Box 11

IMPLEMENTATION OF THE EXCESSIVE DEFICIT PROCEDURE UNDER THE REINFORCED STABILITY AND GROWTH PACT IN EURO AREA MEMBER STATES

Over the last two years the Stability and Growth Pact (SGP) has been substantially reinforced by European governance reforms, including the "six-pack", the "two-pack" and the fiscal compact.[1] The main goal of this reinforcement has been to strengthen fiscal discipline and restore fiscal sustainability – especially for the euro area Member States.[2] At the core of the corrective arm of the SGP remains the excessive deficit procedure (EDP), the purpose of which is to avoid and correct deficits above 3% of GDP and debt ratios above 60% of GDP. This box presents some important aspects of the implementation of the EDP under the reinforced SGP in euro area Member States and offers some lessons in the light of recent experiences during the 2013 European Semester.

Setting deadlines and specifying adjustment efforts for the correction of excessive deficits

The corrective arm of the SGP specifies that an EDP shall be opened for a Member State if the government deficit exceeds 3% of GDP and the excess over the reference value cannot be viewed as temporary and exceptional. Based on the six-pack, an EDP shall, under certain conditions, also be opened if the debt criterion has been breached, even if the deficit remains below the reference value. The excessive deficit shall be corrected in the year following its identification (which typically means two years after its first occurrence) – unless there are special circumstances. The minimum required annual fiscal adjustment effort under the EDP shall be, as a benchmark, at least 0.5% of GDP in terms of improvement of the structural balance.

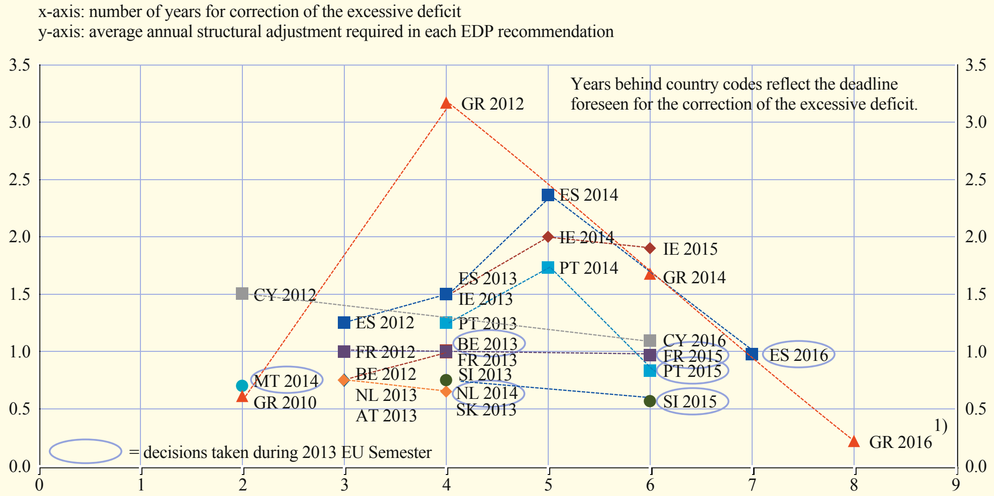
In the context of the financial crisis, excessive deficits were diagnosed in all euro area Member States except for Luxembourg and Estonia. Most of the EDPs started in 2009 and 2010. With the exception of Greece and Finland, the initial deadlines for correction of the excessive deficit were not set at the year following the identification of the excessive deficit as foreseen in the SGP but, in some cases, much later. The Commission diagnosed special circumstances, justifying the deviation from the SGP rule based on the strong deficit-increasing impact of the financial crisis and the need to implement coordinated fiscal stimuli in the context of the European Economic Recovery Plan.

