The preventive arm of the Stability and Growth Pact in the reformed EU governance

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European Commission

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The reform of economic governance

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European Semester – 1st edition in 2011 – EU28

Economic policy coordination

Six-Pack – in force since December 2011 – EU28

Major reforms for economic governance in the EU

Amends Stability and Growth Pact, introduces Macroeconomic Imbalances Procedure, Directive on National Budgetary Framework

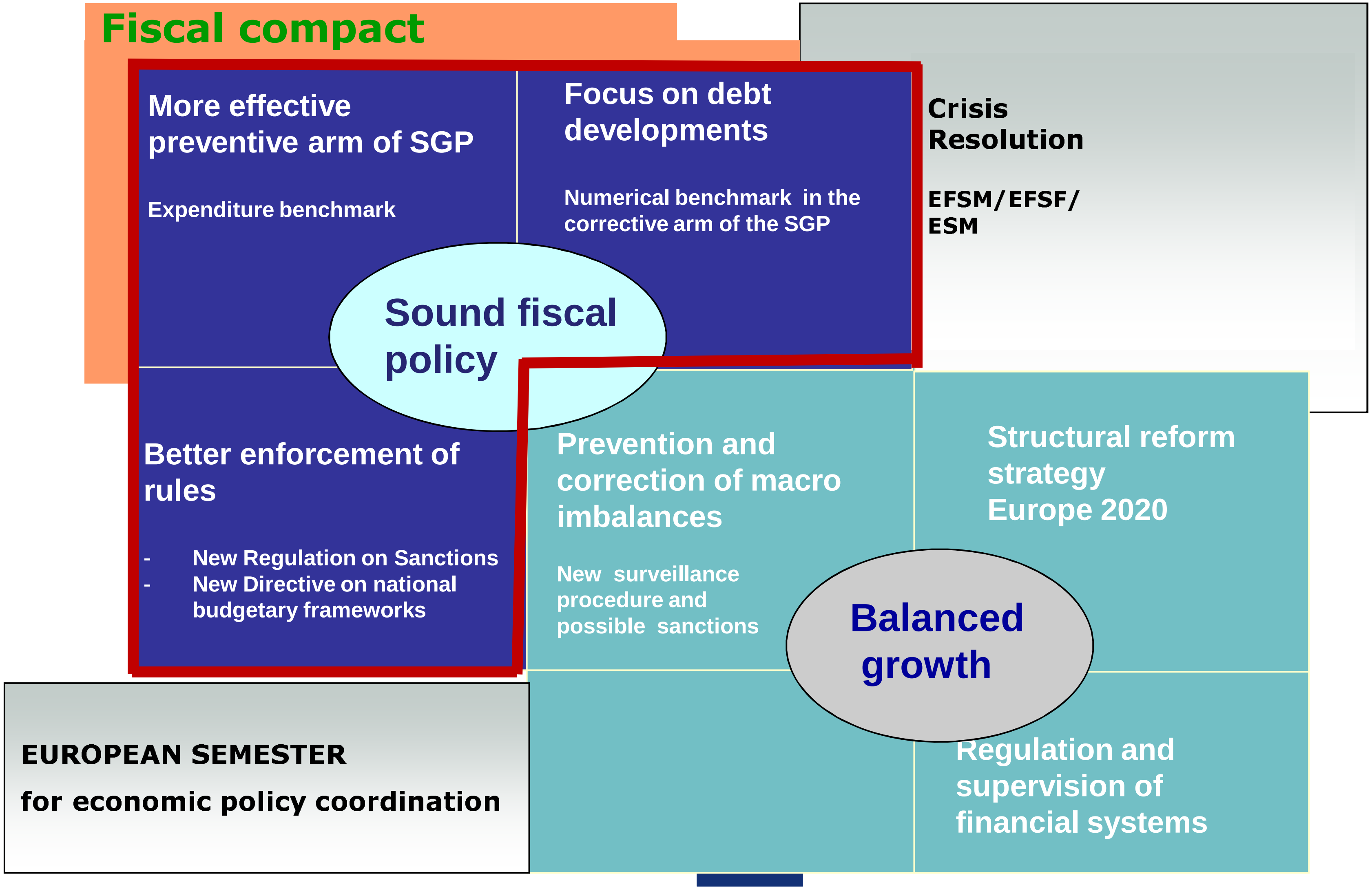
Treaty on Stability Coordination and Governance (TCSG) – Not EU: in force since January 2013 – EA + 8

"Fiscal Compact" to mirror EU rules at the national level

Two-Pack – in force since May 2013 – EA

More stringent framework for budgetary coordination and surveillance among euro area Member States

Strengthening economic governance



OUTLINE

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1. Why does the preventive arm exist? What is its goal?
2. What is the Medium Term Objective?
3. What is the Expenditure Benchmark?
4. What specifically does the preventive arm require Member States to do?
5. When and how is compliance assessed?
6. What happens when a MS breaches the preventive arm of the SGP?

