SGP 3.0: CONTINUITY AND INNOVATION IN THE EVOLUTION OF THE EU FISCAL FRAMEWORK

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1 Introduction

The global economic and financial crises has exposed the need for greater coordination and enhanced surveillance of economic policies in Economic and Monetary Union (EMU). Existing instruments and methods of coordination and surveillance enabled the EU to avert a full-scale depression in the midst of a storm that no Member State could have managed on its own. However, recent experiences also showed remaining gaps and weaknesses in the current system of coordination and in the existing surveillance procedures.

Against this background, a broad-based reform process is under way in the EU that seeks to address the lessons of the crisis. While no one would argue that the post-2007 economic and fiscal crisis was caused by flaws in EU economic governance, its is also clear that (i) existing arrangements did not necessarily facilitate an effective policy response during the crisis and (ii) the unprecedented impact caused by the crisis calls for changes in the governance structure to put public finances back to a sustainable path after.

Our paper provides a detailed presentation of the reform project deliberated at EU level to strengthen economic governance in the Union. Reflecting the sweeping impact of the crisis, which seriously affected the entirety of our economic system – the real economy, financial systems and public finances – the actual reform debate and reform effort goes well beyond fiscal policy. It embraces all areas of economic policy making in the EU including for instance financial market supervision and regulation.

Keeping this in mind, our main objective is to take a closer look at how the broader reform process will change the EU fiscal framework, which together with centralised monetary policy making was and still is at the core of the EU economic governance framework. Our attention will be centred on two sets of specific initiatives: (i) the legislative proposals for a stronger EU economic policy coordination adopted by the European Commission on 29 September 2010; and (ii) initiatives launched by the Member States within the Council creating mechanisms for crisis resolution, that is arrangements that come into play when sovereign borrows are facing problems of illiquidity or insolvency or both.

Although dealing with interlinked issues, the two sets of initiatives are separated by important legal and institutional differences. The legislative package of the Commission emerges from what is generally called the community method and takes the Treaty provisions as given. The Member States' initiatives largely follow the intergovernmental path including possible changes to EU primary law.

Taking a macroscopic view, the Commission's reform package of 29 September 2010 consists of two major blocks. The first comprises a set of measures aimed at strengthening the provisions of the Stability and Growth Pact, the existing EU fiscal surveillance framework. The second block proposes an entirely new surveillance procedure dealing with macro financial developments. Its aim is to prevent and correct macro financial imbalances which, if they unwind,

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can have a bearing on the sustainability of public finances and the stability of the economy as a whole.[1]

Both blocks offer concrete responses to important lessons from the crisis. On the fiscal side, the crisis has drastically reversed the favourable economic and financial conditions that prevailed until 2007 and made clear yet again that windfalls accumulated during good times have not been sufficiently used to create room for manoeuvre. As a result, many Member States entered the crisis with little or no fiscal space.

Also on the fiscal side, the slow decline of public debt before the crisis and the very sharp increase during the crisis underscored the need to pay more attention to debt developments. On the back of slowing potential economic growth and an increasing number of below the line operations, keeping the deficit below the 3 per cent of GDP threshold of the Treaty is not longer sufficient to ensure a declining debt ratio.

Finally, fiscal surveillance before and during the crises clearly showed that EU rules can only work if they are backed by national frameworks. In many Member States arrangements of fiscal governance are not necessarily consistent with the obligations under the Treaty. In particular, few countries have effective fiscal rules, institutions or procedures conducive to achieving the objectives of the SGP. Existing frameworks are largely dominated by national institutional history.

Moving beyond the fiscal area, the emergence of large macroeconomic imbalances, including large and persistent divergences in competitiveness trends, proved highly damaging to the EU and in particular to the euro when the crisis struck. In the years preceding the crisis, low financing costs fuelled the misallocation of resources to often low productive uses, feeding unsustainable levels of consumption, housing bubbles and the accumulation of external and internal private debt.

These accumulated debt positions created significant vulnerabilities which were not captured on the radar screen of existing economic surveillance frameworks. Mirroring the prevailing macroeconomic paradigms, low and stable inflation in combination with sustainable public finances were deemed to be sufficient to guarantee overall macroeconomic stability. When they eventually unwound, macroeconomic imbalances turned into massive liabilities of the government sector as fiscal authorities endeavoured to safeguard overall macro financial stability by expanding its own balance sheet.