The time granted to individual countries for correcting the excessive deficit varied markedly across countries, as did the required adjustment effort. While Greece was supposed to correct the excessive deficit in the year following its identification (2010), Austria, Spain, France, Belgium and the Netherlands were granted three years for the adjustment. Slovenia, Slovakia, Portugal and Ireland received four years for the necessary fiscal adjustment (see the chart). While countries diagnosed with larger adjustment needs tended to receive longer deadlines for the correction, the required fiscal efforts do not appear to have followed a clear rule. It has to be recognised, in this respect, that the SGP – even its 2011 version – offers little guidance on the specification of adjustment efforts and the setting of deadlines in case of deviation from the "year-following-identification" rule. The crisis has revealed that deficits can go far above the 3%

1 See the articles entitled "The reform of economic governance in the euro area – essential elements", *Monthly Bulletin*, ECB, March 2011, and "A fiscal compact for a stronger Economic and Monetary Union", *Monthly Bulletin*, ECB, May 2012, as well as the box entitled "The 'two-pack' regulations to strengthen economic governance in the euro area", *Monthly Bulletin*, ECB, April 2013.
2 For a discussion of the importance of sound fiscal policies for a stability-oriented monetary policy, see the article entitled "Monetary and fiscal policy interactions in a monetary union", *Monthly Bulletin*, ECB, July 2012.

Number of years for correction of the excessive deficit and average annual structural adjustment required under each EDP recommendation at different EDP vintages for ongoing procedures

(percentage of GDP)



1) The data point "GR 2016" reflects the improvement of the cyclically-adjusted government deficit to GDP ratio as specified in the 2012 EDP recommendation to Greece.
Notes: The graph shows, for example, that the EDP recommendation "BE 2012" for Belgium required a structural adjustment of 0.75% of GDP per year and a correction of the excessive deficit within three years (2010-2012). The deadline was subsequently extended by one year (to 2013) and the required structural adjustment was increased to 1% for this additional year.

Source: ECB.

of GDP reference value. In this case, the minimum required adjustment effort foreseen under the SGP is clearly insufficient to ensure correction of the excessive deficits in a sufficiently short time frame. Going forward, the implementation of the SGP would benefit from further clarification of the methodology for specifying adjustment efforts and setting deadlines – this would also help to ensure cross-country consistency in the application of the rules.

Assessing effective action and extending deadlines

Despite initial EDP deadlines going – sometimes far – beyond the year-following-identification rule, several Member States still missed their nominal targets by a large margin. Since the 2005 reform[3], the SGP allows for a revision of the recommendation and an extension of the initial deadline for the correction of the excessive deficit, provided two conditions are met. First, the government has taken "effective action" to correct the deficit in line with recommendations issued under the EDP and, second, "unexpected adverse economic events with major unfavourable consequences for government finances" – when compared with the economic forecast underlying the initial Council recommendation – have occurred.[4] The corrective arm of the SGP foresees that, as a rule, the deadline shall be extended by one year.

Effective action is assessed by the Commission and the Council with a focus on the improvement of the structural balance, which is calculated by an adjustment of the headline balance by cyclical, one-off and other temporary measures. If the improvement of the structural balance

3 See the article entitled "The reform of the Stability and Growth Pact", *Monthly Bulletin*, ECB, August 2005.
4 See Article 3(5) of Regulation (EU) No 1467/97.

falls significantly short of the adjustment required under the EDP recommendation, the SGP foresees a "careful analysis of the reasons for the shortfall".[5] Recently, the Commission presented a three-step methodology operationalising the analysis of effective action under the SGP, which was first applied during the 2013 European Semester.[6]

In a first step, the observed change in the structural balance is evaluated against the required improvement as specified in the EDP recommendation. In a second step, the observed structural improvement is adjusted for revisions of potential output, for revenue windfalls or shortfalls when compared with the time at which the recommendation was issued and for the effects of other unexpected events, e.g. natural disasters or statistical revisions. In a third step, a "bottom-up" analysis to determine the fiscal effort is applied. This is based on the budgetary impact of discretionary measures implemented by governments. Only if the bottom-up analysis also shows that the fiscal effort has fallen short of the requirements of the EDP recommendation, non-effective action is diagnosed and the procedure can be stepped up.

