Box 8

THE EFFECTIVENESS OF THE MEDIUM-TERM BUDGETARY OBJECTIVE AS AN ANCHOR OF FISCAL POLICIES

By the end of April 2015 all euro area countries not subject to an EU-IMF financial assistance programme had to submit their stability programme updates to the Ecofin Council and the European Commission. In line with the preventive arm of the Stability and Growth Pact (SGP), these updates outline governments' budgetary strategies for the current year and at least the following three years. They also specify countries' medium-term budgetary objectives (MTOs) and planned progress towards them. Based on an assessment of the stability programmes, the European Council will endorse country-specific recommendations for fiscal policies on 25-26 June. These recommendations will take into account the January 2015 Commission Communication on flexibility within the SGP[1], which provides new guidance on the fiscal efforts required to achieve the MTOs. Against this background, this box reviews the effectiveness of the MTO as an anchor of fiscal policies under the preventive arm of the SGP.

The medium-term budgetary objective is the cornerstone of the preventive arm of the SGP. The MTO was introduced with the reform of the SGP in 2005 and reflects the budgetary target of governments over the medium term. It is defined in structural terms, i.e. corrected for the impact of the economic cycle and temporary measures.[2] MTOs are subject to regular updates every three years to reflect the latest estimates of the economic and budgetary costs of ageing, which are published in the triennial "Ageing Report"[3]. The SGP's preventive arm requires countries to make appropriate progress towards their MTO each year and, once they have achieved it, to maintain this structural budget balance. Specifically, the SGP foresees a benchmark structural adjustment of 0.5% of GDP towards the MTO, with higher adjustments in good economic times and lower ones in bad economic times. At the same time, the preventive arm regulation allows temporary deviations from a country's MTO, or the adjustment path adopted to achieve it, to take account of the implementation of major structural reforms that have direct, long-term positive budgetary effects, provided that the country returns to its MTO within the stability programme horizon.

The track record of achieving MTOs is poor. Even though the MTOs have been part of the EU's fiscal framework for ten years now, most countries have not achieved them in any single year during this time period. Furthermore, euro area countries have regularly postponed the deadline for achieving them, making MTOs "moving targets" instead of an anchor for budgetary planning. As a consequence, the euro area entered the financial crisis with a sizeable structural deficit[4], which limited the scope for counter-cyclical policies and prevented automatic stabilisers from working freely.

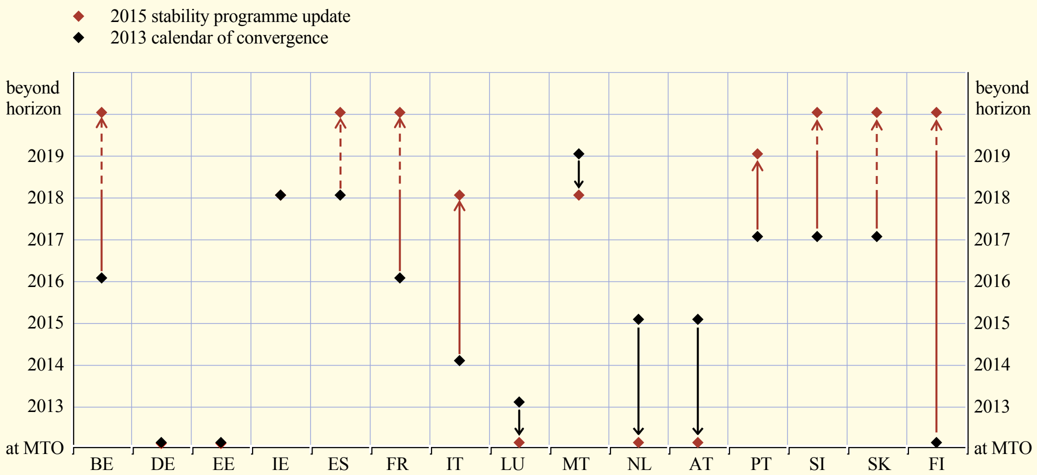
1 For further details, see the box entitled "Flexibility within the Stability and Growth Pact", *Economic Bulletin*, Issue 1, ECB, February 2015.
2 MTOs are set by Member States according to country-specific circumstances. They must respect minimum values and are designed to serve three goals: (i) Member States maintain a safety margin that prevents them from breaching the 3% Maastricht Treaty deficit reference value during cyclical downturns; (ii) Member States' debts are sustainable taking into consideration the economic and budgetary impact of ageing populations; and (iii) Member States have room for budgetary manoeuvre, in particular when it comes to preserving public investment.
3 See also Box 7 of this issue of the Economic Bulletin, entitled "The 2015 Ageing Report – How costly will ageing in Europe be?".
4 The structural balance is also determined by the unobservable output gap, which is generally subject to considerable revisions over time. The output gap is estimated to have had a negative real-time bias of around 1% of GDP over the 2003-13 period, which also implies an overestimation of the structural balance in real time. 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 poor track record regarding MTO compliance was intended to be addressed as part of a significant reform of the EU fiscal governance framework. Given the insufficient enforcement of compliance with the structural effort requirements under the SGP's preventive arm, in 2011 the six-pack reforms[5] further reinforced it by defining a "significant deviation" from the adjustment path towards an MTO that can eventually lead to financial sanctions being imposed on a country. In 2012 the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) made MTOs more ambitious: signatory euro area countries commit to MTOs not lower than -0.5% of GDP (compared with MTOs not lower than -1% of GDP before), unless their debt level is significantly below 60% of GDP and the risks to long-term sustainability are low. Furthermore, in 2013 the "calendars of convergence", i.e. country-specific time frames for achieving MTOs by a specified year, were put forward by the Commission as a follow-up to the TSCG.[6] The correction mechanism provided for in the TSCG, which should be triggered automatically at the national level in the event of a "significant deviation" from the MTO or the adjustment path towards it, was expected to ensure rapid convergence of countries towards their respective MTOs.

