Box 7

FLEXIBILITY WITHIN THE STABILITY AND GROWTH PACT

On 13 January the European Commission issued a Communication on "making the best use of the flexibility within the existing rules of the Stability and Growth Pact" as a "contribution to developing a more growth-friendly fiscal stance in the euro area". It will be implemented with immediate effect. Without modifying existing regulations, it clarifies and at the same time extends the flexibility of applying the rules of the Stability and Growth Pact (SGP) in three major areas: (i) cyclical conditions, (ii) structural reforms and (iii) public investment. This box outlines the main elements of the Communication and its implications for surveillance under the EU's fiscal governance framework.

The new treatment of cyclical conditions under the SGP's preventive arm

Under Article 5(1) of Regulation (EU) No 1466/1997, which lays down the provisions for EU countries under the SGP's preventive arm, Member States which have not yet reached their medium-term budgetary objective (MTO) are required to pursue an annual improvement in their structural budget balance of 0.5% of GDP as a benchmark. The regulation further specifies that Member States with a debt level exceeding 60% of GDP or with pronounced risks of overall debt sustainability are required to achieve an annual improvement in their structural balance that is higher than 0.5% of GDP. In particular, in assessing the appropriateness of each country's progress towards its MTO, the Council and the Commission have to assess whether "a higher adjustment effort is made in economic good times", whereas the effort "might be more limited in economic bad times".

The Commission's Communication defines "economic good times" and granulates economic developments which are worse than what is experienced in "normal times" into "bad", "very bad" and "exceptionally bad" economic times.[1] To this end, it includes a matrix that specifies the fiscal adjustments needed, according to the size of the output gap and economic growth, for countries with government debt below 60% of GDP and for those with government debt above 60% of GDP.[2] According to this matrix, irrespective of the debt level, no fiscal adjustment is needed (which is equivalent to granting a waiver) in countries faced with "exceptionally bad times", defined by negative growth or an output gap of below -4% of GDP. In addition, in "very bad times", defined by an output gap of between -3% and -4% of GDP, the required structural effort is reduced to zero and 0.25% of GDP for countries with debt below and above 60% of GDP, respectively. This compares with requirements of 0.1% and 0.5% of GDP for these groups of countries, respectively, in the 2014 European Semester. In "normal times", defined by an output gap of between -1.5% and 1.5% of GDP, the required structural effort is 0.5% of GDP for countries with debt below 60% of GDP and above 0.5% of GDP for countries with debt above 60% of GDP. In "good times", defined by an output gap of above 1.5% of GDP, the required structural effort gradually increases to above 0.75% of GDP and above 1% of GDP for countries with debt below and above 60% of GDP, respectively. In this respect, the Communication goes

1 The Communication does not, however, define a severe economic downturn and thus the conditions for triggering the "general escape clause" (see Article 5(1) of Regulation (EU) No 1466/1997 and Article 3(5) of Regulation (EU) No 1467/1997), which allows structural adjustment under both the Pact's preventive and corrective arms to be paused in the event of a severe economic downturn in the euro area or the EU as a whole as long as fiscal sustainability is not at risk.

2 As a criterion within this matrix an assessment is made as to whether the economic situation is improving or deteriorating by distinguishing whether real growth exceeds or falls short of a country-specific potential growth rate.

beyond the provisions of the existing SGP Code of Conduct, which states that "in principle, economic 'good times' should be identified as periods where output exceeds its potential level", i.e. periods in which the output gap is positive and larger than zero. Compared with previous requirements applied in the review of draft budgetary plans for 2015, for example, Italy's required structural effort under the preventive arm would be halved to 0.25% of GDP, keeping in mind that compliance with the debt rule is a binding requirement under the SGP.

However, the output gap, which largely determines the adjustment requirements under the new decision matrix, is an unobservable variable subject to considerable revisions over time. Past experience points to a negative real-time bias of the output gap of the order of 1% of GDP over the 2003-13 period.[3] In particular, the boom period of 2006-07 was not identified as "economic good times" in real time. Consequently, the required fiscal adjustment towards the MTO determined by the new matrix in real time might turn out to be smaller than the adjustment that would have been warranted based on ex post data. This could undermine the aim of the Pact's preventive arm, which is to build buffers in economic good times.

