The framework for budgetary surveillance in the European Union

Perspectives of the Fiscal Policy in Latvia and the EU – 6 June 2013

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European Commission

What are the bases of the fiscal governance framework in the EU?

Issue(s): Need of a stable environment for monetary policy to operate + Common pro-cyclical stance of fiscal policies - deficit bias

The European Union answer: rules versus institutions?

A rules-based framework: the Stability and Growth Pact (I)

➔ Rules = predictability/cross-country consistency

A specific institutional setting, with minimum requirements for national budgetary processes + independent institutions (II)

➔ **Fiscal governance = an overall framework**

The rules of the SGP – some history

- Pact signed by all EU Heads of State in 1997 in Amsterdam

- Two complementary texts of EU law
  - Regulation 1466/97
  - Regulation 1467/97

- Amended twice:
  - In 2005: ↗ economic rationale
  - In 2011: ↗ efficiency of surveillance (new tools, new sanctions)

    Six Pack – in force since December 2011 – EU27 + EA

- **Two Pack – entry into force 30 May 2013 – EA**

More stringent framework with COM Opinion on draft budgetary plans

How does the 'Fiscal Compact' fit in?

- Fiscal Compact = Title III of the *Treaty on Stability, Coordination and Governance in the EMU* (TSCG), signed on 2 March 2012 by 25 Member States (i.e. all but UK and CZ)
- In force since January 2013 – fully binding for **EA + DK, RO**
- TSCG = intergovernmental agreement (≠ EU law)

✓ Recalls the rules of the SGP, as strengthened by the Six-Pack

✓ Commitment to enshrine rules of the preventive arm (MTO) in national law + to support COM recommendations for EA MS in the corrective arm

✓ Complements the rules with an automatic correction mechanism and independent monitoring

➔ Fiscal Compact ≈ current SGP in substance (mirrors EU rules at national level)

➔ Strong political signal, adds a national layer to European commitments

The Stability and Growth Pact – EU rules

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1

❖ Objective of **sound budgetary positions close to balance or in surplus**

➔ Country-specific medium-term budgetary objective (MTO)

= "the preventive arm of the SGP"

2

❖ **Avoid excessive government deficits**

➔ Limits enshrined in Treaty
(deficit > 3% of GDP + debt > 60% of GDP and not decreasingly sufficiently)

= "the corrective arm of the SGP"

The preventive arm (TSCG requirements)

	Objective	Specification	Adjustment path	Enforcement mechanism
PREVENTIVE ARM	*Close to balance or in surplus position*	Country specific Medium-Term Objective (MTO) ➔ safety margin against breaching the 3% ➔ rapid progress towards sustainability ➔ room for budgetary manoeuvre Limit for euro area and ERMII: -1% of GDP ➔ TSCG: limit -0.5% (-1% if debt <<60% of GDP + low risks to sustainability)	Change in structural balance= 0.5% of GDP as a benchmark • >0.5% if debt > 60% of GDP or pronounced risks on overall debt sustainability • More in good times less in bad times Respect of expenditure rule Growth of expenditure net of discretionary revenue measures ≤ medium-term potential growth of GDP Possible temporary deviations - Major structural reforms (e.g.: pension reform) - Unusual event outside control of MS with major impact on financial position of the government - Severe economic downturn for the euro area or the Union as a whole (provided this does not endanger fiscal sustainability)	Procedure for correcting "significant deviations" (from MTO/ adjustment path) "significant" = 0.5% of GDP in 1y or cumulatively over 2y from requirement ➔ TSCG Automatic correction mechanism in national legal order monitored by independent national body Financial sanction (euro-area only) for repeated non-compliance (interest-bearing deposit 0.2% of GDP)

Requirements of the preventive arm

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An overall assessment based on 2 pillars:

	Annual improvement in structural balance	Annual growth of expenditure net of discretionary revenue measures
Status	Existing	Innovation
Benchmark	0.5pp. of GDP	MT potential growth of GDP (or a rate below if not at MTO)
Country-specific	×	√

Why an expenditure benchmark?

- Circumvent uncertainty surrounding the (unobserved) structural budget balance
- Ensure control of expenditure growth compared to medium-term economic growth
- Provide operational guidance concerning appropriate adjustment path towards MTO
- Strengthens automatic stabilisation
  - -expenditure on a sustainable path
  - -revenues allowed to fluctuate with the economic cycle

The expenditure rule

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Member State at MTO	Member State not at MTO
Net expenditure growth in line with the reference potential growth rate	Net expenditure growth in line with a rate below the reference potential growth rate
% government expenditure in GDP constant, except if offsetting variation in revenue	% government expenditure in GDP decreases, except if offsetting variation in revenue
Structural balance constant over time	Structural balance strengthens
Remains at MTO	Gap with the MTO closes over time

