporary measures) to correct the excessive deficit by the deadline set by the Council in the view of the latest Council recommendation or decision to give notice in accordance with Article 126(7) or Article 126(9) TFEU, including detailed information on budgetary measures planned or already taken to achieve these targets and their budgetary impact.

In addition, the delegated Regulation provides templates for tables that Member States are required to use to report this information. This harmonised framework should ensure that the monitoring of EDPs in euro area Member States is undertaken consistently across countries, based on a similar set of elements.

In line with the common understanding on delegated acts, this delegated Regulation should enter into force on 27 August 2013 at the latest, provided that the Council and the European Parliament did not raise objections to it; it can enter into force even earlier, provided both co-legislators have explicitly stated their intention not to raise objections to it. Once the delegated Regulation has entered into force, the Commission will be in a position to launch, as appropriate, requests to euro area Member States in EDP for the corresponding additional reporting requirements.

The Commission has so far mainly relied on its own instruments to monitor the progress in the correction of excessive deficits, namely bi-annual forecasts by the Commission services including fiscal notifications by Member States, as validated by Eurostat. However, these long procedures exposed the lack of sufficient information sharing on the side of the Member States, which introduced time lags in the monitoring of the EDPs and reduced the efficiency of the response.

Until the Two Pack, euro area Member States only reported on their fiscal strategy to correct their excessive deficit a few months after the opening of a procedure, in addition to the annual updates of their Stability Programmes. Once positively assessed by the EU, the Member State was left to implement this strategy, more or less until the deadline by which it was expected to have completed the correction in a lasting manner. The Commission monitored the Member State's progress over its EDP, based on the country's bi-annual fiscal notifications and the Commission services' forecasts. The complexity of the challenges created by the economic and financial crisis exposed the importance of enlarging the range of information available to the Commission and the Council, to better understand the progress achieved towards the EDP requirements. The Two Pack's enhanced reporting will provide greater details on the budgetary execution, including on infra-annual developments, and detailed information on the measures being taken, enabling a closer monitoring of the progress of countries under EDP.

The Two Pack has addressed the gap in information, with (i) a better understanding of the

initial point of departure, (ii) a more regular transmission of information on the implementation of the correction strategy, (iii) a possibility for the Commission to launch an audit of the public accounts or to request any additional information needed for a proper understanding of the situation of the Member State and finally (iv) a complementary tool, under the form of a roadmap of a broader fiscal structural strategy, that would come to support the fiscal consolidation measures, to ensure that an excessive deficit would not re-occur.

The innovations associated with this new reporting are summarised in Graph II.2.2, which brings together the existing and new reporting obligations for the various steps of the EDP.

A more regular and more thorough exchange on budgetary information from Member States in the process of correcting their excessive deficit

The new obligations begin with the launch of the EDP: the Commission is able to request that the Member State be subject to new, additional, reporting requirements, until the abrogation of the procedure. Such a request should in principle be formulated at the entry into EDP of any euro area country, except in cases when the Commission deems it to not be useful.

As a first step of these additional obligations the Two Pack introduces an in-depth assessment of the in-year budgetary execution of a country entering EDP, to provide a better understanding of the starting point for the correction strategy. This covers the general government and its subsectors, and needs to feature a consideration of the financial risks associated with contingent liabilities with potentially large impacts on public budgets, to the extent that they may contribute to the existence of the excessive deficit. This is going to help the identification of the particular difficulties that a Member States may face. This comprehensive assessment is to be submitted within the deadline for effective action included in the Article 126(7) Council recommendation, which is usually six months – or three if warranted by the seriousness of the situation.

As presented in a sub-section below, this in-depth review will also be accompanied by another new requirement of the Two Pack, the submission of an EPP, which should support the fiscal correction strategy with a broader structural approach to support the sustainability of the correction of the excessive deficit. ([38])

The first assessment of the action taken in response to the Council recommendation is therefore going to be conducted on the basis of this larger set of information. If the correction appears on track, the EDP is placed "in abeyance" until the correction of the excessive deficit is achieved and the procedure abrogated. Prior to the Two Pack, the SGP was silent on the follow-up of EDPs in abeyance, beyond stating that a regular monitoring should occur. In practice, the Commission regularly observed whether the country was still on track to meet its recommendations, but no formal requirements were placed for countries to update the Commission on the progress of the measures that they are taking to achieve the correction of the excessive deficit. The Two Pack has changed this.

Euro area countries subject to the new reporting requirements will now update the Commission and the Council on the fiscal strategy to correct the excessive deficit that they had presented in the initial report required by the SGP, every six months. In the spirit of transparency, this additional reporting is also going to be made public. If countries are placed in a further step of the procedure for not having effectively implemented the correction strategy (namely when subject to a 126(9) Council notice), the frequency of the regular reports increases to every three months, to reflect the greater need for a close monitoring of the correction of the excessive deficit in this particular country.

The precise information to be submitted in the context of this regular reporting will be set out in a delegated Regulation of the Commission. The detailed regular reports are going to provide the Commission with up-to-date estimates of the yields (in terms of revenue increases or expenditure decreases) of the measures taken by the government. This information is a key feature of the improvement of the monitoring of the correction strategy, in that it is going to allow a

([38]) As opposed to the additional requirements in terms of reporting on the budgetary strategy – which are activated by a request by the Commission – the obligation to submit an EPP applies to all euro area countries entering in EDP.

rolling monitoring of whether the measures taken support the adjustments required under the EDP and therefore whether the country is on track to correct its deficit according within the deadline issued. Box II.2.2 provides more information on the content of this text.

At any point during the EDP, the information at disposal of the Commission may be complemented by new reporting that it can activate upon request. The Two Pack enables the Commission to request that a Member States carry out and report on a comprehensive independent audit of the public accounts of all subsectors of the general governments, preferably to be conducted in coordination with national supreme audit institutions, within the deadline set out by the Commission. With an even broader scope, Member States will have to provide any available information for the purposes of monitoring progress towards the correction of the excessive deficit.

Taken together with the annual DBPs, the new reporting provisions provide the Commission with a full toolbox of information to conduct its monitoring of the response to EDPs. With enhanced possibility to detect early slippages from the path to correcting an excessive deficit, the Commission will be able to address a recommendation directly to the Member State concerned and to ensure that the measures planned are fully implemented. If appropriate, the recommendation may ask for the introduction of further measures. This recommendation is made public – with the Commission standing ready to present it to the Parliament of the Member State concerned at its request – and should act as a warning to the country that it is at risk of breach of its obligations under the EDP if it does not take appropriate action.

Similarly to the integration of the new Commission opinion on draft budgetary plans into the decision-making on the opening of an EDP, compliance with this autonomous Commission recommendation would be a factor that could influence further decisions to be made in that excessive deficit procedure, such as the Council decisions on effective action or the imposition of financial sanctions.

Economic partnership programmes to complement the budgetary monitoring by a roadmap for structural reforms

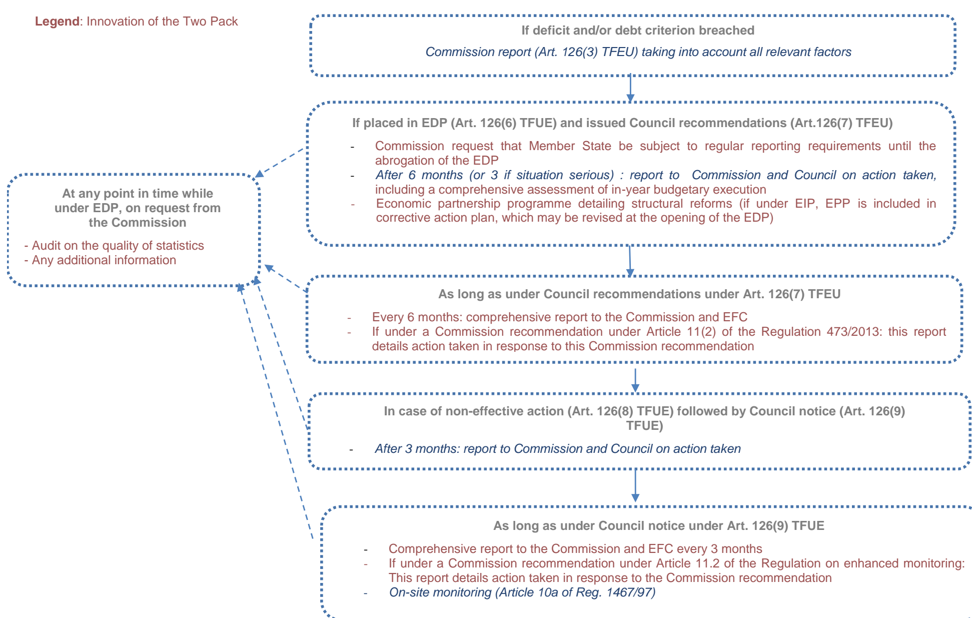
The fifteen or so years since the introduction of the SGP in 1997 have led to a maturing of the context within which fiscal challenges are considered. The crisis has highlighted the interplay between structural policies and the impact on fiscal outcomes, particularly over the medium or longer terms.