This three-step approach for assessing effective action under the EDP raises several issues. First, under the three-step approach, it is possible that Member States are repeatedly assessed to have taken effective action, while nominal deficits stay far above the reference value and show little tendency to converge towards it. As a consequence, government debt ratios can keep rising. Second, the approach is not fully transparent, as not all calculations and underlying data are made public. Third, there is a risk that the approach will not be applied in a fully symmetric way, thereby introducing a deficit bias. In bad times especially, the adjustment of structural balances for revenue shortfalls and downward revisions of potential growth are likely to downplay fiscal adjustment needs. There is a risk that the weakening of the adjustment path in bad times is not followed by an analogous strengthening of the adjustment path in good times. This is a key lesson from the lenient application of the SGP after its 2005 reform and before the crisis. Fourth, downward revisions of potential growth do – from a fiscal sustainability perspective – require stronger fiscal adjustment over the medium term. This aspect seems not to be taken into account in the approach. Fifth, especially the "bottom-up" approach – which so far does not rely on a commonly agreed methodology – does not seem to be sufficiently robust to ensure a reliable assessment of the fiscal effort. In this respect, it remains unclear, for example, how governments' estimates of discretionary tax and expenditure measures can and should be validated and how governments' incentives to over-report these efforts can be contained. It seems necessary to ensure an accurate disentanglement of the share of discretionary measures that reflects improvements in the structural balance and the share that is just necessary to compensate for a worsening of the structural balance resulting, for example, from spending increases inherent to existing policies. Just summing up the fiscal effects of discretionary measures might overestimate the fiscal effort. Furthermore, possible interaction between different measures needs to be taken into account. Finally, it remains unclear how a consistent application of the bottom-up approach across countries can be ensured.

All in all, it is important that the concept of effective action is interpreted in a way that ensures the timely correction of excessive deficits and is not used as a tool undermining the intentions of the reinforced EU fiscal rules to restore and safeguard fiscal sustainability.

5 See European Commission, "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of Stability and Convergence Programmes", 3 September 2012.
6 For a detailed discussion, see European Commission, "Vade mecum on the Stability and Growth Pact", Occasional Papers 151, May 2013, p. 65 ff.

Decisions during the 2013 European Semester

During the 2013 European Semester, the Council abrogated the EDP for Italy. However, most of the EDPs started in the context of the fiscal-financial crisis are still ongoing. Currently 12 out of 17 euro area Member States are subject to an EDP (see also the chart).

Based on the Commission's assessment – which followed the three-step approach – all countries currently under an EDP took effective action (except for Belgium[7]). France, for example, did not make the required structural effort under the first two steps of the procedure, but was attested to have taken effective action based on a bottom-up assessment of discretionary measures taken.[8]

As discussed above, if effective action has been taken and unexpected adverse economic events have occured, the regulations of the SGP foresee the possibility of an extension of the deadline for the correction of the excessive deficit by "one year as a rule".[9] However, deadline extensions of one year were only granted to the Netherlands and Portugal – in the latter case on top of the one-year extension granted in October 2012. Two-year deadline extensions were granted to France, Slovenia and Spain. Against the background of the regulations of the SGP specifying an extension by one year as a rule, these two-year EDP deadline extensions should only be considered under exceptional circumstances, such as in the event of excessive macroeconomic or financial sector imbalances that have major unfavourable consequences for public finances. Looking ahead, these two-year extensions should therefore be accompanied by intensified monitoring to ensure that the additional time granted to correct the excessive deficit is effectively used to implement growth-enhancing and imbalance-reducing structural reforms.

The new EDP recommendations put in place during the 2013 European Semester not only implement far-reaching deadline extensions, they also imply a marked slowing-down of the required fiscal adjustment. When compared with previous EDP recommendations, they reduce – as shown in the chart – the required average structural annual adjustment efforts for all countries but Belgium. In several cases, the reduction of the required average annual structural adjustment is substantial. For some countries (notably Portugal and Spain), even the cumulative future structural adjustment effort has been scaled back under the latest EDP recommendations. This could increase the risks to fiscal sustainability.

Taken together, the experiences from the 2013 European Semester demonstrate the challenge for the European Commission and the Council to apply the reinforced fiscal framework in a transparent and consistent way. This application needs to be guided by the main goal of the fiscal governance framework: restoring and safeguarding fiscal sustainability. Against this background, further improvements are called for with respect to the clarification of the applied methodologies as well as with respect to the strict implementation of the rules in order to effectively ensure the correction of unsound fiscal policies and the credibility of the reinforced SGP.

7 The reinforced framework foresees – based on Regulation (EU) No 1173/2011 – that in such a case the Commission recommends sanctions within 20 days of the Council's decision that a Member State has not taken effective action under Article 126(8) of the Treaty on the Functioning of the European Union.

8 See Commission staff working document on France, available at http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/other_documents/2013-05-29_fr_126-7_commission_-_swd_en.pdf.

9 See Article 3(5) of Regulation (EU) No 1467/97.