In particularly severe cases, the financial and economic crisis developed into a sovereign debt crisis where the solvency or liquidity of government was at stake. Such a situation was alien to the logic of the SGP. A forceful implementation of the fiscal framework in combination with the no-bail out clause of the Treaty was meant to prevent any sovereign debt crisis.

Once the unthinkable eventually happened, the no-bail out clause lost its credibility and the lack of provisions to deal with an outright crisis turned into a clear handicap. When faced with the choice of accepting a sovereign default or providing financial help to ailing countries the Council eventually went for the latter. The risk of a financial meltdown of a highly integrated financial market such as the euro area was deemed to be more serious than deviating from the spirit of EU primary law.

While the issues and problems outlined above did not come as a complete surprise their extent and relevance was clearly underestimated. This holds particularly true for macro-economic imbalances. In its Communication and Report on “EMU@10: successes and challenges after

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[1] A schematic view of the reform package is provided in the Annex.

10 years of Economic and Monetary Union",[2] the Commission had stressed the need to broaden economic surveillance in order to detect and address macroeconomic imbalances at an early stage. Enhanced surveillance efforts were seen as warranted in the area of external competitiveness and current account balances where noticeable divergences between Member States had emerged since the launch of the euro. However, at the time no one anticipated that macro imbalances could shake the foundations of EMU.

With the benefit of hindsight we know better. The crisis has triggered a veritable paradigm shift. An eloquent and succinct account of why and how the crisis forces us to rethink macroeconomic policy is provided by Blanchard *et al.* (2010). Similar and more extensive (re)appraisals are likely to follow. As part of this learning process, the official narrative of EU economic governance, whereby monetary and fiscal discipline would be sufficient to ensure macroeconomic stability and that existing rules would effectively stave off the risk of sovereign default, have been put into question.

Europe is currently trying to adapt its economic policy framework to the "new paradigm". Although incisive and comprehensive, the reform approach is not a radical one. It represents a reasoned balance between continuity and innovation. Existing arrangements, notably the rules-based framework of EU fiscal surveillance, are not thrown over board. Their rational is still valid. The reform seeks to strengthen them. In addition, the reform extends the scope of fiscal policy coordination to include national fiscal arrangements, the interplay between macroeconomic imbalances and public finances and explicit crisis resolution mechanisms.

The remainder of our paper takes a closer look at the main elements of the proposed reform of the EU's fiscal framework. Section 2 details the proposals to strengthen the existing provisions of fiscal surveillance, that is the SGP proper. Section 3 describes the planned extension of the surveillance framework to prevent and correct macro-economic imbalances which, if out of hand, can weigh on public finances and jeopardise overall macro financial stability. Section 3 focuses on crisis resolution reviewing both the ad hoc instruments decided in the face of the Greek sovereign debt crisis in May 2010 and the plans for a permanent mechanism outlined by the Council on 16 December 2010 and confirmed in March 2011.

2 Fiscal surveillance and coordination

2.1 The EU rules: a stronger Stability and Growth Pact

The SGP consists of two arms: one on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies – the so-called preventive arm, based on Article 121 of the Treaty – and one on the implementation of the excessive deficit procedure – the so-called corrective arm, based on Article 126 of the Treaty.

The SGP underwent a first reform in 2005 as a direct consequence of the institutional stand-off in November 2003 when the Council decided not to step up the excessive deficit procedure for Germany and France as required by the SGP. The declared goal of the first reform was to make the Pact "smarter". Existing rules were felt to be excessively rigid and to lack economic rational. As a result, while professing the rules-based nature of the SGP, the 2005 reform introduced additional elements of flexibility that were expected to improve the working of the Pact not least by modulating fiscal adjustment as a function of economic conditions. Concretely, the Council report underpinning the 2005 reform considered that, in order to avoid pro-cyclical fiscal

[2] See European Commission (2008).

policy, Member States should "[…] use more effectively periods when economies are growing above trend for budgetary consolidation […]".

Backed by remarkably favourable public finances in the vast majority of Member States, the assessment of the 2005 reform prior to the crisis was fairly positive. In 2007, the headline deficit of the EU as a whole was 0.7 per cent of GDP, the lowest level in more than two decades and the debt ratio had embarked on a downward trend. Moreover, available estimates of the structural deficit seemed to suggest the improvement in the headline deficit was accompanied by an improvement in the structural budget balance; most countries were considered to be close or at their respective medium-term objective (MTOs)

Admittedly, doubts were raised about the truly structural nature of the observed improvements. In the 2007 edition of its annual report on Public Finances in EMU the European Commission, when commenting budgetary outturns in 2006 noted that "*the improvement of government budget balances took place against the background of a broad-based economic recovery over the course of which the inflow of tax revenues went clearly beyond normal rates*". However, these concerns did not impact on actual fiscal policy making as official recommendations and opinions issues under the SGP were strictly based on the indications of the commonly agreed assessment tools in particular the cyclically-adjusted budget balance net of one-offs and other temporary measures.