OUTLINE

1. **Why does the preventive arm exist? What is its goal?**
2. What is the MTO?
3. What is the EB?
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The Stability and Growth Pact

- Framework within which Member States make their budgetary decisions – set up in 1997
  - Provide a stable environment for monetary policy to operate
  - Ensure the sustainability of the public finances and overcome disincentives to prudent fiscal policy

- Two arms, set up to be consistent*:*
  - **The preventive arm** aims to ensure strong underlying public finances
  - **The corrective arm -** aka Excessive Deficit Procedure (EDP) - corrects gross policy errors

1. What is the goal of the Preventive Arm?

To ensure that MS run a prudent fiscal policy

What is a prudent fiscal policy?

- Structurally sound
- Builds a buffer against bad times
- Builds a buffer against too high debt
- Builds a buffer against future liabilities
- Controls expenditure dynamics

1. What is the goal of the Preventive Arm?

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- All these five features are captured by two indicators in the preventive arm

- The medium-term budgetary objective (MTO)
  - **Country-specific numerical value for the structural balance:**
    - ❑ Structural indicator

    And by construction it has built-in buffers against:
    - ❑ Debt
    - ❑ Bad times
    - ❑ Future liabilities

- The Expenditure Benchmark (EB)
  - **Expenditure rule that avoids explosive and unsustainable expenditure trends**
    - ❑ Expenditure dynamics

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The Medium-term budgetary objective

Country-specific numerical value of SB

Requirements (Regulation 1466/97)

- (i) Safety margin with respect to the 3% → BAD TIMES
- (ii) Sustainability of public finances → DEBT and FUTURE
- (iii) Allow room for stabilization over the cycle → STRUCTURAL

Limits

- Euro area and ERMII: -1.0%
- TSCG: -0.5% (unless debt ↓↓ 60% and ↓sustainability risks)

Process

- MS chose their MTO in the Stability or Convergence Programmes

Minimum MTO

- While MS choose their MTO, Commission checks that it complies with the above requirements

- Minimum MTOs are computed for each MS:

$$MTO_{\,min} = \max(MTO^{MB}, MTO^{ILD}, -1^{€/ERM})$$

Limit for EA and ERMII

Minimum benchmark MTO:

BAD TIMES

Implicit Liabilities and Debt MTO:

DEBT and FUTURE

Regular updates

- Every 3 years or after reforms with major impact on sustainability

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The Expenditure Benchmark

Rule that limits annual *net* expenditure growth

Requirements (Regulation 1466/97)

- (i) For Member States **at MTO**, net expenditure growth should not exceed the medium-term potential GDP growth.
- (ii) For Member States **not at MTO**, net expenditure should grow at a lower rate.

Objective

- Ensure that increases in expenditure are properly financed
- The EB does not constrain the size of the government

Process

- Net expenditure growth is assessed every year once for all MS and twice for EA MS

Clarifying the role of expenditure

The Structural Balance:

- remains constant if expenditure grows in line with potential GDP
- Improves if expenditure grows below potential GDP
- Deteriorates if expenditure grows faster than potential GDP