The corrective arm

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	Objective	Specification	Adjustment path	Enforcement mechanism
CORRECTIVE ARM	*Correct gross policy errors*	<u>Limits</u> *Deficit:* 3% of GDP *Debt:* 60% of GDP or sufficiently diminishing = debt reduction benchmark = distance to 60% of GDP ➘ by 5% per year - on average over 3y - or taking cycle into account - or respect in next 2y (no-policy change scenario) ⚐Transition period for MS in EDP at entry into force (Dec. 2011) = compliance with the benchmark 3y after correction of excessive deficit BUT sufficient progress in the meantime	At least 0.5% of GDP (structural) Possible extension of the deadline (i) effective action + unexpected adverse economic events with major unfavourable consequences for government finances (ii) severe economic downturn in euro area or Union as a whole, provided that it does not endanger MT fiscal sustainability	Early and gradual sanction system at each stage of the EDP for euro area + Possibility to suspend cohesion funds commitments / payments

The effort measure:
the change in the structural balance

S = CAB – one-offs ; CAB=x% Pot. GDP

Observed change in S stem from:

- Discretionary fiscal policy
- Unexpected events (change in potential growth, change in expected revenue elasticity, other events)

→ To assess the fiscal effort, the observed changes in "S" need to be corrected from forecast errors

$$\Delta S^{*} = \Delta S - (\alpha + \beta + \gamma)$$

The debt benchmark

Operationalization of the "debt criterion" = <60% or "sufficiently diminishing"

Numerical benchmark for sufficiently diminishing debt is respected:

- **If the gap to the 60% reference declines over 3 preceding years at an average rate of 1/20th per year**

Or

- **If the excess is only due to the impact of the cycle**

Or

- **If the required reduction will occur in forward-looking 2-year horizon, based on Commission unchanged policy forecast.**

(II) Fiscal governance: the institutional setting

interaction of the EU with national budgetary processes

Who does what

- **Member State:** draws and implements budgetary plans

- Six Pack Directive on national fiscal frameworks transposed by end-2013
- Fiscal Compact (euro area + RO and DK) transposed by end-2013
- Two Pack (euro area only) in force 30 May 2013 (6 months transition for some provisions)