The treatment of structural reforms

Under Article 5(1) of Regulation (EU) No 1466/1997, countries may deviate from the adjustment path towards their MTO if they have implemented major structural reforms which improve long-term fiscal sustainability. The SGP Code of Conduct provides examples of major health, pension and labour market reforms but also clarifies that "only major reforms that have direct long-term positive budgetary effects" and "a verifiable positive impact on the long-term sustainability of public finances" will be taken into account. Furthermore, the Code of Conduct specifies that "only adopted reforms should be considered". Contrary to the Code of Conduct, the Commission's Communication provides that reforms can now also be taken into account "ex ante" on the basis of a dedicated structural reform plan presented by the Member State. This plan should contain a timeline for the adoption and delivery of the reforms. In the absence of a methodological framework to gauge the budgetary costs of structural reforms in a consistent manner across time and countries, the Commission envisages granting countries a fiscal loosening for planned structural reforms in the form of a deviation from the adjustment path towards their MTO of up to 0.5% of GDP for up to four years. It would be useful to develop a methodological framework to gauge the short-term budgetary costs of structural reforms and to link any allowance to clearly quantified costs, also given the fact that not all structural reforms entail budgetary costs.

Under the Pact's corrective arm, i.e. the excessive deficit procedure (EDP), the Commission will take into account the existence of a dedicated structural reform plan, which must provide detailed and verifiable information as well as credible timelines for adoption and delivery, as a relevant factor when recommending opening a procedure and when setting the deadline for correction of the excessive deficit or extending that deadline. Importantly, the Commission has clarified that there is no trade-off between structural reforms and the delivery of "effective action", i.e. countries subject to an excessive deficit procedure remain obliged to achieve their fiscal consolidation targets.

3 See also Kamps, C., Leiner-Killinger, N., Sondermann, D., De Stefani, R. and Rüffer, R., "The identification of fiscal and macroeconomic imbalances – unexploited synergies under the strengthened EU governance framework", *Occasional Paper Series*, No 157, ECB, Frankfurt am Main, November 2014.

The treatment of public investment

The Commission's Communication has re-established the "investment clause". This was applied in 2013 and 2014 but had been discontinued for 2015, allowing countries under the SGP's preventive arm to deviate temporarily from the adjustment path towards their MTO to accommodate additional public investment. The investment clause was introduced by the Commission in 2013 by subsuming investment under the above-mentioned "major structural reform" clause of the SGP. This was controversial, as public investment is different in nature from structural reform. The clause now pertains to capital expenditure on projects co-funded by the EU, including the Structural and Cohesion Policy, the Trans-European Network and the Connecting Europe Facility as well as the newly established European Fund for Strategic Investment (EFSI)[4]. While the activation of the old investment clause hinged on negative economic developments in the EU as a whole (i.e. negative GDP growth with a negative or a large negative EU output gap forecast), the new investment clause can be activated on the basis of economic developments in the Member State concerned (either negative GDP growth or an output gap below -1.5% of GDP). As with the old investment clause, Member States need to ensure a safety margin so that the 3% of GDP deficit reference value is respected. An important condition that applied under the old investment clause has been dropped, as there is no longer any reference to compliance with the debt rule. In spring 2014 the Italian authorities' request for activation of the investment clause was rejected by the Commission on the grounds that compliance with the debt rule was not ensured.

Implications for EU fiscal surveillance

The Commission's Communication has implications for the implementation of the Pact's preventive arm in particular. Specifically, the reduction of structural adjustment requirements can be quite substantial as countries can draw on all three provisions in a cumulative manner. While the flexibility of the SGP should be used to avoid fiscal policy hampering the economic recovery and to support structural reform, it has to be carefully calibrated in order not to undermine debt sustainability and thus the credibility of the Pact and its consistent application across countries and over time. In this context the reduction of adjustment requirements also for high-debt countries increases the risk of inconsistencies with the requirements under the debt rule. To avoid the mistakes of the pre-crisis governance framework being repeated, it is also important that the debt rule, which was one of the major lessons of the crisis, is not sidelined. There is also a need for a clear methodological framework for taking into account the budgetary costs of structural reforms. It is important in this respect that structural reforms are only taken into account in the framework once they have actually been implemented.

4 Cash contributions to the setting-up of the EFSI will not have an impact on the deficit, but will have an impact on debt if financed through government borrowing (as has been the case for financial contributions to the ESM), which will likely be dealt with through the consideration of relevant factors within the EDP framework.