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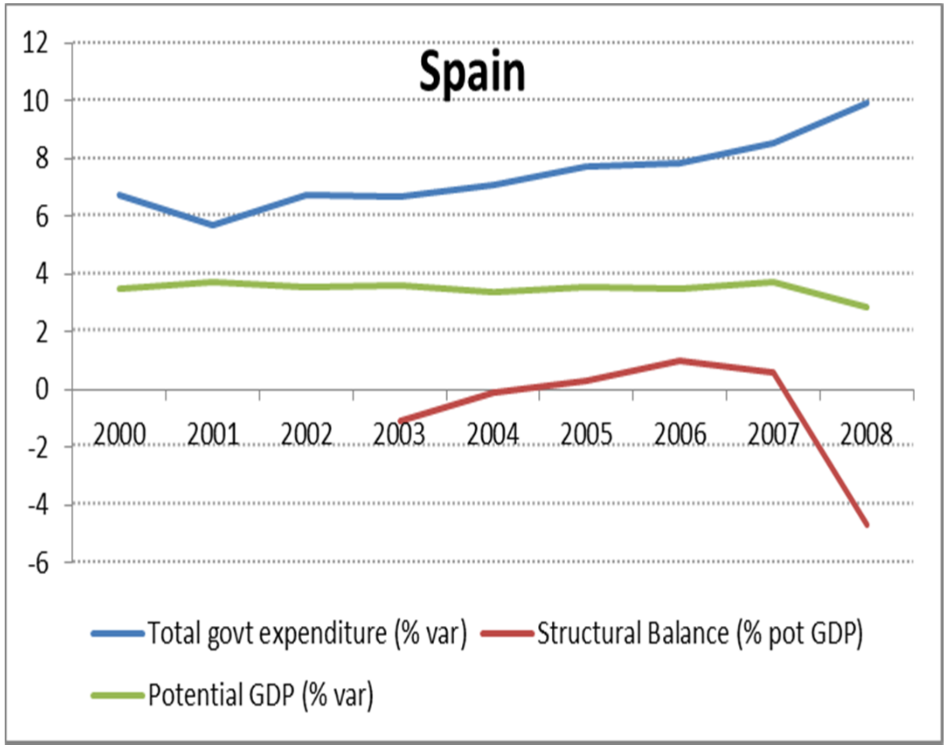
Before the Six Pack

- Expenditure dynamics were not looked into:



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Before the Six Pack

- Expenditure dynamics were not looked into.

- This is wrong from a fiscal surveillance point of view, because of:
  - **A theoretical argument:** only expenditure trends can be exogenously controlled over the medium term
  - **A methodological argument:** the SB is frequently distorted because of its endogenous relation with GDP

The EB enriches the fiscal surveillance toolbox

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The components of the EB

- The net expenditure aggregate whose growth rate is limited
  - **Non-discretionary expenditure items are removed**
  - **Expenditure matched by EU funds are removed**
  - **GFKF is smoothed over four years**
  - **Discretionary revenue measures and revenues mandated by law are netted out**
- The benchmark growth rate against which the former is compared
  - **For Member States at MTO, net expenditure growth should not exceed the medium-term potential GDP growth**
  - **For Member States not at MTO, net expenditure should grow at a lower rate**

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4. Specific requirements

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- If not at MTO at the start of the year:
  - Adjust towards the MTO, while respecting the expenditure benchmark.
  - Required adjustment: 0.5% of GDP as benchmark, less in bad times, more in good times + if sustainability concerns

    - **Structural reform clause**
    - **Unusual event outside control of government**
    - **Severe overall economic downturn**

- If at MTO at the start of the year:
  - Remain at MTO, while respecting the expenditure benchmark, and do not jeopardize it.

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5. Assessing compliance: WHEN?

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- Every Spring, on the basis of budgetary plans presented in SCPs:
  - Ex post assessment of previous year (t-1)
  - In-year assessment (t)
  - Ex ante assessments (t+1 and beyond)

⇒ ***Can trigger a Significant Deviation Procedure***

- Autumn for EA MS, on the basis of DBPs:
  - In-year and ex-ante

- A double time-dimension:
  - One-year budgetary execution
  - Two-year averages