In order to encourage euro area Member States which are facing fiscal challenges, and are placed in EDP for this reason, to undertake the necessary structural reforms to support their consolidation plans, the Two Pack introduces the requirement to prepare and submit an economic partnership programme (EPP) at the start of the EDP. This requirement implements a commitment taken by Member States signatories of the TSCG. This EPP should act as a roadmap for the fiscal structural reforms which are deemed necessary by the Member State to ensure an efficient and lasting correction of the excessive deficit; the Member State should also identify and select its priorities in terms of competitiveness, long-term sustainable growth and addressing its structural weaknesses. The EPP thus complements the budgetary measures leading to the correction of the budgetary slippage, with a wider strategy aimed at avoiding the occurrence of excessive deficits.

The EPPs are documents which are produced and implemented by national authorities. When drawing up its EPP a Member State would be expected to proceed on the basis of the existing surveillance instruments (including existing Country Specific Recommendations it has been addressed by the European Council) in order to select the appropriate set of reforms and priorities to include, thus enhancing the links and coordination between the budgetary procedure and the work developed throughout the European Semester. The Code of Conduct presents more detailed guidelines for the content of the EPPs.

In terms of timeline, the EPP will be submitted a few months (usually six months) after the opening of the EDP, at the same time as the authorities report on the action taken in response to the

Graph II.2.2: **The EDP process for euro area Member States including the changes introduced with the Two Pack**



Source: Commission services

Council recommendation. ([39]) After its review by the Commission, the EPP receives an Opinion of the Council based on a proposal by the Commission. Following approval by the Council a light process based on the regular monitoring of NRPs and SCPs has been created, to follow the implementation of the EPP at EU level without burdening Member States with new procedure.

Euro area Member States already subject to the corrective arm of the MIP (known as the Excessive Imbalances Procedure) will not need to draft a new roadmap for reforms when entering the EDP. This is because these countries will already have presented present a comprehensive roadmap for reforms, the Corrective Action Plan (CAP). Graph II.2.3 presents the interaction between the two procedures and the streamlining which has been decided in the different cases.

([39]) The Two Pack contains transitional provisions so that Member States currently under EDPs will not submit an EPP unless a new EDP step (extension of deadline through a new Article 126(7) Council recommendation or a step-up through an Article 126(9) Council notice) is taken.

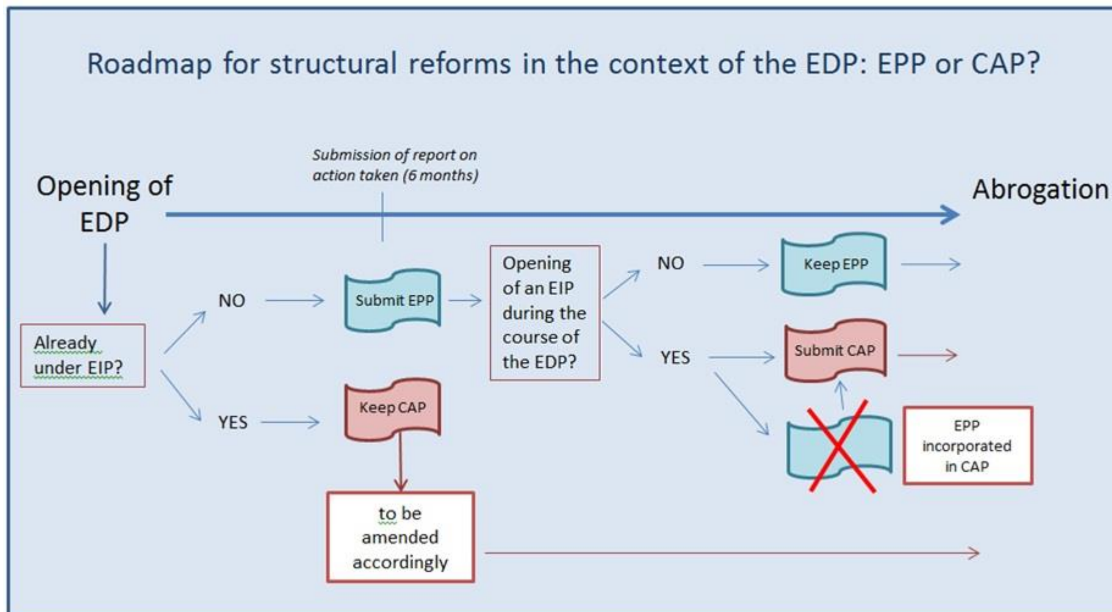
2.2. ACCOUNTABILITY AND RESPONSIBILITY IN SETTING FISCAL POLICY. EQUIPPING COUNTRIES WITH THE BEST CHANCE TO MAKE THE RIGHT POLICY CHOICES.

The second axis of the Two Pack concerns the circumstances under which national policy-makers set fiscal policy. Improving the quality of budgetary policy relies strongly on national institutions and processes being accountable and responsible. This is important not just in terms of the fiscal policy outcomes which affect both the country in question and the euro area as a whole via the spillovers and interdependencies between countries, but also in allowing national stakeholders – including the electorate – to understand and monitor government policy.

In focussing on national institutions and processes, the Two Pack builds on an approach that underlies the Directive on national budgetary frameworks ([40]), which was introduced as part of the Six Pack in 2011. This directive recognised the importance of the role that national policy-makers

([40]) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0041:0047:EN:PDF

Graph II.2.3: **Interaction of the EPP with the EIP Corrective Action Plan**



Source: Commission services

have in countries' ability to comply with the European requirements under the SGP and sets certain minimum criteria for national budgetary frameworks that countries should comply with. These criteria concern accounting and statistics, forecasts, numerical fiscal rules, the need to rely on medium-term budgetary frameworks, coordination arrangements and transparency. The Directive should be transposed into national legislation by 31 December 2013.

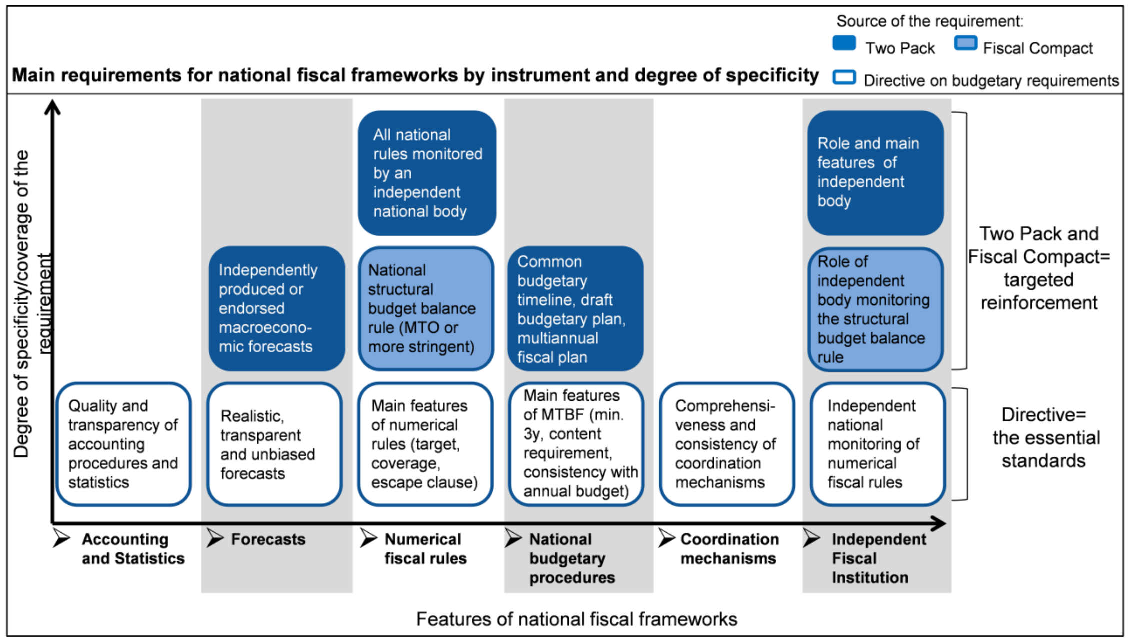
Building on this approach, the Two Pack goes further. It extends and specifies requirements for certain features of the national fiscal framework toolkit for the euro area. In order to enhance the reliability of the information that policy choices are based on and assessed with, it recognises the importance of credible macroeconomic forecasts by requiring that independent forecasts are used to underpin the budgetary process. It gives national independent fiscal institutions the role of monitoring domestic fiscal rules, and sets out the main features that makes such institutions able to ensure operational independence, in order to provide a credible watchdog to monitor how governments comply with their own fiscal rules.

In safeguarding the role of national fiscal rules, the Two Pack also builds on the commitments made by the euro area Member States in the TSCG (see Box II.2.1 for a summary of the TSCG Chapter II.5 of European Commission (2012) for a detailed discussion of its contents). The fiscal compact contained within the TSCG commits the signatories to introducing national provisions of binding force and permanent character to ensure compliance with the MTO – which forms the cornerstone of the preventive arm of the Pact – along with a correction mechanism to be triggered automatically. Independent institutions are given the role of ensuring compliance with this mechanism. The common objective of the TSCG commitments and the Two Pack requirements is to codify in national law a strong legal requirement and implement a national budgetary process which will put meeting the requirements of the preventive arm at the very heart of national fiscal policy.

