European Commission - Fact Sheet

Commission issues guidance to encourage structural reforms and investment – Frequently Asked Questions

Strasbourg, 13 January 2015

1. General questions

What is the purpose of this Communication?

The European Commission has presented today detailed new guidance on how it will apply the existing rules of the Stability and Growth Pact to strengthen the link between structural reforms, investment and fiscal responsibility in support of jobs and growth.

The guidance, which the Commission will apply as of now, has three key aims:

1. Encourage effective implementation of structural reforms;
2. Promote investment, specifically in the context of the new European Fund for Strategic Investments (EFSI) (see press release IP/15/3222);
3. Take better account of economic cycle in individual Member States.

Why is the Commission presenting these ideas now?

The Communication follows the commitment made in the Political Guidelines of President Juncker, on the basis of which the European Parliament elected the European Commission: *"As regards the use of national budgets for growth and investment, we must – as reaffirmed by the European Council on 27 June 2014 – respect the Stability and Growth Pact, while making the best possible use of the flexibility that is built into the existing rules of the Pact, as reformed in 2005 and 2011. I intend to issue concrete guidance on this as part of my ambitious Jobs, Growth and Investment Package.*"

The European Council stated in its Conclusions on 26/27 June 2014: *"We respect the Stability and Growth Pact. All our economies need to continue to pursue structural reforms. Very clearly, our common strength hinges upon each and every country's success. That is why the Union needs bold steps to foster growth, increase investments, create more and better jobs and encourage reforms for competitiveness. This also requires making best use of the flexibility that is built into the existing Stability and Growth Pact rules."*

Is the Commission watering down the Stability and Growth Pact and reducing pressure on Member States to bring down their excessive deficits and debt?

No. Adequate safeguards and conditions are in place to ensure that while the best use is made of the flexibility within the Pact, its credibility and effectiveness in upholding fiscal responsibility are preserved. This is fundamental for the sustainability of public finances and for financial stability in the EU.

Since the Pact was created in 1997, it has been reformed and complemented, notably in 2005 and in 2011-13. It is now applied at different points in the year as part of the overall annual cycle of economic policy coordination at EU level, known as the European Semester.

This Communication does not amend any of the provisions of the Pact. Instead, it is part of the Commission's efforts to further reinforce the effectiveness and understanding of its rules, to give Member States additional predictability in how the Commission will apply the Pact and to ensure their equal treatment, which is at the core of the Pact. The Communication is also a contribution to develop a more growth-friendly fiscal stance in the euro area.

When will this guidance apply?

The Commission is not proposing any changes to the existing rules. No legislative steps are needed and the Commission will thus apply this new guidance immediately.

The Commission will enter into a dialogue with Member States and the Council to provide any necessary explanations ahead of forthcoming milestones, notably the presentation of the Stability/Convergence Programmes (Member States' medium-term fiscal plans) and National Reform Programmes expected in spring 2015.

The Commission will also present this Communication to the European Parliament.

2. Clarifications regarding structural reforms

What flexibility will be available under the "structural reform clause" for countries in the preventive arm of the Pact?

The Communication gives guidance on how structural reforms will be taken into account from now on under the preventive arm of the Pact, (the so-called "structural reform clause").

In line with the rules of the Pact, Member States implementing major structural reforms are allowed to deviate temporarily from their medium-term budget objective (MTO) or the adjustment path towards it. This allows them to cater for the short-term costs of implementing structural reforms that will have long-term positive budgetary effects, including by raising potential sustainable growth.

From now on, the Commission will take into account the positive fiscal impact of structural reforms under the preventive arm of the Pact, provided that such reforms (i) are major, (ii) have demonstrable long-term positive budgetary effects, including by raising potential sustainable growth, and (iii) are actually implemented.

For reform measures adopted by the government and/or the Parliament to qualify "ex ante", Member States will have to present a dedicated structural reform plan with detailed and verifiable information and a credible timeline.

Provided the above criteria are met, Member States will be granted additional time to reach the MTO, hence allowing temporary deviations from the structural adjustment path towards it, or to temporarily deviate from the MTO for Member States that have reached it.

The temporary deviation must not exceed 0.5% of GDP and the MTO must be reached within the four year horizon of the Stability or Convergence Programme. Moreover, an appropriate safety margin must be continuously preserved so that the deviation does not lead to a breach of the 3% of GDP deficit reference value.

How will this be monitored?

The implementation of the reforms will be monitored closely in the context of the European Semester.

In the specific case of a Member State subject to the Excessive Imbalances Procedure (EIP), the structural reform plans should be set out in the Corrective Action Plan. The implementation of the reforms will then be monitored through the EIP.

What if countries fail to follow through on their reform commitments?

In case of failure to act, the temporary deviation from the MTO, or from the adjustment path towards it, will no longer be considered as warranted and the Commission may apply the procedure envisaged under the Pact in the case of a significant deviation from the MTO or the path towards it.