However, available evidence suggests that compliance with the MTOs has not significantly improved over recent years (see chart). Notably, MTO deadlines as set in the 2015 stability programmes are, for a large number of countries, further in the future than prescribed in the

Year of achieving the MTO as recommended in the 2013 calendar of convergence and as implied by the 2015 stability programmes

(as recalculated by the European Commission)



Source: 2015 stability programme updates, Commission staff working documents.
Notes: The chart compares the deadlines that the calendars of convergence set in 2013 for achieving MTOs with the year in which they are expected to be achieved as set out by the 2015 stability programme updates. The years of achieving the MTOs are based on the structural balances outlined in the stability programmes as recalculated by the Commission using the commonly agreed methodology and taking into account the 0.25% compliance margin. Consequently, the year of achieving the MTO as planned within a stability programme may differ from the year it is expected to be achieved according to the Commission calculations. For example, Portugal plans to reach its MTO in 2016, Italy and Slovakia in 2017, France in 2018 and Spain in 2019. For MTOs that are planned to be reached "beyond horizon" no recalculated structural balances are available. "Beyond horizon" denotes a time frame beyond the final year included in the 2015 stability programme, which is 2018 for Belgium, Spain, France and Slovakia, and 2019 for Finland. The dotted line thus reflects the period beyond the programme horizon. For Ireland the deadline has not changed.

5 Five regulations and one directive on fiscal and macroeconomic surveillance in the EU.
6 The deadlines for achieving the MTOs were set on the basis of the medium-term budgetary plans presented in the 2013 update of the stability and convergence programmes and in line with the SGP. See European Commission, "Report on public finances in EMU 2013", Part 1, Annex 1, *European Economy*, Issue 4, European Commission, Brussels, 2013.

2013 calendars of convergence. The Commission Communication on flexibility within the SGP released earlier this year may entail a slowdown in countries' progress towards the MTOs.[7] This clarified but also extended the SGP's flexibility as regards the application of the rules in three major areas: (i) cyclical conditions, (ii) structural reforms and (iii) government investment. When eligible under the structural reform and investment clause, countries are allowed to deviate from the adjustment path towards their MTOs.[8] For example, in their 2015 update of the stability programmes, Latvia and Italy applied to be considered under the structural reform clause for 2016.[9] Latvia was not granted a deviation under the clause owing to the absence of a sufficient safety margin towards the 3% deficit value. In the case of Italy, the European Commission allowed it to temporarily deviate by 0.4% of GDP from the required adjustment towards its MTO in 2016, after a zero adjustment requirement in 2014 and a reduced requirement in 2015 based on changes in the treatment of cyclical conditions applied by the Commission in spring 2014 and January 2015, respectively. Lithuania applied for the pension reform clause, but its eligibility will depend on Eurostat's confirmation of the systemic nature of the reform. Other countries, e.g. Slovakia, may benefit from the cyclical conditions clause, as their adjustment requirements have been lowered.

If used excessively, SGP flexibility could lead to further sizeable and long-lasting deviations from the adjustment path towards the MTOs, which could increase risks to debt sustainability. It is therefore essential to avoid the "moving-target syndrome" from which the preventive arm of the SGP suffered before the crisis. If euro area countries fail to restore fiscal buffers in a timely manner, they will be ill-prepared for adverse economic shocks, which is precisely when fiscal stabilisation is most needed. The current environment of strengthening economic recovery and favourable financial conditions should be used to accelerate progress towards MTOs. This would increase the resilience of the euro area economy.

7 On 13 January 2015 the European Commission issued a Communication entitled "Making the best use of the flexibility within the existing rules of the Stability and Growth Pact", see http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/2015-01-13_communication_sgp_flexibility_guidelines_en.pdf.
8 For further details, see the box entitled "Flexibility within the Stability and Growth Pact", op. cit.
9 In its 2015 convergence programme update, Romania applied to be considered under the structural reform clause, but its application has not yet been accepted owing to an absence of sufficiently detailed information.