The interaction and mutually reinforcing provisions of the Two Pack, the Directive and TSCG are presented graphically in Graph II.2.4.

The Two Pack's approach to how the national side effects budgetary outcome in the euro area contains one more dimension – it looks at how

Graph II.2.4: **Main requirements for national fiscal frameworks by legal instrument and degree of specificity**



Source: Commissions services

national processes affect the ability to coordinate and monitor policy at the euro area level. Section II.1.1 set out how the Two Pack enhances the information flow going both from the Member States to the EU and vice versa in order so that the impact of countries' policies on the euro area is assessed on a rolling basis. In order to do this, however, the timing of the policy decisions needs to be such as to allow the new continuous monitoring to feed into the national policy debate and an appropriate and common time. The Two Pack therefore introduces a common budgetary timeline to allow this monitoring to operate optimally by mirroring European budgetary milestones at national level.

Finally, the Two Pack also introduces a new aspect to European economic coordination by placing the onus on Member States to share information on debt issuance plans. This information, which was previously only recorded at national level, will enable a monitoring of debt development at European level and increase the accountability and responsibility with which countries take their debt issuance decisions – which are so vital to the functioning of the euro area.

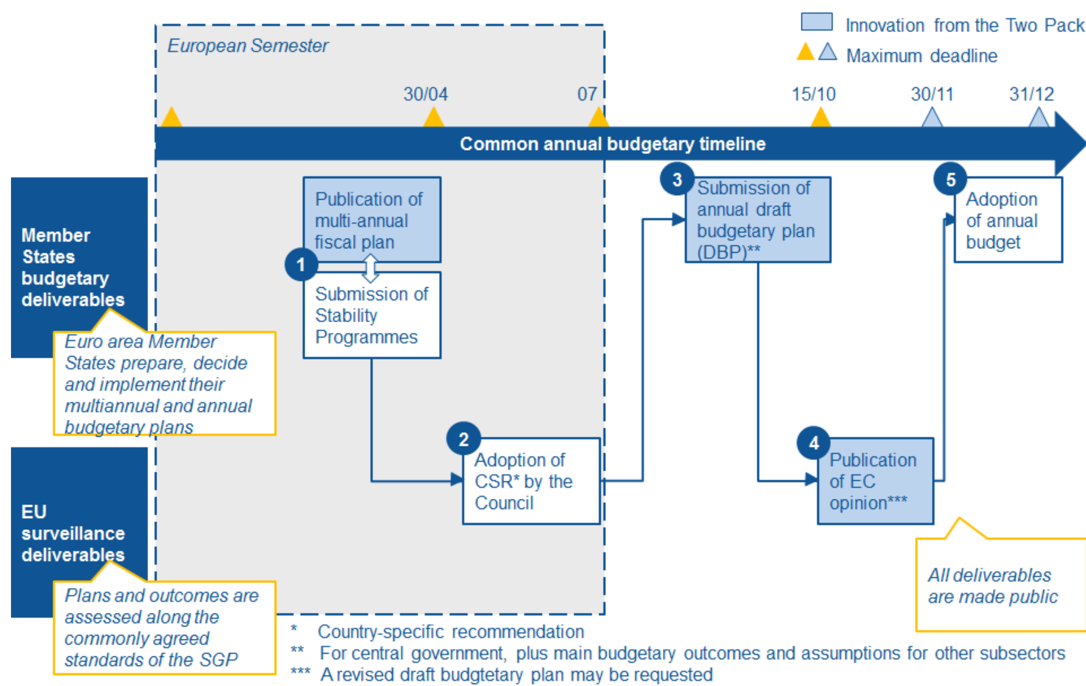
2.2.1. A common budgetary timeline for coordinated budgetary procedures across the Euro area

Section II.1.1 set out how the Two Pack closes the

circle of monitoring at the European level for Member States of the euro area, with the new assessment of the draft budgetary plans every autumn, complementing the annual exercise of the European Semester. In order to enable this to play an optimal role in the budgetary processes of all euro area countries, the Two Pack strengthens the collective approach to fiscal policy design by defining a common budgetary timeline, spanning over the whole year. The Two Pack supports the continuity of consistent national processes in the budgetary area to smooth their interaction with this EU surveillance.

This new timeline contains the following components, as illustrated by Graph II.2.5. First, the strategic budgetary perspective for the medium-term is to be consolidated at the national level and made public in a medium-term national fiscal plan (step 1 in Graph II.2.5), which should be the basis for each Member State to draw the Stability Programme that it submits under the

Graph II.2.5: **The common budgetary timeline: interactions between the national and the European levels**



Source: Commission services

European Semester. This multiannual fiscal plan will be a key national budgetary document, whose content, format and role in the national budgetary debate will be for each Member State to define, provided that it includes at least all the information required for the Stability Programme and that it meets the essential requirements from the Directive with respect to the country's medium-term budgetary framework (MTBF). ([41]) Member States may also choose to designate their own Stability Programme as serving the function of this multiannual fiscal plan, since they have the same deadline for publication/submission (end of April).

Second, the annual perspective in terms of budgetary policy, driven by the annual budget law, is now also going to be more coordinated at the euro area level, with common milestones for the design and adoption of the budget. Accordingly, as foreseen by the Two Pack, the budget needs to be adopted, or at least set in a definitive manner, in each euro area Member State by 31 December of the previous year (step 5 in Graph II.2.5). Before adoption takes place, all Member States of the euro area need to publish their draft budget by 15 October (step 3), which forms the basis of the DBP which will be assessed at European level according to the new procedure set out in Sub-section II.2.1.1.

This common timeline, in full respect of national budgetary rules and procedures, is reinforcing ex-ante budgetary coordination within the euro area by synchronizing key steps of the national budgetary process and aligning it with the EU mechanism of budgetary surveillance. As the Two Pack entered into force on 30 May 2013, 2014 will be the first fully-fledged common budgetary cycle for all euro area Member States. ([42])

([41]) These requirements include the time horizon (minimum 3 years), content (impact of medium-term policies envisaged on revenue and expenditure, projections of main budgetary aggregates) and robustness (ensured by the use of independent forecasts) of the data included.

([42]) With the exception of those subject to a macroeconomic programme: as described in Sections II.1.2.3 and II.1.3, those countries are exempted from submitting a multiannual fiscal plan, a draft budgetary plan and a debt issuance plan. Nevertheless the pre-existing requirements contained in Chapter IV of the Directive remain and all Member States are expected to have established medium-term budgetary framework by 31 December 2013.

2.2.2. Improving the national fiscal debate: greater transparency and stronger national institutions

Budgetary transparency and independent forecasts

The Two Pack requirement to have independent macroeconomic forecasts to underpin all aforementioned budgetary documents is expected to bring a substantial improvement to the quality of national budgetary planning of all euro area countries which did not have this practice in place, by providing an unbiased assessment of the projected fiscal developments. The independence of those forecasts is guaranteed by their production or endorsement by a national independent fiscal institution, where the independence of the institution follows the pre-existing provisions of Chapter III of the Directive.

Whether the Member States choose endorsement or production of the macroeconomic forecasts by the independent body is up to them, but they will have to communicate that choice. If they select endorsement, and the independent body refuses to endorse the forecasts, the refusal should typically trigger a review of the forecasts in the light of comments issued by the independent body and a revised forecast may be submitted for assessments of the independent body, leading to a new opinion. Irrespective of the choice of having the forecasts produced or endorsed independently, Member States should have in place specific mechanisms to cope with situations in which there are different views between steps to be taken, in the case of significant deviations of assessments on the main variables/aggregates between the independent body and the Ministry of Finance on the main variables of the forecast.

Member States are not formally required to ensure a similar independence of the budgetary forecasts – i.e. the projections of the main budgetary outcomes such as the deficit or the debt level. However, they are asked to communicate whether or not their budgetary forecasts are independent.

In terms of transparency, the Two Pack requests the publication of the medium-term fiscal plan, the draft budgetary plan and the macroeconomic forecasts they are based on. The corresponding role and opinion of the national independent fiscal institution(s) has to be indicated publicly. Being part of the public domain, these elements should enable a well-informed public debate on national policy choices, which can only improve the accountability of the decision-makers, the democratic legitimacy of the budgetary process and, eventually, enhance the quality of the decisions taken.

A national independent oversight of the attainment of the budgetary objectives

In the TSCG, the euro area countries and eight other EU countries, committed to establishing a rule constraining their budget balance in structural terms – to a value equal or more stringent than their MTO under the preventive arm of the SGP – and an associated correction mechanism to be triggered in case of deviation from the target level or from the convergence path to it in their national legal order. This should be monitored by an independent fiscal institution. This commitment complements the pre-existing principle set out in the Directive, that national independent monitoring for all numerical fiscal rules be in place, irrespective of the aggregate or subsector targeted. The Two Pack extends and reinforces the role of such national independent fiscal bodies, which have gradually become a prominent feature of national fiscal frameworks.