What about countries in the corrective arm of the Pact?

The main purpose of the corrective arm is to ensure the prompt correction of excessive deficits. The relevant rules do not include detailed provisions to take account of structural reforms (or investment) when assessing whether a country has taken effective action in response to the Council's recommendations to correct the excessive deficit.

However, structural reforms are recognised in the corrective arm of the Stability and Growth Pact when deciding different steps in the EDP.

First, when examining whether or not an EDP needs to be opened for a Member State, the Commission carefully analyses all relevant medium-term developments (economic, budgetary and debt). These "relevant factors" include the implementation of structural reforms.

Second, "relevant factors" are also taken into account when recommending the deadline to correct the excessive deficit. While the correction of the excessive deficit is expected to take place within a year of its detection, implementing structural reforms is a key factor that is taken into account when setting the deadline to correct the excessive deficit or the length of any extension to that deadline.

As part of this Communication, the Commission indicates that it will also take account of reforms that have not yet been implemented, provided that they have been clearly specified - with a credible timetable for adoption - in a structural reform plan that has to be adopted by the Member State in question. (For Member States with excessive macroeconomic imbalances, the Corrective Action Plan would normally serve this purpose).

In case a Member State fails to implement the agreed reforms, the Commission will consider it an aggravating factor when assessing effective action in response to the EDP recommendation and when setting a deadline for the correction of the excessive deficit. Lack of effective action will lead to a stepping up of the procedure and the possible suspension of European Structural and Investment Funds.[1] For euro area Member States, this means that the Commission will recommend to the

Council the imposition of a fine.

Third, when closing an EDP, the Commission considers, where relevant, the direct cost of pension reforms. Concretely, an EDP can be closed even if the deficit is over 3% of GDP, provided that the excess is entirely due to the costs of implementing the pension reform and the deficit has been reduced substantially and continuously and has reached a level that comes close to the reference value.

3. Clarifications regarding investment

Will national contributions to the future European Fund for Strategic Investments count as part of countries' deficit or debt and will these be taken into account in the application of the Pact?

The statistical recording of such contributions in the deficit and/or debt of a Member State is a matter for Eurostat, the independent Statistical Office of the EU, which will need to assess the details once the Fund is established.

However, irrespective of the exact statistical recording, the Commission is able to clarify how the existing rules of the Pact can apply to these contributions (to the extent they would have an impact on the statistics). It confirms that Member States' contributions to the EFSI will not be counted when defining the fiscal adjustment under either the preventive or corrective arm of the Pact, because such contributions can be considered as "one-off measures" that are deducted for the assessment of the fiscal effort in structural terms.

In the case of a 3% deficit reference value is no longer respected, the Commission will not launch an Excessive Deficit Procedure if it is due to the contribution, provided the deviation is small and expected to be temporary. When assessing respect of the debt reference value, contributions to the EFSI will be considered as a "relevant factor "and this not be taken into account.

In its Investment Plan for Europe, it had already announced that it would take account favourably such contributions under the Pact, and this was echoed by the December 2014 European Council.

What will be the conditions for applying the "investment clause" from now on?

The so-called "investment clause" applies to countries in the preventive arm of the Pact.

The Commission has previously provided guidance on how the Pact can support public investments with positive, direct and verifiable long-term budgetary effects on growth and on the sustainability of public finances. Today's Communication specifies and formalises this guidance to take better account of country-specific circumstances.

It clarifies that Member States in the preventive arm of the Pact can deviate temporarily from their medium-term budgetary objective (MTO) or adjustment path towards it to accommodate for investment, provided that

(i) their GDP growth is negative or GDP remains well below its potential (with an output gap greater than minus 1.5%);

(ii) the deviation does not lead to a breach of the 3% deficit limit and an appropriate safety margin is preserved;

(iii) investment levels are effectively increased a result.

(iv) Eligible investments are national expenditures on projects co-funded by the EU under the Structural and Cohesion policy (including projects co-funded under the Youth Employment Initiative), Trans-European Networks and the Connecting Europe Facility, and the co-financing of projects also co-financed by the EFSI.

v) The Member State must also compensate for any temporary deviations and the MTO must be reached within the four-year horizon of its current Stability or Convergence Programme.

Which countries have benefitted from the investment clause in the past?

In 2013, Bulgaria benefitted from the investment clause. In 2014, this was the case for Bulgaria, Romania and Slovakia.

Is the Commission introducing a "golden rule"?

No, there is no so-called "golden rule" exempting investment from deficit and debt calculations. This is not envisaged in the Pact. (The notion of "golden rule" is often discussed, for instance in the academia, but there are various definitions and interpretations).

4. Clarifications regarding cyclical conditions

How have cyclical conditions been taken into account until now?