The post-2007 crisis eventually exposed the "Emperor's new clothes". Progress towards MTO turned out to be insufficient and the structural balance, while conceptually a valid indicators, proved an inadequate measure of the underlying fiscal position of a country for two reasons: (i) the difficulty of assessing the cyclical position of the economy in real time and (ii) insufficient account being taken of revenue windfalls and shortfalls not directly related to the economic cycle (in particular housing and financial market developments). As a result, apparently sound budgetary positions before the crisis masked in a number of countries strong reliance on windfall revenues to finance expenditure, the reversal of which contributed to soaring budget deficits.

The crisis also underscored the need to keep a closer eye on debt developments. Within two years, the combined effect of falling revenues, discretionary fiscal expansions and below the line operation aimed at stabilising the financial system, led to an increase of the debt-to-GDP ratio in the EU by around 20 per cent of GDP. In addition, in the face of a general slowdown of potential output growth, visible before the crisis and accelerating as a consequence of the crisis, respecting given thresholds for the budget deficit would no longer be sufficient to ensure a decline in the debt ratio.[3]

2.1.1 Strengthening the preventive arm

The preventive arm of the SGP is meant to ensure that Member States follow prudent fiscal policies, and thereby avoid more stringent forms of coordination, so as to not put fiscal sustainability at risk with potentially negative consequences for EMU as a whole. Accordingly, Member States are required to present stability and convergence programmes outlining their plans to achieve medium-term budgetary objectives (MTO), which are defined in percentage of GDP in structural terms (*i.e.*, adjusting for the effect of the cycle and excluding one-off and temporary measures) and are differentiated across countries around a close-to-balance position to reflect the level of public debt and liabilities related to ageing. Member States not having reached the MTO

[3] When the SGP was designed in the 1990s the 3 per cent of GDP reference value of the Treaty was rationalised as the level of deficit which, with an average growth rate of at the time 3 per cent per year and an inflation target of 2 per cent per year, would ensure a declining debt ratio.

are expected to converge towards it at annual pace of 0.5 per cent of GDP in structural terms. However, as indicated above progress towards MTOs has been generally insufficient, leaving public finances badly exposed to the economic downturn.

To respond to these shortcomings the reform of the preventive arm put forward by the Commission on 29 September 2010 as part of the overall reform package defines principles of prudent fiscal policy-making (PFM), which, while retaining the current MTOs, and the 0.5 per cent of the GDP annual convergence requirement, provide operational guidance on how to effectively achieve the required annual adjustment in structural terms. In point of fact, the structural budget balance and the PFM have a common basis. In both cases fiscal policy is assessed with respect to a benchmark of medium-term economic growth. The analytics of the relationships is detailed in the Annex.

PFM implies that annual expenditure growth should not exceed – and, if the MTO has not been achieved, should be clearly *below* – a prudent medium-term rate of growth of GDP, unless the MTO has been more than attained or the excess of expenditure growth over the prudent medium-term rate is matched by discretionary measures on the revenue side. The essential aim is that of preventing that revenue windfalls are spent and are instead allocated to debt reduction.[4]

PFM will provide the benchmark against which countries' fiscal plans in the stability and convergence programme will be examined. Additionally, failure to respect the agreed rate of growth of expenditure, in conjunction with the stipulated revenue measures, will make the concerned Member State liable to a warning from the Commission and, in case of a persistent and/or particularly serious infraction, to a Council recommendation to take corrective action, on the basis of Article 121 of the Treaty.

It is important to note that principles of PFM do not impose constraints on the size of government or changes thereof. Irrespective of the size of government, principles of PFM simply ensure that, taking into account budgetary objectives, expenditure plans are adequately resourced, specifically, by discretionary measures on the revenue side and not through reliance on revenue windfalls. Consequently, the prime objective of principles of PFM is to have a transparent and effective benchmark for assessing whether fiscal-policy making is geared towards achieving and maintaining the MTO across the cycle.