5. Assessing compliance: WHEN?

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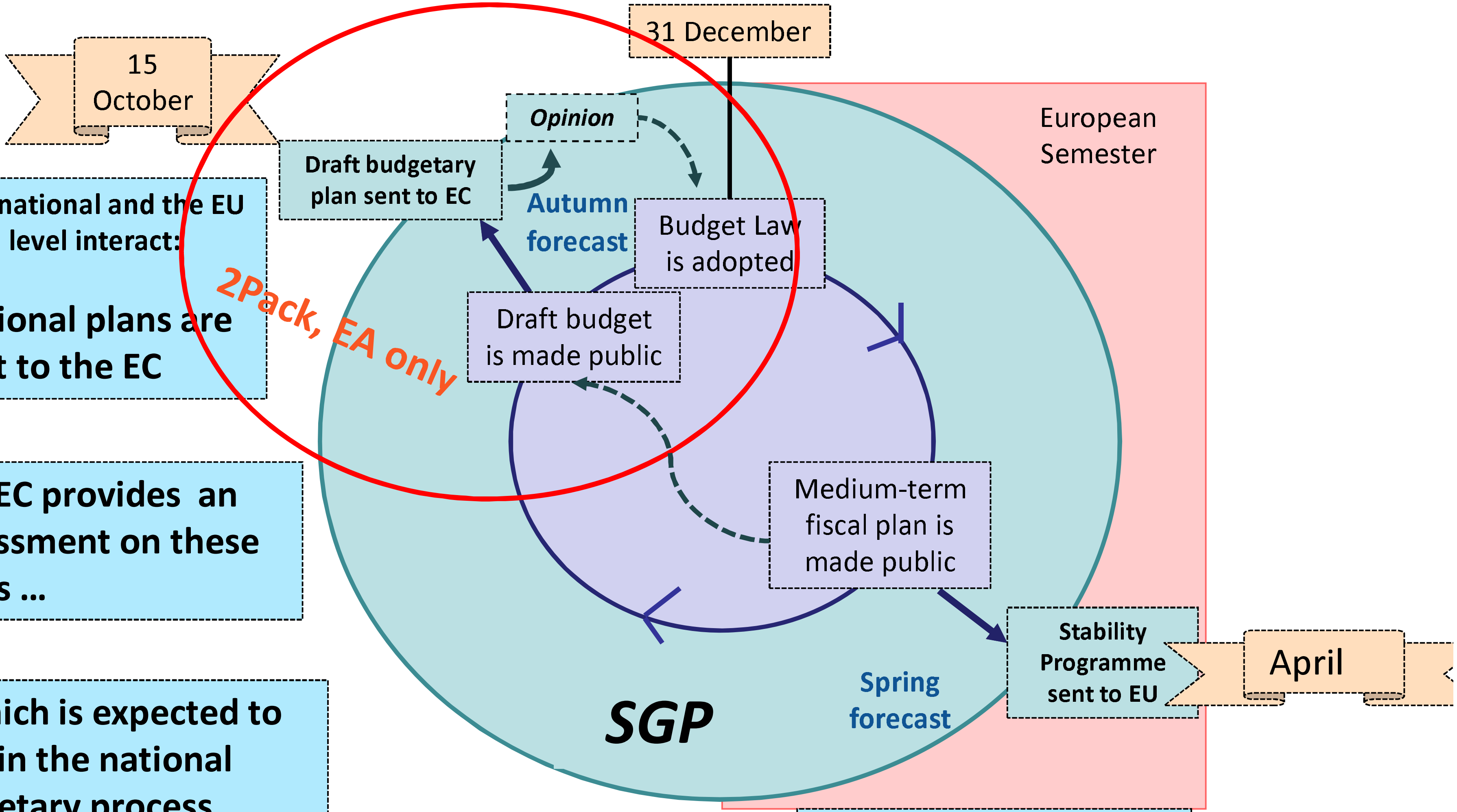
Full cycle of fiscal surveillance



The national and the EU level interact:

National plans are sent to the EC

The EC provides an assessment on these plans …

… which is expected to feed in the national budgetary process

The EU issues CSRs

5. Assessing compliance: HOW?

- Both pillars taken into account: SB and the EB
  - MS that overachieved MTO: only structural balance

- Compare observed developments with the required ones

- Significant deviation thresholds:

Significant deviation criteria (Articles 6(3) and 10(3) of Regulation 1466/97)

Indicator \ Year	Year *t*	(Year *t* + Year *t-1*)/2
Deviation SB	0.5%	0.25%
Deviation EB	0.5%	0.25%

How have the DBPs been assessed?

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- MS in the preventive arm of the SGP: the COM opinion assesses whether the expected outcomes of the plan comply with the required progress towards the Medium-Term Objective
   - *structural balance / adjustment, expenditure benchmark, significant deviation*
- + compliance with debt rule (if relevant)

- MS in EDP: the COM opinion assesses whether the expected outcomes of the plan comply with EDP recommendations
   - *headline balance, structural balance, structural balance adjusted for revisions in potential growth and revenue windfalls / shortfalls, bottom-up assessment*

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6. The Significant Deviation Procedure