The Two Pack sets out in EU law the definition of main features promoting the independence of such national fiscal institutions. To be considered as independent, a body needs to (i) feature a statutory regime grounded in national laws, regulations or binding administrative provisions; (ii) not take instructions; (iii) have the capacity to communicate publicly; (iv) have in place procedures for nominating members on the basis of their experience and competence; and (v) have access to adequate resources and appropriate information to carry out its given mandate. This definition is consistent with the provisions of the Directive, the TSCG and the Commission Communication COM(2012)342 on common principles on the national fiscal correction mechanism, which further details the role of such independent bodies, in connection with the fiscal compact provisions.

According to the Two Pack, these independent bodies have two major roles to play. These roles can be fulfilled by a single independent body or

different ones, depending on what is appropriate in each Member State. Independent bodies should produce or endorse the macroeconomic – and possibly budgetary – forecasts underpinning the budgetary process. Independent bodies should be given the mandate to monitor compliance with all national numerical fiscal rules in place, in the sense of Chapter III of the Directive, including the rules incorporating the MTO in the national budgetary. They are also expected to issue public assessments over the relevance of the activation of the correction mechanism in the case of significant deviations from the budgetary objective, over the conformity of the implemented correction with national rules and plans and over the relevance of using the escape clauses.

In its provisions of the role of national independent bodies, the Two Pack does not intend to replace the EU surveillance process but to create a strong national layer of monitoring of budgetary outcomes, in order to increase the national ownership and awareness of the necessity to adhere to budgetary discipline, as a means to ensure independence and sustainability of the country's finances.

2.2.3. Sharing information on the issuance of national debt

Government debt is the most visible component of sustainability, with more immediate impact than implicit liabilities such as ageing costs. As part of the increasing awareness of the need to carefully monitor debt developments, the Two Pack introduces the sharing of information on debt issuance plans by Member States. This increased transparency allows an understanding of the short-term dynamics of the Member States' debt, of which the level of deficits only gives a partial image. For this purpose, the new legislation requires that Member States report to the Commission and the Eurogroup on their national debt issuance plans, on an ex ante basis (i.e. one week before the start of each quarter and of each year), and according to an harmonised framework established by the Commission in coordination with the Member States. This is one of the elements of the TSCG that the Two Pack legislates on. Under the TSCG, the contracting parties, while committing to this ex ante reporting, explicitly foresaw that such common reporting would facilitate the coordination of debt issuance.

An understanding of the dynamics of debt renewal is necessary for the smooth functioning of the sovereign debt market. Annual and quarterly reporting on debt issuance plans by the central government for euro area Member States will be broken down between short and medium or long-term maturities, and will be complemented with general information on the overall financing needs of the central budget of each Member State. The quarterly periodicity of the reporting of issuance plans was chosen to strike the right balance between increasing the transparency and predictability of funding plans, while leaving enough flexibility for issuing policies and procedures.

The Two Pack does not place requirements on Member States beyond the reporting of their debt issuance plans.

2.3. ESTABLISHING AN EU FRAMEWORK FOR DEALING WITH THREATS TO FINANCIAL STABILITY IN EURO AREA MEMBER STATES

The second regulation of the Two Pack has been established with a number of precise objectives. First, the regulation makes Member States experiencing severe difficulties with regard to their financial stability or receiving financial assistance on a precautionary basis subject to a new form of enhanced surveillance. A Member State under enhanced surveillance has to take measures to address the sources or potential sources of difficulties. In addition, the Commission can request specific measures to implement the enhanced surveillance regime. The Commission will regularly monitor the progress made in implementing all those measures, in liaison with the ECB (European Central Bank) and the relevant European Supervisory Authorities (ESAs) and, where appropriate, the International Monetary Fund (IMF). If the assessment of progress made concludes that further measures are needed and that the financial situation of the Member State has significant adverse effects on the financial stability of the euro area, the Council has the possibility to recommend to the Member State concerned to adopt precautionary corrective measures or prepare a draft macro-economic adjustment programme.

Second, the new regulation aims to dovetail the financial assistance granted outside the framework

of the Union with the Treaty. During the crisis, new financial stability mechanisms have been established to provide financial assistance to euro area Member States. Mostly, these new mechanisms are based on intergovernmental arrangements (e.g. European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM)). Against that background, the regulation aims to ensure that there is full consistency between the Union multilateral surveillance framework established by the TFEU and the possible policy conditions attached to financial assistance granted outside the Treaty framework. It sets out a clear procedure for preparing and adopting macro-economic adjustment programmes. Because of the wide-encompassing nature of those adjustment programmes, the new legislation foresees the suspension of the monitoring and reporting on the implementation of the Stability and Growth Pact, the application of the Macroeconomic Imbalance Procedure (MIP) and the monitoring under the European Semester. The aim is to ensure consistency and to avoid overlaps between these procedures and the policies and monitoring taking place in the context of the relevant macro-economic adjustment programmes.

Third, the regulation creates a post-programme surveillance structure for countries which have received financial assistance, until a minimum of 75% of the financial assistance received has been repaid. This will help keep the country concerned firmly on a safe track, to the benefit of the Member State itself and of its lenders.

2.3.1. Establishing an EU enhanced surveillance regime

The new regulation allows the Commission to make a Member State subject to enhanced surveillance in certain situations. Enhanced surveillance involves an obligation on the Member State to adopt measures to address the sources of financial instability. When developing those measures, the recommendations already addressed by the Council to that Member State should be taken into account. In addition, the Commission can request specific measures to implement the enhanced surveillance: 1) a stress test on banks to be implemented by the ECB/EBA; (43) 2) an assessment of the domestic financial supervisory capacity to be implemented by the ECB/EBA; 3) any information needed for the monitoring of macro-economic imbalances; 4) a comprehensive independent audit of the public accounts of all sub sectors of the general government; 5) any information available for the monitoring of the fiscal deficit; 6) access to disaggregated data on the developments of the financial sector. (44) In addition, Member States must also meet new reporting requirements foreseen for countries under the EDP irrespective of the existence of the latter. (45) The measures to address the sources of financial instability together with the specific measures to implement enhanced surveillance constitute the set of policy requirements that are linked to the enhanced surveillance regime. These policy requirements are expected to be set out in a "Letter of Intent" by the Member State (see Box II.2.3).

Regular review missions are conducted by the Commission in liaison with the ECB and the relevant European Supervisory Authorities (ESAs) and, where appropriate the IMF, to verify progress with implementation of the policy requirements by the Member State concerned. In addition, the Commission is responsible for quarterly reporting to the Economic and Financial Committee (EFC) of the Council and to the Economic and Financial Committee (ECON) of the European Parliament to communicate the findings of the reviews missions. Enhanced surveillance applies in two different situations:

- Regular enhanced surveillance: the Commission makes a euro area Member State subject to enhanced surveillance when it is facing or experiencing severe difficulties with

(43) These activities will be undertaken by the ECB once the Single Supervisory Mechanism (SSM) enters into force and by the EBA as long as this is not the case.

(44) This is only the case for Enhanced surveillance regime with precautionary financial assistance and not for the regular Enhanced surveillance regime. In the latter case, the disaggregated data can only be provided through the intermediation of the ECB, in its supervisory capacity, and where appropriate through the relevant ESAs.

(45) Irrespective of the existence of an excessive deficit, the Member State subject to enhanced surveillance needs to fulfil some of the new reporting requirements foreseen for countries under EDP as set out in the other Two Pack regulation on closer budgetary monitoring

regard to financial stability. This is a situation where no financial support is provided.

- Enhanced surveillance with precautionary financial assistance: the Commission is obliged to make a euro area Member State subject to enhanced surveillance in case a Member State receives precautionary financial assistance from the ESM/EFSF under instruments such as an Enhanced Conditions Credit Line (ECCL) or a Precautionary Conditioned Credit line (PCCL) when the latter has been drawn. ([46])

The objective of precautionary financial assistance is to support sound policies and prevent crisis situations by allowing euro area Members to secure the possibility to access financial assistance before they face major difficulties with raising funds in the capital markets. Precautionary financial assistance aims at helping euro area Members whose economic conditions are still relatively sound to maintain continuous access to market financing.

There are clear policy conditions attached to the precautionary financial assistance depending on the form that the financial assistance takes. These policy conditions are outlined in the Memorandum of Understanding (MoU, see Box II.2.3) in line with the relevant ESM/EFSF guidelines on precautionary financial assistance. The MoU is negotiated with the Member State concerned by the Commission on behalf of the ESM/EFSF and in liaison with the ECB and, wherever possible, together with the IMF. In addition to the monitoring of the policy requirements mentioned above, the Commission also monitors the implementation of the policy conditions outlined in the MoU (see Box II.2.3).