2.1.2 Taking stock of the Excessive Deficit Procedure

The corrective arm of the SGP is meant to avoid gross errors in budgetary policies, which may put at risk the sustainability of public finances and potentially endanger EMU. This translates into the obligation for Member States to avoid excessive government deficits, which are defined against numerical threshold for deficit (3 per cent of GDP) and debt (60 per cent of GDP or sufficiently declining toward it). The excessive deficit procedure (EDP) that implements the ban on

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[4] Conceptually, the principle of prudent fiscal policy making draws on the main intuition underlying the notion of fiscal sustainability, namely that over the long term government expenditures should not grow faster than available government revenues. The intuition can be formalised by looking at the derivative with respect to time of the budget-balance-to-GDP ratio:

$$\dot{bb} = \left(\frac{\dot{R}}{R} - \frac{\dot{Y}}{Y}\right)\frac{R}{Y} - \left(\frac{\dot{G}}{G} - \frac{\dot{Y}}{Y}\right)\frac{G}{Y}$$

where a dot indicates a change over time, bb stands for the government balance-to-GDP ratio, R for government revenues, G for government expenditures and Y for the growth rate of GDP. Assuming that the growth rate of revenues equals the growth rate of GDP, the dynamics of the budget-balance-to-GDP ratio depends on the growth rate of expenditure *vis-à-vis* the growth rate of GDP. To achieve an annual reduction of the budget balance of 0.5 per cent of GDP over the cycle with a government size of say 0.5, the growth rate of government expenditure needs to be 1 percentage point lower than the rate of economic growth.

excessive deficits foresees a sequence of steps, which, for euro-area countries, include the eventual imposition of financial sanctions.

The 2005 reform of the SGP did not alter the core of the corrective arm. In line with the overall objective of the project, it only introduced elements of flexibility into the sequence of steps which were made contingent on relevant economic factors and economic conditions. Government actions to correct an excessive deficit were to be considered in a conditional manner, that is, in connection with the prevailing economic outlook. As a consequence, a failure to bring the headline deficit below the 3 per cent of GDP reference value would not necessarily imply a tightening of the EDP, provided the Member State had taken the agreed action and an unexpected deterioration of economic conditions had hampered the achievement of nominal deficit targets. Apart from these procedural innovations, the government deficit remained the focal point of the corrective arm.

The EDP has been regularly applied in line with the relevant provisions, even against the background of the exceptional circumstances of the financial crisis, thereby contributing to anchoring expectations of its orderly resolution. However, a number of shortcomings have emerged. While the deficit and the debt criterion are in principle on an equal footing, and persistently high levels of debt arguably represent a more serious threat to public finance sustainability than occasionally high deficits, in practice the 3 per cent of GDP threshold has been the nearly exclusive focus of the EDP, with the debt playing so far a marginal role. This owes to the less straightforward nature of the debt threshold compared to the deficit, including the ambiguity of the notion of sufficiently diminishing pace of reduction and the greater impact on the debt ratio of variables outside the control of the government, notably inflation.

The existing EDP is backed in principle by a strong enforcement mechanism, as financial sanctions can, and should be, imposed in case of persistent failure to correct an excessive deficit. However, such sanctions arguably come into play too late in the process to represent an effective deterrent against gross fiscal policy errors, not least because the financial situation of the concerned country may be so deteriorated to make the threat of a fine less credible at the moment when it should become actual.

The credibility of sanction is further dented by the discretion effectively enjoyed by the Council in the decisions to proceed with the successive steps of the EDP. Finally, the recent crisis has highlighted that if the obligation to correct excessive deficits contributes to anchoring the expectation that government solvency will be maintained, the timeline of the correction and the profile of the adjustment may have to reflect EMU-wide considerations, in a situation where the assignment of the respective roles of fiscal and monetary policy may be less clear than in normal circumstances.

2.1.3 Ensuring a more effective corrective arm

To respond to these shortcomings the following key proposals for the reform of the corrective arm are being put forward.

The debt criterion of the EDP is to be made operational, notably through the adoption of a numerical benchmark to gauge whether the debt ratio is sufficiently diminishing toward the 60 per cent of GDP threshold. Specifically, a debt-to-GDP ratio above 60 per cent is to be considered sufficiently diminishing if its distance with respect to the 60 per cent of GDP reference value has reduced over the previous three years at a rate of the order of one-twentieth per year. Non-respect of this numerical benchmark however is not necessarily expected to result in the concerned country being placed in excessive deficit, as this decision would need to take into account all the factors that are relevant, in particular for the assessment of debt developments, such as whether very low inflation is hampering debt reduction as well as risk factors linked to the

structure debt, private sector indebtedness and implicit liabilities related to ageing. In line with the greater emphasis on debt, more leeway in taking into account relevant factors is also foreseen in case of non-respect of the deficit criterion, if a country has a debt below the 60 per cent of GDP threshold.