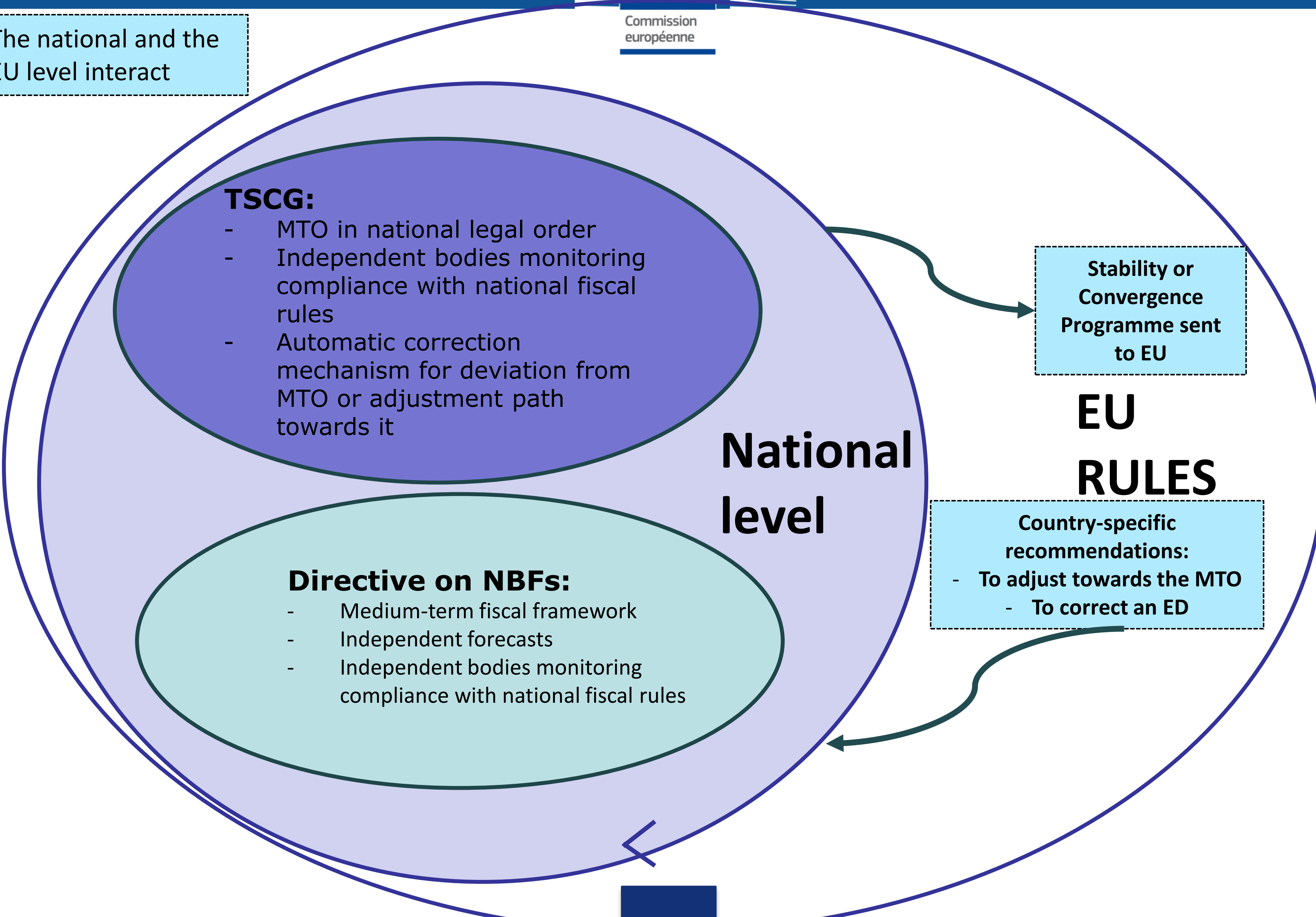
- **EU level:**

European Commission: regularly assesses compliance with SGP
if needed, recommends to the **Council** (Member States) to

- Take decisions (e.g. opening of corrective procedures)
- Issue recommendations to correct policy slippages

Interaction between National and EU level

The national and the EU level interact



A double cycle of fiscal policy-making: new elements for the euro area with the Two Pack