The Commission will only make a Member State under a PCCL subject to enhanced surveillance when the credit line is actually drawn. A number of eligibility criteria need to be fulfilled for euro area Member States to obtain access to a PCCL. The PCCL is accessible for euro area Member States whose economic and financial situation is still fundamentally sound, while fulfilling a set of eligibility criteria including: 1) respect for the commitments under the Stability and Growth Pact. An ESM Member under EDP may still access a PCCL, provided it fully abides by the Council decisions and recommendations aimed at ensuring a smooth and accelerated correction of its excessive deficit; 2) a sustainable level of government debt; 3) respect for the commitments under the macroeconomic imbalances procedure. An ESM Member under EIP may still access a PCCL, provided it is established that it remains committed to addressing the imbalances identified by the Council; 4) a track record of access to international capital market on reasonable terms; 4) a sustainable external position; 5) absence of any bank solvency problems that would pose systemic threats to the stability of the euro area banking system. The eligibility criteria for accessing a PCCL also need to be respected by the ESM Member after the precautionary assistance is granted. Therefore, they are included as policy conditions in the MoU (see Box II.2.3).

Access to an ECCL is open to euro area Member States that do not comply with some of the eligibility criteria required for accessing the PCCL but whose general economic and financial situation remains sound. Like the PCCL, the ECCL is a credit line based on meeting a set of eligibility criteria. In addition, even if no money is drawn, also a set of corrective measures need to be taken aimed at addressing the identified weaknesses and avoiding any future problems regarding market financing while ensuring a continuous respect of the eligibility criteria which were considered met when the credit line was granted. Both the eligibility criteria and the corrective measures are included in the MoU detailing the set of policy conditions attached to the financial assistance (see Box II.2.3).

The activation of Enhanced Surveillance

As a first step, the Commission needs to provide an assessment as to whether a Member State is experiencing or threatened with serious difficulties with regard to its financial stability that are likely to have adverse spill-over effect on other euro area Member States. If this condition is fulfilled, the Commission may unilaterally decide to make the Member State subject to enhanced surveillance.

([46]) Under the ESM/EFSF financial stability mechanisms, precautionary financial assistance may be provided via a Precautionary Conditioned Credit Line (PCCL) or via an Enhanced Conditions (ECCL).

Box II.2.3: **Comparing EU and intergovernmental arrangements**

The policy requirements linked to enhanced surveillance are applied to the Member States within the EU framework while the policy conditions linked to the precautionary financial assistance are imposed in an intergovernmental context. This distinction is important because of the different implications of the Commission's monitoring role. Within the EU framework, the Commission's assessment of the overall economic situation and of the implementation of the policy requirements can lead to a recommendation to a Member State to adopt precautionary corrective measures or to prepare a draft macroeconomic adjustment programme. Within the intergovernmental framework, however, the Commission assessment of the respect of the policy conditions can lead to the termination of the financial assistance. The figure below provides an illustration for two instruments, i.e. the PCCL and the ECCL.

In case a Member State is receiving financial assistance on a precautionary basis (i.e. PCCL or ECCL), the Commission is required by the legislation to make the Member State subject to enhanced surveillance. However, in case of a PCCL, the Commission will not make the Member State subject to enhanced surveillance as long as the credit line is not drawn.

As outlined above, a Commission assessment is required as a basis for the Commission decision to make euro area Member States subject to enhanced surveillance. A number of parameters need to be investigated in this comprehensive assessment to check whether the Member State concerned is experiencing or threatened with serious economic difficulties with regard to its financial stability that are likely to have negative spill-over effects on other Member States. ([47])

([47]) When conducting this comprehensive assessment, the legislation requires the Commission explicitly to take a number of parameters into account: 1) the parameters of the alert mechanism report; 2) the latest in-depth review, where available; 3) the borrowing conditions of that Member State; 4) the repayment profile of its debt obligations; 5) the robustness of its budgetary framework;

2.3.2. Establishing an EU framework for macroeconomic adjustment programmes

When a Member State is under enhanced surveillance, the Commission will regularly monitor the progress made, in liaison with the ECB. If the assessment concludes 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 has the possibility to recommend to the Member State concerned to take precautionary measures or prepare a macro-economic adjustment programme.

The preparation and adoption of adjustment programmes

The new Two Pack regulation sets out a clear procedure for the preparation and adoption of a macro-economic adjustment programme. The draft programme is prepared by the Member State requesting the financial assistance in agreement with the Commission acting in liaison with the ECB and, where appropriate, with the IMF. The draft programme should be based on an assessment of the sustainability of the government debt prepared by the Commission, in liaison with the ECB, and, where possible, with the IMF. It should address the specific risks emanating from that Member State for the financial stability of the euro area and shall aim at rapidly re-establishing a sound and sustainable economic and financial situation and restoring the Member State's capacity to finance itself fully on the markets.

The draft programme prepared by the Member State requesting financial assistance within the EU framework is approved in the Council by qualified majority voting on a proposal from the Commission. Within the intergovernmental framework, the MoU outlining the policy conditions attached to the financial assistance provided in the context of the macroeconomic adjustment programme, is signed by the Commission on behalf of the EFSF/ESM with the Member State requesting financial assistance. The MoU and the Council decision on the adjustment programme need to be aligned and fully consistent. The aim is to avoid situations where a Member State would be requested to abide by policy conditions in the MoU that would deviate from its commitments under the existing EU multilateral surveillance procedures.

Monitoring adjustment programmes and non-compliance

The Commission will ensure the monitoring of the implementation of the programme in liaison with the ECB and, where appropriate, with the IMF. It will inform the Economic and Financial Committee of the Council every three months. The Member State concerned will fully cooperate with the Commission and the ECB and provide all the information that they deem necessary for the monitoring of the programme.

If the monitoring highlights significant deviations from the macroeconomic adjustment programme, the Council may decide that the Member State concerned does not comply with the policy requirements contained in the programme. This decision would have very significant effects since it would de facto trigger the interruption of the disbursements of the financial assistance of the EFSF/ESM.

A Member State subject to a macroeconomic adjustment programme experiencing insufficient administrative capacity or significant problems in the implementation of its adjustment programme can seek technical assistance from the Commission. The Commission can then establish a group of experts with Member States and other Union and/or relevant international institutions, for this purpose. Such technical assistance may include the establishment of a resident representative and supporting staff to advise authorities on the adjustment programme implementation. An example of this kind of technical assistance is the Greek Task Force that was established in the context of the Greek macroeconomic adjustment programme.

Ensuring consistency with other surveillance processes

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6) the long term sustainability of its public finances; 7) the importance of the debt burden; 8) the risk of contagion from severe tensions in its financial sector on its fiscal situation or on the financial sector from other Member States.

Macro-economic adjustment programmes have a broad scope in terms of policy fields covered. They cover all policies that can be identified as likely to improve the economic and financial situation. It follows that all attention naturally focuses on the monitoring of the adjustment programme in particular because it acts as the passport to the disbursements of the financial assistance. As the macroeconomic adjustment programme normally encompasses all relevant policy advice imposed already in the context of the Stability and Growth Pact (SGP), the Macroeconomic Imbalance Procedure (MIP) and the EU semester, the new legislation avoids duplication and overburdening by suspending the reporting and monitoring on the implementation of the SGP, the application of the MIP, the monitoring under the European Semester and the other regulation of the Two-pack on fiscal issues.

Establishing a regime of post-programme surveillance

The new regulation establishes post-programme surveillance. This surveillance arrangement aims at ensuring that the beneficiary remains on the right fiscal track, thus protecting its capacity to repay its debt. It remains in place until the country has repaid 75% of its debt. This can potentially lead to a relatively long surveillance period.

The Commission will have monitoring powers and report twice a year. Where appropriate, it can propose to the Council to recommend to the Member State concerned to adopt corrective measures. It should be noted that the Commission will implement post-programme surveillance only if the financial support is financed by the EU (under European Financial Stability Mechanism) or its Member States (EFSF, ESM), but not if it comes from the IMF or third countries.

The use of reverse qualified majority voting as decision-making rule has been inserted in the legislation to take the decision to extend the duration of the post-assistance surveillance and also for the decision to adopt corrective measures. The Council, on a proposal from the Commission may extend the duration of the post-programme surveillance in case of persisting risks for the financial stability or fiscal sustainability of the Member State concerned. The proposal of the Commission is then automatically adopted unless a qualified majority of the Council decides to reject it within 10 days of the Commission adopting it. The same decision-making procedure applies when the Commission proposes the adoption of additional corrective measures.

2.4. COMPLETING THE EU BUDGETARY SURVEILLANCE PROCESS

In completing the SGP, the Two Pack is part of a drive for a stronger budgetary surveillance and a deeper integration in EMU. It builds on the requirements made in the Directive on national budgetary frameworks introduced as part of the Six Pack, by moving from a framework where Member States were required to ensure that the complied with certain minimal requirements in terms of their national arrangements for setting budgetary policy, to much stronger provisions. As discussed in the previous sections, the Two Pack is also instrumental in placing commitments made under the TSCG, signed in March 2012, into the EU legal framework.

Half a year after the signature of the TSCG, the Commission presented its Blueprint for Deep and Genuine Economic and Monetary Union on 28 November 2012, setting out both concrete priorities for immediate implementation and the short term, as well longer term strategy aims covering the next five years. ([48]) Over time, it aims to achieve economic, fiscal and banking union, by balancing any transfer of power with political integration to ensure legitimacy and accountability. It sets out the Commission's vision of the instruments and steps required to bring about a genuine EMU over time.