A particularly important element among the other relevant factors is the impact of the economic cycle. If the numerical benchmark of on average one-twentieth per year over the previous three years was applied mechanically, there would be a clear risk of pro-cyclicality: The assessment would signal non-compliance, and possibly warrant procedural steps during temporary downturns, while it would conceal unfavourable debt dynamics and delay procedural steps during temporary economic upturns. In order to avoid this type of situation, the assessment of debt developments needs to take into account the effect of the cycle. Such an exercise is not going to be easy as any adjustment for cyclical factors is subject to a considerable degree of uncertainty. Moreover, while there are established methods for purging headline deficits there is no equivalent for the debt. A good portion of judgement will be necessary.

More flexibility in taking into account relevant factors when determining the existence of an excessive deficit could also benefit countries undertaking systemic pension reforms, beyond the currently foreseen five-year transitory period. The special provisions of the SGP for systemic pension reforms with regards to the deficit criterion are also extended to the debt criterion, through establishing the same 5-year transitory period for considering the net costs of such reforms when assessing the compliance with the debt criterion. Finally, equal consideration shall be given to the partial or total reversal of previously implemented systemic pension reforms, during both the launch and the abrogation of an EDP.

2.1.4 Backing up the new framework with meaningful sanctions

Enforcement is strengthened by introducing a new set of financial sanctions for euro-area Member States, which would apply much earlier in the process according to a graduated approach. Specifically, in addition to the "atomic option" at the very end of the Excessive Deficit Procedure under current provisions the new set of instruments will involve an increasing cost for each successive deviation from the provision of the Stability and Growth Pact. These costs would be mainly reputational at the beginning and translate in real financial costs as the obligations under the Pact are successively violated.

To start with, euro-area Member States could be asked to lodge an interest-bearing deposit amounting to 0.2 per cent of GDP already under the preventive arm of the Pact. The triggering event would be the Council recommendation under Art. 121(4) mentioned in Section 0 issued in the event of a persistent and/or severe deviation from the path of fiscal adjustment towards the MTO. The deposit would become due semi-automatically that is on the issuance of the recommendation by the Council, unless the Council within ten days decides the contrary by qualified majority.

If the euro-area Member State concerned corrects the situation giving rise to the deposit, meaning if it corrects the significant deviation from the adjustment path, the deposit will be returned with accrued interest and the actual financial cost will, depending on the difference between the interest paid on the deposit and the interest rate paid on government debt, be fairly negligible for most countries. The main price to pay is more of moral kind; a country is singled out and has to provide a sort of bail.

The second stage in the proposed set of new sanctions is a non-interest bearing deposit amounting again to 0.2 per cent of GDP. It would apply upon the decision of placing a country in excessive deficit. Like for the interest-bearing deposit, the non-interest-bearing variant would

effectively be imposed with reversed qualified majority: Following the decision to place a country in EDP according to Art. 126(6) of the Treaty, the decision to impose the non-interest bearing deposit would be deemed adopted by the Council unless it decided to reject within ten days of the respective Commission proposal.

In case a country that was previously asked to lodge an interest-bearing deposit does not correct the deviation from the adjustment path and ends up with an excessive deficit, the existing deposit is converted into a non-interest bearing one taking into account the accrued interest. Finally, the non-interest bearing deposit would be converted into a fine in case of non-compliance with the initial recommendation to correct the deficit.

The amount of the fine is equal to the fixed component of the sanctions already foreseen in the final step of the EDP, *i.e.*, 0.2 per cent of GDP. It also bears a link with the minimum amount that Member States currently receive in annual commitments from a relevant subset of EU expenditure categories whose effectiveness depends on sound fiscal policies and that have an impact on the quality of public spending and structural adjustment (Cohesion Fund, European Regional Development Fund, European Social Fund, European Agricultural Fund for Rural Development, European Fisheries Fund). Specifically, half of the amount (0.1 per cent of GDP) corresponds to the minimum GDP share perceived by any Member States under the above-defined subset of EU expenditure categories.