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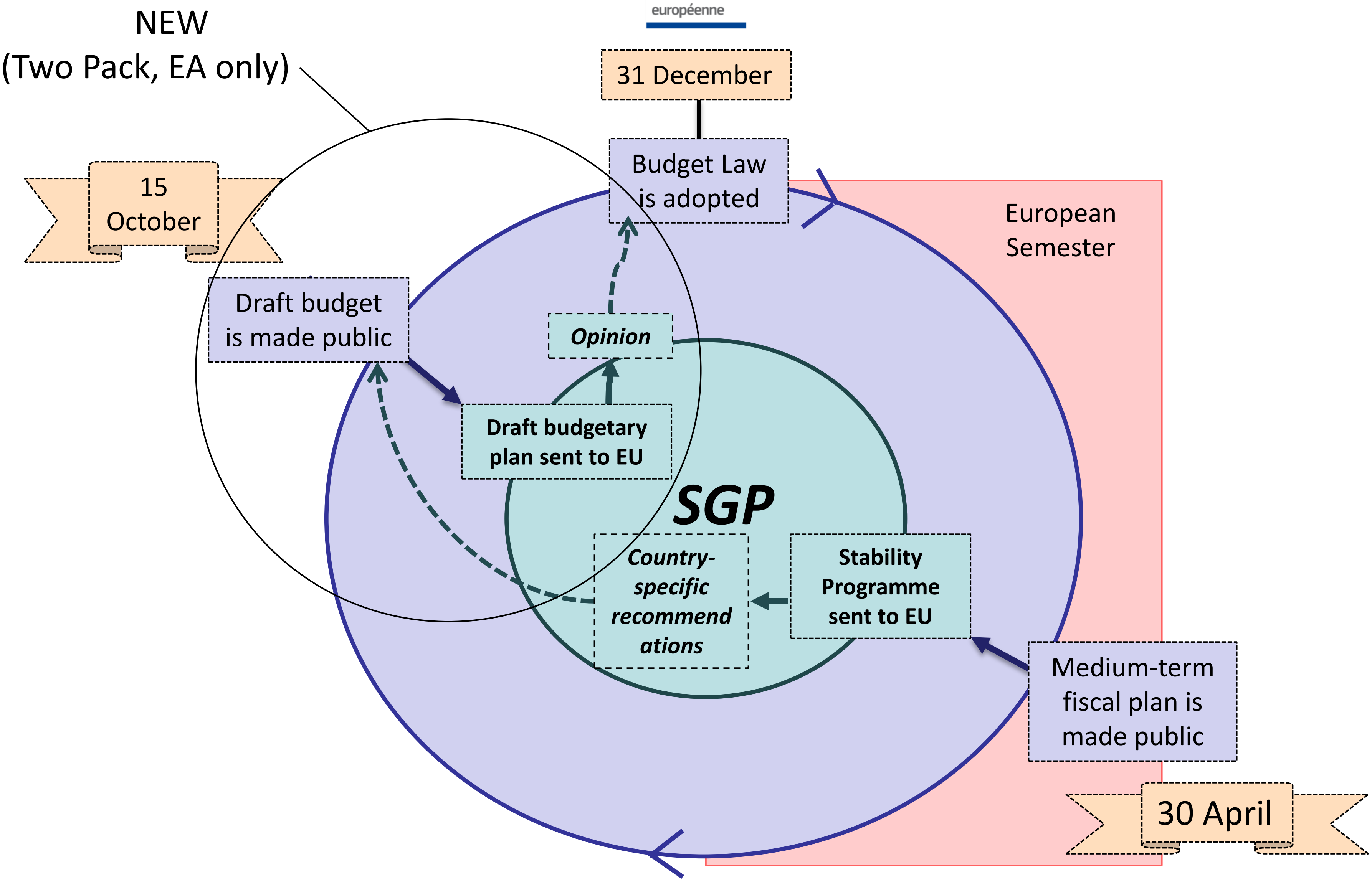
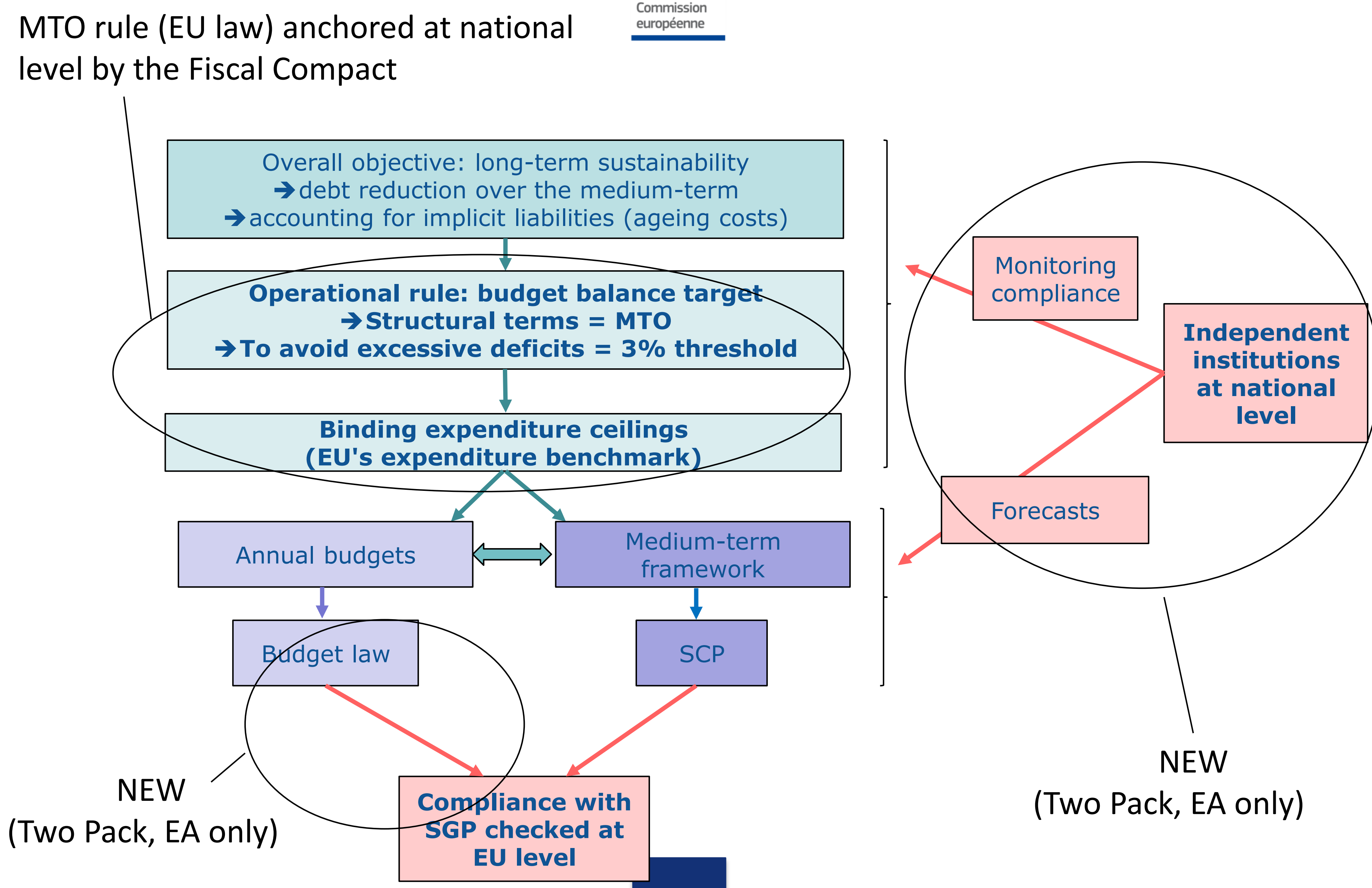


Complementarity between rules and institutions



Thank you for your attention