The Blueprint's immediate priorities for the first 6 months after its publication were the full deployment of the new provisions of the Six Pack, the adoption of the Two Pack regulations and the regulation on the Single Supervisory Mechanism for euro area banks. The Two Pack therefore marks the fulfilment of one of the immediate Blueprint policy priorities. On 20 March 2013, the Commission issued two communications: one on

([48]) http://ec.europa.eu/commission_2010-2014/president/news/archives/2012/11/pdf/blueprint_en.pdf

the ex-ante coordination of economic reforms [49] and one on the convergence and competitiveness instrument, [50] setting out the next steps in the setting up of these policies.

While these new policies will contribute to the completion of EMU, they fall outside the scope of budgetary policy. In the budgetary sphere, the Two Pack has completed the SGP insofar as the possibilities of reform that are afforded by the TFEU. The possibilities of change under Articles 121 and 126 TFEU, which underpin the original SGP, have provided most if not all the significant change that they can deliver.

Putting this new structure into full operation will be the first challenge for the coming months and years. While the Six Pack has been in operation since December 2011, some of the changes it introduced are still to enter the surveillance procedure for all countries. For example, 2013 is the first year when the ex post assessments under the preventive arm were based on SCPs submitted after the entry into force of the Six Pack. Similarly, the debt requirement – initially in its transitional form – is only now applying to countries as they exit their pre-existing EDPs. The entry into force of the Two Pack is another significant milestone which will affect the surveillance procedure, with the new monitoring provisions entering into force in the autumn with the submission and assessment of the draft budgetary plans. Ensuring the smooth and effective implementation of the new provisions will be crucial to the success of the surveillance structure in providing the right incentives for stronger public finances as the European economies emerge from the crisis.

Beyond the implementation of the most recent changes, it is clear from the Commission's Blueprint that further reform remains on the agenda. Substantive Treaty change could enable more ambitious changes, including steps towards fiscal union which could mark the agenda for the coming years.

The guiding principle would be that any steps to further mutualisation of risk must go hand-in – hand with greater fiscal discipline and integratioh. The required deeper integration of financial regulation, fiscal and economic policy and corresponding instruments must be accompanied by commensurate political integration, ensuring democratic legitimacy and accountability. On 2 July 2013 an Expert Group was established to deepen the analysis on the possible merits, risks, requirements and obstacles of partial substitution of national issuance of debt through joint issuance in the form of a redemption fund and eurobills. As stated in the Blueprint, both of these possibilities would require amending the Treaties. The groups will present a report to the Commission by March 2014.

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(49) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:DKEY=724506:EN:NOT

(50) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:DKEY=724520:en:NOT

3. MEDIUM TERM OBJECTIVE (MTO)

The preventive arm of the Stability and Growth Pact (SGP) aims to ensure that Member States achieve and maintain budgetary positions that lead to strong public finances over the economic cycle. By doing so, countries will use good times to strengthen their underlying sustainability and achieve the fiscal space necessary to be enable them allow the automatic stabilisers to work and support their economies through more difficult times. The economic crisis has highlighted the need to use favourable economic conditions to avoid that consolidations be necessary in times of recession, and the weakness of the pre-2011 SGP in achieving this. As countries exit their current EDPs, the role played by the preventive arm will therefore be of paramount policy importance.

The cornerstone of the preventive arm is the country-specific medium-term objective (MTO), which corresponds to the structural budgetary position that ensures that Member States have (i) a safety margin against breaching the Treaty reference value for the deficit at times of negative output gaps; (ii) sustainable public finances; and (iii) room for budgetary manoeuvre in bad economic periods. The SGP prescribes that Member States should achieve their MTO and maintain it over the cycle – it therefore acts as an anchor for medium-term policy setting. When a significant deviation from the MTO, or from the convergence path towards it, is observed, the Member State has to remedy and to correct such a deviation.

The same concept of the MTO also plays a central role in the TSCG. While not being part of EU law as such, the inter-governmental TSGC is consistent with EU law and the fiscal compact (Title III of the TSGC) incorporates the core concepts and provisions of the SGP and reinforces it for the countries that are bound by it. The TSCG sets a more stringent lower bounds for the country specific MTOs, whose attainment must be incorporated in national legal systems and reinforced through automatic corrective mechanisms. The TSCG required the Commission to set the adjustment paths towards the MTOs. The Commission provided deadlines to meet the MTO in its proposed Country Specific Recommendations (see Annex of Part I)

This Chapter aims at providing an overall view of the concepts used in setting the MTO along with their practical applications and the related procedural aspects. The Chapter first defines the concept of MTO and explains the logic and the steps behind its computation (II.2.1). It then turns to the procedural aspect, by explaining how the MTO is used in the preventive arm of the Stability and Growth Pact. Section II.2.2 describes how, once the country specific MTOs are set, the Commission conducts its assessment of the Member States' convergence towards their MTOs, based on both the structural balance and the expenditure benchmark. Finally, the Chapter illustrates the interrelations between the EU surveillance framework and institutions.

3.1. THE DEFINITION AND COMPUTATION OF THE MEDIUM-TERM OBJECTIVE

The MTOs are defined in structural terms, meaning that they represent a cyclically-adjusted general government budget position, net of one-off and other temporary measures (see Box II.3.1 on the calculation of the structural balance). Removing one-off and temporary measures from the cyclically adjusted balance is important in order to better assess the underlying budgetary positions, as the improvement in the fiscal balances stemming from one-off or temporary measure does not necessarily imply an improvement in the inter-temporal budgetary position of a country.

According to Regulation 1466/97 ([51]) the MTOs should be set so as to:

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

(ii) Ensure sustainability or rapid progress towards sustainability. This is assessed against the

([51]) OJ L 209, 2.8.1997, page 1, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1466:20111213:EN:PDF

Box II.3.1: Cyclically adjusted budget balance used in the EU fiscal framework

The structural balance used in EU fiscal surveillance is computed by subtracting one-off and other temporary measures from the cyclically adjusted budget balance (CAB). The CAB corresponds to the deficit/surplus ratio that would prevail if the economy was running at potential (see Mourre et al., 2013). It is computed as the difference between the actual balance (as a percentage of GDP) and an estimated cyclical component.

$$CAB_t = \frac{(R_t - G_t)}{Y_t} - \varepsilon \cdot OG_t$$

where R and G stand for the government revenue and expenditure (nominal) respectively and Y for nominal GDP. The cyclical component of the budget is the product of the output gap (OG) and the semi-elasticity (ε) of the balance-to-GDP ratio with respect to the output gap. The semi-elasticity ε corresponds to the *cyclical adjustment parameter of the budget balance* and is assumed to be constant. It is computed as the difference between the semi-elasticity of revenue and the semi-elasticity of expenditure, which can themselves be easily derived from the (constant) revenue and expenditure elasticity with respect to the output gap. It could be expressed mathematically as:

$$\varepsilon = \frac{d(\frac{B}{Y})}{\frac{dY}{Y}} = \frac{d(\frac{R}{Y})}{\frac{dY}{Y}} - \frac{d\left(\frac{G}{Y}\right)}{\frac{dY}{Y}} = \left(\frac{\frac{dR}{R}}{\frac{dY}{Y}} - 1\right)\frac{R}{Y} - \left(\frac{\frac{dG}{G}}{\frac{dY}{Y}} - 1\right)\frac{G}{Y} = (\eta_R - 1)\frac{R}{Y} - (\eta_G - 1)\frac{G}{Y}$$

where η_R and η_G denote respectively the revenue and expenditure elasticity with respect to the output gap. The CAB methodology assumes that revenues are fully cyclical, while on the expenditure side only unemployment related benefits are cyclically driven.

On the revenue side, the elasticities of individual revenue items to the output gap are estimated by the OECD (personal income taxes, corporate income taxes, indirect taxes, social security contributions, non-tax revenue). They correspond to the percentage change in a particular type of revenue associated with a percentage change in output. They are then aggregated using the share of each in total revenue as weights, so as to derive the elasticity of total revenue level (in monetary amount) with respect to output. Subtracting one from the value of the revenue elasticity gives the value of the elasticity of the revenue-to-GDP ratio with respect to output. Multiplying the latter with the size of total revenue as a share of GDP yields the value of the semi-elasticity of revenue.

On the expenditure side, the OECD elasticity of unemployment-related expenditure is used and weighted with the share of unemployment-related expenditure in total expenditure (based on Eurostat data). Subtracting one from the value of the revenue elasticity gives the value of the elasticity of the expenditure-to-GDP ratio with respect to output. Multiplying the latter with the size of total public spending as a share of GDP yields the value of the semi-elasticity of expenditure. The weights (tax and spending structure, revenue/expenditure-to-GDP ratio) are computed by the European Commission as an average over the period 2002-11 and are to be updated every 6 years to reflect changes in the government receipts and spending.