This should facilitate the eventual move to a system of enforcement linked to the EU budget as outlined in the above-mentioned Commission communication of 30 June 2010. Further non-compliance would result in an intensification of the sanction, in line with the already existing provisions in the SGP. To reduce discretion in the enforcement, the procedure of "reverse voting" mechanism is foreseen for the imposition of the new sanctions in connection with the successive steps of the EDP. Specifically, upon each step of the EDP, the Commission will make a proposal for the relevant sanction, and this will be considered adopted unless the Council within ten days decides against it by qualified majority. The size of the non-interest bearing deposit or the fine can only be reduced by the Council based on a specific proposal the Commission following a reasoned request by the Member State concerned.

Moreover, the criteria for assessing compliance with the recommendations at each step, including the possibility allowing an extension of the deadlines for the correction of the excessive deficit, are clarified by placing explicit emphasis on the fiscal variables that can be assumed to be under the direct control of the government, notably expenditure, in analogy with the approach proposed for the preventive arm. Beyond these country-specific circumstances, the possibility of extending the deadlines is introduced also in case of a crisis threatening the smooth functioning of EMU.

Compared to current arrangements, the proposed set of graduated disincentives and sanctions in combination with the reversed qualified majority voting constitutes an important step forward. Sanctions will kick in earlier and be imposed in a semi-automatic fashion. Critical observer, however, doubt whether the reversed qualified majority voting will lead to a more effective enforcement of the rules. In their view the term semi-automatic is misleading because sanctions would only be imposed after the Council has determined, via traditional voting, that provisions of the SGP have been breached. They argue that one can speak of semi-automatic sanctions only if there is no discretionary filter between the breaching of an SGP rule and the reversed qualified majority voting on the sanction. At the same time they acknowledge that it would be difficult to attain such an unfiltered mechanism because it would require a Treaty change. According current EU primary law pertaining to fiscal surveillance, any type of procedure, with the exception of the warning under Article 121(4) which, however, does not lead to sanctions, can be stepped up only after the Council has found the required majority to do so.

2.2 National arrangements: domestic fiscal frameworks

Effective enforcement of the EMU budgetary coordination framework cannot be expected to derive only from provisions established at EU level. The particular decentralised nature of fiscal policy-making in the EU and the general need for national ownership of EU rules make it essential that the objectives of the EMU budgetary coordination framework are reflected in the national budgetary frameworks.

A *national budgetary framework* can be understood as the set of elements that form the basis of national fiscal governance, *i.e.*, the country-specific institutional policy setting that shapes fiscal policy-making at national level. This includes public accounting systems, statistics, forecasting practices, numerical fiscal rules, independent national budget offices or institutions acting in the field of budgetary policy, budgetary procedures governing all stages of the budget process and medium term budgetary frameworks in particular, and fiscal relations across government layers. While Member States' specific needs and preferences must be respected, a number of features stand out as being needed in terms of ensuring minimum quality and consistency with the EMU budgetary framework.

These are the subject of the Directive on national budgetary that is being proposed to complement the reform of the SGP. Such features firstly require that the most fundamental elements of national budgetary frameworks, namely accounting and statistical issues as well as forecasting practices, accord to minimum European standards to facilitate transparency and the monitoring of fiscal developments. Domestic budgetary frameworks need also to adopt a multi-annual fiscal planning perspective so as to ensure the achievement of the medium-term objectives set at EU level. Additionally, Member States must have in place numerical fiscal rules conducive to the respect of the deficit and debt thresholds. Member States must ensure that these features apply to all general government layers. National authorities must also guarantee the transparency of the budget process by providing detailed information on the existing extra-budgetary funds, tax expenditures and contingent liabilities.

3 Tackling macroeconomic imbalances

The foreseen mechanism strives to provide the framework for identifying and addressing macroeconomic imbalances, including deteriorating competitiveness trends. As such it complements the macro-structural country surveillance process foreseen under Europe 2020. It would comprise a regular assessment of risks of imbalances, including an alert mechanism, coupled with a system of rules designed to enable corrective action in case of adverse macroeconomic imbalances beyond fiscal policy. Its scope would cover all Member States.

3.1 The Alert Mechanism

Surveillance would start with an alert mechanism that aims at identifying Member States with potentially problematic levels of macroeconomic imbalances. The alert mechanism would consist of a scoreboard complemented by judgemental analysis. The scoreboard is designed to be transparent, reasonably simple and underpinned by economic rationale. For that purpose, a set of indicators aims at timely identification of imbalances emerging in different parts of the economy. The set of indicators should be sufficiently large to cover any possible case of major imbalance and making sure that it is sufficiently sensitive to detect imbalances early on.