The Stability and Growth Pact focuses on improving public finances in structural terms (already ironing out the effects of the economic cycle and/or one-off measures). For countries in the preventive arm, a medium-term budgetary objective (MTO) is identified, which is updated at least every three years, with the goal of improving their structural budget balance by 0.5% of GDP a year as a benchmark. This provides an appropriate safety margin against breaching the 3% headline deficit limit, with Member States, particularly those with debts over 60% of GDP, expected to do more when economic times are good and less when they are bad.

What is going to change?

From now on, for Member States in the preventive arm of the Pact, the Commission will use a 'matrix' to set out the appropriate fiscal adjustment and take better account of their cyclical situation. This means that Member States will be required to make a smaller fiscal effort during difficult economic conditions and a larger fiscal effort during better times (see Annex 1).

The matrix takes into account the direction in which the economy is moving, i.e. whether the economic situation is improving or deteriorating, by distinguishing whether real GDP exceeds or falls short of a country-specific potential growth rate.

In normal times, interpreted as an output gap between -1.5% and +1.5%, all EU Member States with a debt-to-GDP ratio below 60% would be required to make an effort of 0.5% of GDP, whereas the Member States with debt levels above 60% of GDP would need to make an adjustment greater than 0.5% of GDP.

In bad times, interpreted as an output gap between -3% and -1.5%, the required adjustment would be lower. All EU Member States with the debt-to-GDP ratio below 60% would be required to ensure a budgetary effort of 0.25% of GDP when their economies grow above the potential. A fiscal adjustment of zero would be temporarily allowed when their economies grow below the potential. For Member States with debt above 60% of GDP the required budgetary efforts would be 0.5 and 0.25, respectively.

In very bad times, interpreted as an output gap between -4% and -3%, all Member States with the debt-to-GDP ratio below 60% would be temporarily allowed zero adjustment, meaning that no fiscal effort would be required, whereas Member States with debt-ratios exceeding 60% would need to provide the annual adjustment of 0.25% of GDP.

In exceptionally bad times, interpreted as an output gap below -4% or when real GDP contracts, all Member States, irrespective of their debt levels, would be temporarily exempted from making any fiscal effort.

Is there anything foreseen for countries under the corrective arm?

For countries which are in the corrective arm and thus subject to the Excessive Deficit Procedure, the Commission has developed a new approach to assessing the delivery of the required structural fiscal effort, which the ECOFIN Council endorsed in June. This helps to disentangle as much as possible those budgetary developments that can be assumed to be under the control of the government from those linked to an unexpected fall in economic activity.

Under which circumstances would the Commission activate the "crisis clause" of a severe economic downturn?

The Pact takes into account unusually negative economic conditions at the EU or euro area level both in the preventive arm and in the corrective arm.

It states that, in cases of a severe economic downturn in the euro area or the EU as a whole, the pace of fiscal consolidation can be adapted for all Member States, if this does not endanger fiscal sustainability in the medium-term. The clause has so far never been applied, although it reflects the logic used at the time of the 2008 financial crisis when the adjustment paths were re-designed for several Member States.

If it were to be activated, this would not mean pausing the fiscal adjustment, but rather re-designing the adjustment path on a country-specific basis, both in terms of the adjustment effort and the deadlines to achieve the targets, taking into account the exceptional circumstances of the severe economic downturn in the euro area or the Union as a whole.

The Commission considers that these provisions should be used as necessary, but only in exceptional circumstances.

[1] Article 23 of Regulation No 1303/2013 of 17 December 2013.

For further information:

http://europa.eu/rapid/press-release_IP-15-3220_en.htm

http://ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm

Annex 1: Matrix for specifying the annual fiscal adjustment towards the medium-term objective (MTO) under the preventive arm of the Pact

		Required annual fiscal adjustment*	
	Condition	Debt below 60% and no sustainability risk	Debt above 60% or sustainability risk
Exceptionally bad times	Real growth <0 or output gap <-4	No adjustment needed	
Very bad times	-4 ≤ output gap <-3	0	0.25
Bad times	-3 ≤ output gap < -1.5	0 if growth below potential, 0.25 if growth above potential	0.25 if growth below potential, 0.5 if growth above potential
Normal times	-1.5 ≤ output gap < 1.5	0.5	>0.5
Good times	output gap ≥ 1.5%	>0.5 if growth below potential, ≥ 0.75 if growth above potential	≥ 0.75 if growth below potential, ≥ 1 if growth above potential

* all figures are in percentage points of GDP

Definitions:

- Fiscal adjustment: improvement in the general government fiscal balance measured in structural terms (i.e. cyclically adjusted and without one-off measures).
- Growth potential: estimated rate of growth if the economy is at its potential output.
- Output gap: difference between the level of actual and potential output (expressed in percentage points compared to the potential output).
- Potential output: a summary indicator of the economy's capacity to generate sustainable, non-inflationary output.

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