The overall budgetary semi-elasticity ε, can be rewritten as:

$$\varepsilon = \varepsilon_R - \varepsilon_G = (\eta_R - 1)\frac{R}{Y} - (\eta_G - 1)\frac{G}{Y} = (\sum_{i=1}^{5}\eta_{Ri}\frac{Ri}{R} - 1)\frac{R}{Y} - (\eta_{G_U}\frac{G_U}{G} - 1)\frac{G}{Y}$$

Therefore, the necessary components to perform the calculation are the individual elasticities of five revenue categories and of unemployment expenditure with respect to the output gap (η_{Ri} and η_{G_U}) and the fixed weighting parameters (the weights of the individual revenue categories in total revenue R_i/R, the weights of the unemployment-related expenditure to total expenditure G_U/G, the total revenue of general government as a percentage of GDP R/Y as well as the total expenditure of general government as a percentage of GDP G/Y). The individual elasticities are still based on OECD estimates, for most EU countries covering the period 1985-2005. They are currently being updated to reflect changes in the revenue structure.

The budgetary semi-elasticity is averaging out to 0.53 for the EU and ranges from 0.30 to 0.61 across Member States, suggesting significant differences in the cyclicality of the budget balance. The semi-elasticity for revenue is close to zero, ranging from -0.13 to 0.04, since revenue is almost as cyclical as GDP, except for non-tax revenue. Therefore, the revenue-to-GDP ratio moves only slowly with the business cycle, especially in Member States where non-tax revenue is relatively low. In contrast, the semi-elasticity for expenditure is ranging from -0.38 to -0.67, which accounts for the larger part of the disparity in the

(Continued on the next page)

Box (continued)

budgetary semi-elasticity across Member States. Its value broadly corresponds to the share of total expenditure in GDP. This mirrors the fact that the elasticity of the expenditure-to-GDP ratio to the output gap is close to minus one. Indeed, the cyclical effect of the denominator (GDP) largely dominates the low cyclicality of expenditure in level, given the small share of unemployment-related expenditure in total expenditure

need to ensure the convergence of debt ratios towards prudent levels, with due consideration to the economic and budgetary impact of ageing populations.

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

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

The MTOs presented by the Member States in their SCPs need to comply with the requirements (*i*, *ii* and *iii*) set out above. Nevertheless, the Member States are free to set more ambitious MTOs to be pursued, when presenting their Stability and Convergence Programmes, if they feel circumstances call for it.

The methodology used to compute country specific lower bounds ensures that the requirements of the Pact are complied with in such a way to take into account both the impact of the cycle on the specific country (and the dynamics of the automatic stabilisers), and the future risks to the country's sustainability (based on debt levels and challenges posed by ageing), on top of the compliance with the -1% lower bound for euro area and ERM2 Member States.

(i) The safety margin with respect to the 3% of GDP deficit limit: the minimum benchmark. The impact of the cycle on a Member States budget depends on how large are the cyclical fluctuations typically faced by the country and on how much the budget reacts to the cycle. Thus for each Member State, the minimum value of the MTO that ensures this safety margin ("minimum benchmark") is assessed by taking into account past output volatility and budgetary sensitivity to output fluctuations. A country with greater past output volatility and a larger budgetary sensitivity will need a more demanding MTO in order to ensure that the 3% limit is not breached during a normal economic cycle. Hence automatic stabilisers can operate without risking breaching the 3% limit.

In other words, the minimum benchmark (MTO^{MB}) adjusts the 3% of GDP deficit threshold for the effect of cyclical fluctuation, based on country-specific features.

Thus, the first step is to compute what constitutes a normal cyclical fluctuation of GDP for each Member State. This is called the representative output gap (*ROG*). The calculation of the minimum benchmark is based on the computed ROG multiplied by the semi-elasticity (ε) of the budget to the output gap:

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

The ROG reflects the fact that individual countries typically experience different magnitudes of economic cycles, which impact on the cyclical fluctuation of their public finances. The representative output gap is calculated in the following way, containing a country-specific and a horizontal component:

$$ROG = \frac{N_i}{(N_t + N_i)} P_{5\%}(country) + \frac{N_t}{(N_t + N_i)} P_{5\%}(EU27)$$

where $P_{5\%}$ (country) represents the 5% percentile of the distribution of the country-specific output gap series and $P_{5\%}$ (EU 27) the 5% percentile of output gap data for all countries. N_i and N_t stand for

Table II.3.1: **2012 update of the Minimum Benchmarks and semi-elasticities**

	Updated Minimum Benchmark	Semi-elasticities
BE	-1.5	0.55
BG	-1.8	0.32
CZ	-1.6	0.39
DK	-0.8	0.61
DE	-1.5	0.57
EE	-1.8	0.30
IE	-0.9	0.51
EL	-1.8	0.47
ES	-1.4	0.48
FR	-1.5	0.55
IT	-1.5	0.55
CY	-1.7	0.43
LV	-1.8	0.31
LT	-1.8	0.31
LU	-1.6	0.47
HU	-1.4	0.47
MT	-1.8	0.40
NL	-1.4	0.57
AT	-1.8	0.49
PL	-1.8	0.41
PT	-1.8	0.46
RO	-1.7	0.33
SI	-1.7	0.46
SK	-1.9	0.33
FI	-0.7	0.53
SE	-1.0	0.59
UK	-1.4	0.48

Source: Commission services

the number of country-specific and common annual observations available, respectively, over a period of 25 years. N_t is set at 25. The relative weights of the common and country-specific component are different across countries, due to limited availability of data before 1995 for the recently acceded Member States, which makes necessary the use of EU27 data to have long enough series (i.e. 25 years long). However, the weights will automatically converge to the same value when the length of the time series increases over time reaching and exceeding 25 years.

The percentiles are computed after outlier values are deleted. Outliers are defined as observations of the distribution for the entire sample – including all Member States – below, and above, respectively, the 2.5% and the 97.5% percentiles. Exceptionally, the country-specific series have also been trimmed of their most negative values between 2009 and 2010, as the last financial and economic crisis cannot be considered as a normal cyclical fluctuation. Thus including the high values of the output gap recorded in these years in the calculation of the ROG would bias the result, which would not reflect normal cyclical conditions only. The 2012 updated values of the minimum benchmark are set out in Table II.3.1.

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

$$MTO^{ILD} = \underbrace{Balance_{debt-stabilizing\,(60\%\,of\,GDP)}}_{(1)} + \underbrace{\alpha * AgeingCosts}_{(2)} + \underbrace{Effort_{debt-reduction}}_{(3)}$$

Component (1) represents the budgetary balance that would stabilise the debt ratio at 60% of GDP. It corresponds to the product of 60% with the forecast average nominal growth over the next 50 years as calculated by the Ageing Working Group. ([52])

Component (2) represents the budgetary adjustment that would cover a fraction of the present value of the projected increase in age-related expenditure, where α =33%.

Component (3) represents a supplementary debt-reduction effort, specific to countries with general government gross debt above 60% of GDP. It follows a continuous linear function, which ensures a supplementary effort of 0.2% of GDP when debt exceeds 60%, while requiring a supplementary effort of 1.4% of GDP when the debt ratio attains 110%.

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

Once the three bounds on the MTO are computed (so as to comply with the requirements *i*, *ii* and *iii*), they are then combined to yield a country-specific lower bound for the MTO, which corresponds to the lowest MTO that fulfils all the criteria defined above:

([52]) http://ec.europa.eu/economy_finance/publications/european_economy/2012/pdf/ee-2012-2_en.pdf

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

The resulting value of the MTO (up to one decimal pace) is then rounded to the most favourable ¼ of a percentage point. Exception clauses can be granted so that the MTO does not lead to a primary balance significantly above 5.5% of GDP for a sustained period of time. Regulation 1466/97 requires that the MTOs be revised every three years, thereby taking into account the latest economic and budgetary costs of ageing, as published in the Commission's triennial Ageing Report. In addition, countries undertaking structural reforms with a major impact on the sustainability of the public finances can also have their minimum MTOs revised on a case-by-case basis, in agreement with the Commission. In particular, the introduction of major pension reforms having an impact on long term fiscal sustainability could result in a minimum MTO revision. ([53])

3.2. THE ASSESSMENT OF THE CONVERGENCE PATH TOWARDS MTO

The preventive arm of the SGP provides guidance to Member States to reach and remain at their MTOs. As described in the legislation and in the Code of Conduct, the Commission conducts an assessment of Member States' budgetary plans over a three-year horizon, on the basis of the Stability and Convergence Programmes submitted to the Commission each year in April, against the requirements of the preventive arm of the SGP.

Member States that have not yet reached their MTO should pursue an appropriate annual improvement of their cyclically-adjusted budget balance, net of one-off and other temporary measures, in order to meet their MTO, with 0.5 % of GDP as a benchmark. For Member States faced with a debt level exceeding 60 % of GDP or with pronounced risks of overall debt sustainability, the Council and the Commission examines whether the annual improvement of the cyclically-adjusted budget balance, net of one-off and other temporary measures is higher than 0.5 % of GDP. Likewise, the Council and the Commission take into account whether a higher adjustment effort is made in good economic times, whereas the effort might be more limited in bad economic times. Both an ex ante (for the current year and the following year) and an ex post (previous year) assessment are conducted.