Alert thresholds would be defined and announced for each indicator to increase transparency and accountability. For some indicators, thresholds would be symmetric in the sense of detecting imbalances for both excessively high levels and excessively low levels of the variable. The thresholds should therefore be seen as indicative values which would guide the assessment but should not be interpreted in a mechanical way; they should be complemented by economic judgment and country-specific expertise.

The scoreboard would be composed of several indicators for each Member State. Its composition may evolve over time due to changing threats to macroeconomic stability or advances in data availability. Although the same indicators would be used for all Member States, their availability and underlying methodology may differ from one Member State to another. The structure of the scoreboard would be updated informally, depending on any new threats to macroeconomic stability or progress in statistics availability.

3.2 Preventive surveillance

The Commission would release the results of the scoreboard on a regular basis and attach a Commission report putting it into perspective. On the basis of all available information, the Commission will draw a list of Member States deemed at risk of imbalances. The early discussion of such a list at the Council and the Euro Group will enable the Commission to get appropriate feedback from Member States and ensure transparency of the Commission deliberations. Following such discussions and for Member States where the Commission has detected possible imbalances or the risk thereof, the Commission will provide country-specific in-depth reviews. The in-depth reviews will consist of a detailed investigation of the underlying problems in the identified Member States. When assessing imbalances, account should be taken of their severity, of the degree to which they may be considered unsustainable and of the potential negative economic and financial spillovers to other Member States. The economic adjustment capacity and the track record of the Member State concerned as regards compliance with earlier recommendations under this Regulation and recommendations issued as part of multilateral surveillance should also be considered.

The analysis may be undertaken, where needed, in conjunction with surveillance missions to the country concerned. Any early warnings or recommendations from the European Systemic Risk Board will be taken into account, as well as the policy intentions of the Member State under review as reflected in its Stability and Convergence Programme and National Reform Programme.

If macroeconomic imbalances are considered unproblematic, the Commission will propose that no further steps are undertaken. If the Commission considers that macroeconomic imbalances (or the risk thereof) do exist, it will come forward with preventive recommendations for the Member State(s) concerned. Consistent with the macro-structural surveillance process and depending on the nature of the imbalance, the preventive recommendations may address policy challenges across a range of policy areas.

3.3 The excessive imbalance procedure (EIP)

When the alert mechanism points to severe imbalances or imbalances that jeopardise the proper functioning of Economic and Monetary Union in a specific Member State, the Council, on a recommendation from the Commission, may adopt recommendations in accordance with Article 121(4) of the Treaty declaring the existence of an excessive imbalance and recommending the Member State concerned to take corrective action within a specified deadline. Member States in excessive imbalances in the meaning of the EIP would be subjected to a regime of stepped-up peer pressure. Depending on the nature of the imbalance, the policy prescriptions could potentially address fiscal, wage and macro-structural as well as macro-prudential policy aspects under the control of government authorities. Following the opening of an EIP, the Member State concerned will be obliged to adopt a corrective action plan to set up a roadmap of implementing policy measures.

The flexibility embedded in the procedure should enable the Council to set appropriate deadlines when issuing corrective recommendations, taking into account the nature, scale and urgency of imbalances and the capabilities of policies to remedy the situation. Unlike fiscal policy, not all policy levers are under the direct control of national governments when it comes to the resolution of imbalances. Furthermore, corrective policies may only have a lagged impact on the correction of imbalances, depending on their nature. The Commission will monitor the implementation of corrective action by the Member States concerned.

The Council, on the basis of a Commission recommendation, will conclude by the expiration of the initial deadline whether or not the Member State concerned has taken the recommended corrective action. If the Council decides that the Member State concerned has taken appropriate action, the procedure will be placed in abeyance. Abeyance means that the Member State is making satisfactory progress with corrective action. However, due to the possibly long lags between adoption of corrective action and its effect on the ground, effective resolution of macroeconomic imbalances might take some time. The Member State concerned will be subject to periodic reporting and surveillance until the EIP is effectively closed.

Eventually, sustained and successful corrective action will facilitate the resolution of imbalances. The Excessive Imbalances Procedure shall be closed once the Council, on the basis of a recommendation by the Commission, concludes that the Member State is no longer experiencing excessive imbalances.

3.4 Enforcement measures

If the Member State concerned has not taken appropriate action, the Council would have to adopt stepped up recommendations associated with a new deadline – likely to be shorter – for corrective action. For euro area Member States the enforcement mechanism may ultimately lead to sanctions. If a Member State fails repeatedly to act in compliance with the Council recommendations to address excessive macroeconomic imbalances, it will have to pay a yearly fine, until the Council establishes that corrective action has been taken.