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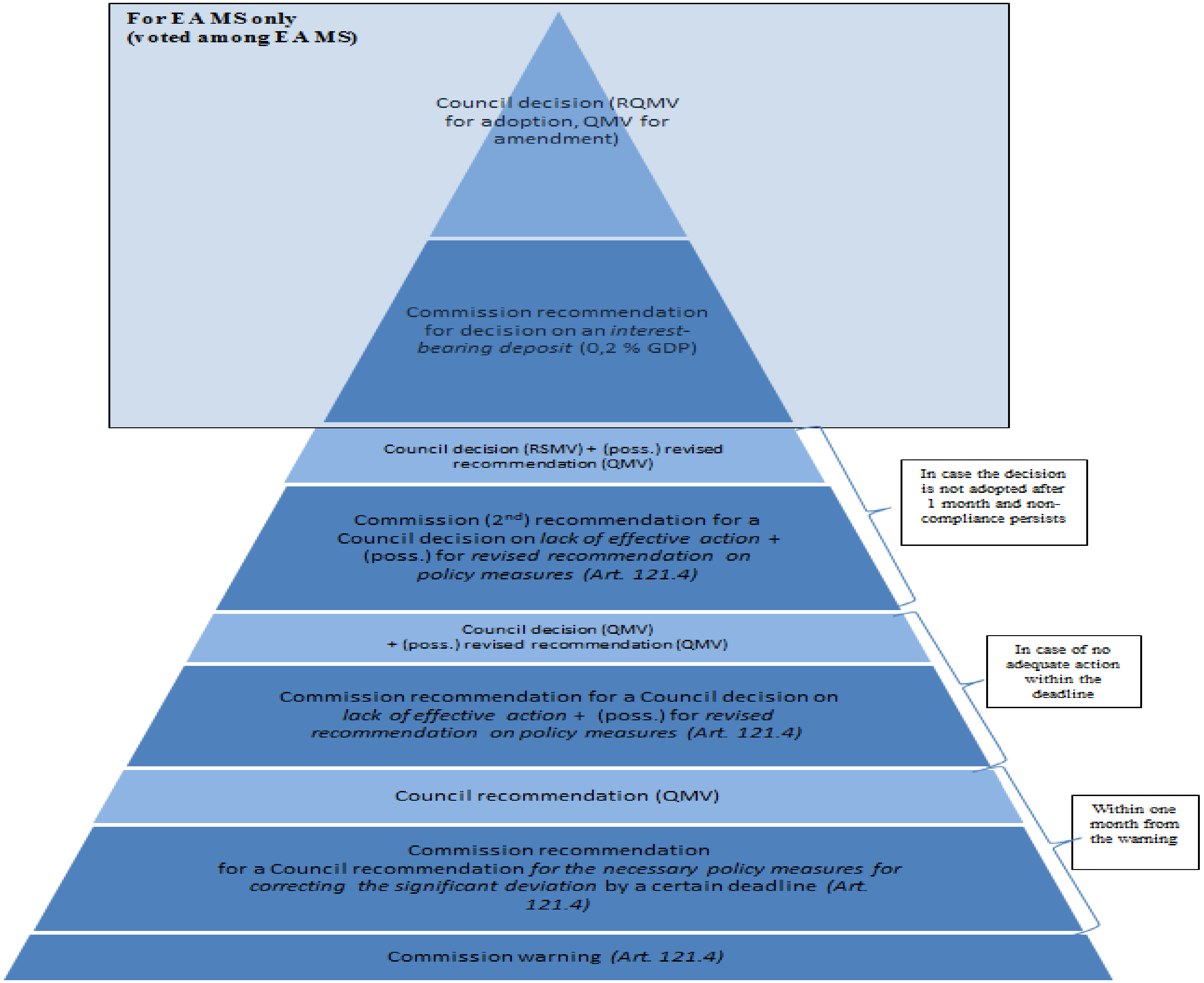
If a significant deviation is observed…



Main take-aways

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1. **Why does the preventive arm exist? What is its goal?**
   - Ensure prudent fiscal policy
2. **What is the MTO?**
   - A country-specific level for the structural balance that has built-in buffers against bad economic times, high debt levels and future liabilities
3. **What is the EB?**
   - A rule that limits net expenditure growth rate and enriches the fiscal surveillance toolbox
4. **What specifically does the preventive arm require Member States to do?**
   - Adjust towards the MTO and do not jeopardize it
5. **When and how is compliance assessed?**
   - Every Spring (and Autumn for EA MS), taking into account both the ΔSB and the EB
6. **What happens when a MS breaches the preventive arm of the SGP?**
   - A significant deviation procedure is launched

Thank you

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