The aim of the ex ante and of the ex post assessments is different. The aim of the ex ante assessment is to alert Member States of possible deviations from the requirements and so to provide guidance for further adjustments to be implemented either for the current year through additional budgetary measures or in the following year's budget.

The aim of the ex post assessment is to determine cases of "significant deviations" for the previous year. If the Commission finds evidence of significant deviation from the MTO or the adjustment path towards it, the Commission will, in order to prevent the occurrence of an excessive deficit, address a warning to the Member State concerned. The latter is followed by a Council recommendation within one month on how to return to the adjustment path towards the MTO. In case a Member State does not act upon the recommendation, the latter recommendation can be followed by a Council decision on lack of effective action and, possibly, a revised recommendation on policy measures. ([54]) In the case of persistent non-compliance by a euro area Member State, the Council on the recommendation of the Commission will impose a sanction equal to an interest-bearing deposit of 0.2% of GDP. ([55])

Since the adoption of the Six Pack reforms in 2011, compliance with the requirement to be at the MTO or to converge towards it is assessed by the Commission based on an overall assessment of compliance with two complementary indicators: the change in the structural balance and the expenditure benchmark. The expenditure benchmark aims to prevent expenditure overruns by avoiding that public expenditure, adjusted by factors outside the direct control of the government in the short term, grows at rate above the potential

([53]) In the particular case of systemic pension reforms, Member States would have two alternatives: their minimum MTO could either be relaxed (provided the minimum value is respected), or kept unchanged. The latter would imply that a larger share of the ageing cost would be pre-funded through the reform. The choice between these alternatives would remain with Member States and therefore guarantee their ownership of the MTO revision process.

([54]) See Regulation 1175/2011, articles 6 and 9.

([55]) See Regulation 1173/2011, article 4.

growth rate of the economy in the medium run, unless such expenditure deviations are matched by discretionary revenue measures of the same amount. As those two indicators are built on different variables, they could provide different, although complementary, indications on governments' budgetary positions. ([56]) The conclusion of this assessment is further framed by the Code of Conduct, which specifies that, for a Member State that has not reached its MTO, the deviation will be considered significant if both indicators are in deviation and reach the threshold for significance or the deviation for one of the indicators reaches the threshold for significance and the overall assessment also shows limited compliance with respect to the other condition.

In this way, when both indicators give the same message (i.e. they both show compliance with the required adjustment or both indicate a significant deviation from it), their concurring message provides the straightforward conclusion of the assessment.

The overall assessment can then conclude on: compliance, 'risk of a significant deviation' or occurrence of a significant deviation. To conclude on the occurrence of a significant deviation, the Code of Conduct requires that at least one indicator points to a significant deviation from the required adjustment. These different cases are summarised in Table II.3.2.

Table II.3.2: **The scenarios of the overall assessment under the preventive arm of the SGP**

	Change in the structural balance		
Deviation from the expenditure benchmark	**Adjustment delivered**	**Deviation**	**Breach of the threshold of significance**
Benchmark respected	Compliance	Need an overall assessment (cannot lead to S.D.)	Need an overall assessment (can lead to S.D.)
Deviation	Need an overall assessment (cannot lead to S.D.)	Need an overall assessment (cannot lead to S.D.)	Need an overall assessment (can lead to S.D.)
Breach of the threshold of significance	Need an overall assessment (can lead to S.D.)	Need an overall assessment (can lead to S.D.)	Significant deviation (S.D.)

Source: Commission services

For a deviation to be considered "significant", thresholds have been set for the size of the deviation from the required adjustment. Those thresholds apply equally to deviations from the adjustment path set in structural terms and from the expenditure benchmark in terms of GDP:

– over one year, the deviation is above 0.5pp of GDP from the required adjustment.

– over two years (on average), the deviation is above 0.25pp of GDP from the required adjustment.

As those thresholds are applicable over two different time periods, the assessment should be conducted both (i) over the year under consideration and (ii) taking into account the preceding year to check the average deviation over two years. This compliance should be ensured over both time periods.

3.3. THE CALENDAR OF CONVERGENCE TOWARDS THE MTO

Title III of the TSCG, the fiscal compact, commits contracting parties to enshrining key elements of the SGP into national law. The requirements of the fiscal compact are part of a broader process initiated with the 2011 reform of the SGP (the Six Pack) to increase national ownership of the Union's fiscal surveillance framework. Accordingly, the fiscal compact requires signatory Member States to introduce a balanced budget rule with the country-specific medium-term objective (MTO) as the anchor into national law. Contracting parties are hence required to run balanced or in-surplus budgets with a lower limit of a structural deficit of 0.5% GDP, and to respect and ensure convergence towards the country-specific MTO. The balanced budget rules are to be implemented in national law through provisions of "*binding force and permanent character, preferably constitutional*".

([56]) The main differences between the changes in the structural balance and the deviations from the expenditure benchmark are related to the following elements: a) the cyclical adjustment methodology in the structural balance, which in particular leads to revenue windfalls/shortfalls on the revenue side; b) the presence of one-offs and other temporary measures; c) the volatility of potential growth rates; d) the different cyclical adjustment of unemployment expenditure; e) the smoothing of public investment and; f) interest payments and expenditure programmes matched with EU funds that are removed to calculate the expenditure benchmark. A deep analysis of the factors explaining the differences between the change in the structural balance and an expenditure benchmark-based indicator is made in Annex I.

The contracting parties which are not yet at their MTO are supposed to converge rapidly towards the MTO, according to a time-frame for such convergence proposed by the Commission. ([57]) The main innovation of the fiscal compact with respect to the SGP is that it requires the contracting parties to introduce a correction mechanism to be triggered automatically in the event of significant observed deviations from the MTO or the adjustment path towards it in their national law. The Commission issued a Communication on common principles on national fiscal correction mechanisms as requested by the TSCG in June 2012. ([58]) Within the Community framework, a significant deviation from the MTO or the adjustment path towards it will also trigger actions by the Commission and the Council. ([59])

As stated by Art. 3(1b) of the TSCG, "[…] *The Contracting Parties shall ensure rapid convergence towards their respective MTO. The time-frame for such convergence will be proposed by the European Commission taking into consideration country-specific sustainability risks*.[…]". The country-specific time-frame for convergence towards the MTO proposed by the Commission has been designed to respect the SGP rules and, in order to favour national ownership of the adjustment path towards the MTO, is based on the medium-term budgetary plans presented by the contracting parties in the 2013 update of their SCPs. The principles against which the Commission has assessed the calendars of convergence are the following:

- The contracting parties in EDP should follow a structural adjustment path which will guarantee compliance with the fiscal effort as recommended by the Council in the EDP recommendations, until the excessive deficit is corrected.

- For the contracting parties that have corrected their excessive deficit, but have not yet reached their MTO, the required fiscal effort is, centred on an annual effort of 0.5% of potential GDP ([60]) with some differentiation according to the cyclical position as well as the level of public debt and sustainability risk, in line with the SGP. Specifically, this benchmark fiscal effort is modulated according to the following criteria:

(1) Country-specific sustainability risks: the Commission examines whether the annual improvement of the structural effort is higher than 0.5% of GDP for the contracting parties faced with a debt level exceeding 60% of GDP or with pronounced medium-term risks of overall debt sustainability ([61]), as assessed by the Commission in its fiscal sustainability report. ([62])

(2) Economic situation: the assessment takes into account "whether a higher adjustment effort is made in economic good times, whereas the effort might be more limited in economic bad times."

(3) The non euro area contracting parties that are not participating in ERM-II with a debt-to-GDP ratio below 60% and with low risk of debt sustainability are not bound by the benchmark fiscal effort mentioned in (2).

(4) Following the abrogation of on-going EDPs, the contracting parties are expected to undertake a structural adjustment ensuring the respect of the debt reduction benchmark, according to the specific transition provisions in the SGP, irrespective of their position vis-à-vis their MTO.

Based on these principles and on plans submitted by the contracting parties, the country-specific deadline for convergence towards the MTO is recommended by the Council in the Country Specific Recommendation issued at the end of the 2013 European Semester (see Annex 1 in Part I).

The Commission will pursue its monitoring based on SGP rules and will therefore act as a fail-safe mechanism guaranteeing that the benchmark pace of adjustment - 0.5% of GDP annually - would be effectively delivered, ensuring continuous fiscal consolidation towards the MTO.

([57]) Title III, article 3, paragraph 1(b).
([58]) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0342:FIN:EN:PDF
([59]) See Regulation 1466/97, article 6(2) and 10(2).
([60]) Regulation 1466/97, articles 5 and 9.
([61]) The indicator retained for assessing overall debt sustainability is a medium-term 'debt compliance risk' indicator which shows the budgetary adjustment effort required, in terms of a steady improvement in the structural primary balance to be introduced until 2020, and then sustained for a decade, to bring debt ratios [61] Title III, article 3, paragraph 1(b).
([62])http://ec.europa.eu/economy_finance/publications/european_economy/2012/pdf/ee-2012-8_en.pdf