To ensure equal treatment between Member States, the fine should, as a rule, be identical for all euro area Member States and be equal to 0.1 per cent of the GDP in the preceding year of the concerned Member State. As a rule, the Commission will propose the maximum amount of the fine foreseen by this regulation. The Council, on the basis of a Commission proposal, may decide to cancel or to reduce the size of fine.

The Council decisions concerning the fine will be made by only those members of the Council that represent Member States whose currency is the euro. The vote of the member of the Council representing the Member State concerned by the decisions shall not be taken into account.

ANNEX

Schematic overview of the Commission reform proposals

Fiscal governance	**Macroeconomic governance**
Surveillance - Preventive arm of the SGP: principles of prudent fiscal policy making (amendment to Regulation (EC) 1466/97) - Corrective arm of SGP: benchmark for sufficiently diminishing debt ratio (amendment to Regulation (EC) 1467/97) - Minimum requirements of national fiscal frameworks (new draft directive)	**Surveillance** New procedures for monitoring, preventing and correcting macro-economic imbalances (new draft regulation)
Enforcement New disincentives/sanctions in case of non-compliance in preventive and corrective arm of SGP (new draft regulation)	**Enforcement** New disincentives/sanctions in case of non-compliance with new macro surveillance procedure (new draft regulation)

Changes in the CAB versus principles of PFM

This box examines the analytical basis the CAB and its link with the PFM approach. Starting with the CAB, the budget can be described as the sum of two components a structural and cyclical. Expressing all budgetary variables in percent of GDP we have:

$$b_t = r_t - g_t = r^s - g^s + (\varepsilon_r - \varepsilon_g)\,(\frac{y_t}{y_t^P} - 1) \tag{1}$$

where r, g, y and y^P are total revenues, total expenditures, actual GDP and potential GDP respectively. The cyclical component of the budget balance is typically modelled as a function of the output gap $(\frac{y_t}{y_t^P} - 1)$ scaled by the difference between cyclical sensitivity of revenues and expenditures ε_r and ε_g. The structural components of the budget balance are indicated by the superscript *s*.

The total differential of equation (1) gives the change of the budget balance:

$$db_t = \left(\frac{\partial r_t^s}{\partial y_t^P} y_t^P - \frac{\partial g_t^s}{\partial y_t^P} y_t^P\right)\frac{dy_t^P}{y_t^P} + \left(\varepsilon_r - \varepsilon_g\right)\left[\frac{dy_t}{y_t} - \frac{dy_t^P}{y_t^P}\right]\frac{y_t}{y_t^P} \tag{2}$$

Subtracting the cyclical component from the change in the headline balance yields the change in the CAB:

$$dcab_t = db_t - (\varepsilon_r - \varepsilon_g)\left[\frac{dy_t}{y_t} - \frac{dy_t^P}{y_t^P}\right]\frac{y_t}{y_t^P} = \left(\frac{\partial r_t^s}{\partial y_t^P}y_t^P - \frac{\partial g_t^s}{\partial y_t^P}y_t^P\right)\frac{dy_t^P}{y_t^P} \tag{3}$$

Turning to the PFM-based approach we know that:

$$dcab_t = dr_t^s - dg_t^s = \left(\frac{\dot{R}^s}{R^s} - \frac{\dot{Y}^p}{Y^p}\right)\frac{R^s}{Y^p} - \left(\frac{\dot{G}^s}{G^s} - \frac{\dot{Y}^p}{Y^p}\right)\frac{G^s}{Y^p} \tag{4}$$

where capital letters indicate levels of the respective variable and a dot a change with respect to time. This expression tells us how the underlying budget, *i.e.*, the CAB, evolves depending on how fast revenues and expenditures grow relative to potential GDP.

If government revenues *R* have a unit elasticity with respect to potential GDP the first term on the right hand side of equation (4) is equal to zero. In that case, the change of the CAB can only be zero if expenditure *G* grows in line with potential GDP. In terms of equation (3) it means that the increase in expenditure equals the increase in revenues implied by an increase in potential GDP.

Similarly, assuming a government size (G/Y) of around 0.5 an improvement of the CAB in the order of 0.5 per cent of GDP requires that expenditure growth is one percentage point lower than potential GDP growth, unless higher expenditure growth is compensated by discretionary revenue measures, which would go on top of the "natural" increase of *R*.

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