The Stability and Growth Pact since 2011: More complex – but also stricter and less procyclical?

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The European fiscal framework has been extensively reformed since 2011. Nevertheless, it is consistently criticized for its procyclicality, its complexity and its large consolidation requirements.

We provide a general overview of European fiscal rules. Then we argue that while recent reforms have undoubtedly made the Stability and Growth Pact more complex, one cannot make such a general statement concerning its procyclicality and its strictness. The preventive arm of the SGP has been made both stricter and less procyclical, while the newly introduced debt benchmark is not only very complex, but also more procyclical than the rest of the SGP. Furthermore, the effect on the procyclicality of Excessive Deficit Procedures is ambivalent; procyclicality was increased by the introduction of intermediate headline targets, but also decreased via new effective action indicators.

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The Stability and Growth Pact (SGP) lays down fiscal rules to ensure that EU Member States pursue sound public finances, preventing negative spillovers to other Member States and to common policy areas such as monetary policy within the euro area.

The establishment of the SGP in 1997 followed the Maastricht criteria applicable from 1993, in turn setting the basis for the current fiscal governance framework. The SGP has been adjusted several times since 1997, with the most important reforms dated 2005 and 2011, and a few smaller reforms coming into effect after 2011. This article serves as an update to Holler and Reiss (2011), which focused on those portions of the so-called six-pack of EU regulations specifically aimed at reforming the SGP in 2011. In the following, we discuss important changes since the finalization of the previous article:[2]

1. Two new regulations (the two-pack) and one intragovernmental treaty (the Fiscal Compact) related to the SGP have been agreed and implemented.
2. The European Commission has adjusted its interpretation of existing rules, most importantly by changing the methodology for assessing effective action and by refining the assessment of the required adjustment path to the medium-term budgetary objective (MTO) (European Commission, 2015f).
3. Last but not least, the European Commission has implemented the new rules for about four years. The application of some six-pack-related elements specifically offers the opportunity for a first assessment of the implications for Member States' recent fiscal policies and the European Commission's handling of the enhanced fiscal framework.

Since the beginning of the financial crisis, Member States have made massive consolidation efforts irrespective of

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[2] *Note that we have also published a much shorter article in German (Prammer and Reiss, 2014b) discussing flexibility in the SGP before publication of the so-called flexibility note of January 2015 (European Commission, 2015f).*

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their cyclical situation, partly owing to the need to meet SGP requirements. Hence, the SGP has attracted substantial criticism for its lack of flexibility and its procyclicality. The changes in interpretation of existing SGP rules after the six-pack reforms, such as the effective action methodology, and the interpretation and guidance contained in the communication referred to as the flexibility note (European Commission, 2015f), partly addressed this criticism. This flexibility, however, comes at the cost of even more complexity. Precisely this tradeoff will be one of the main topics in this article: Section 1 outlines the current SGP and stresses its partly new flexibility elements. Section 2 discusses whether the changes to the fiscal framework since 2011 (including the six-pack) have really made the European fiscal framework stricter. Section 3 then goes into detail in explaining the tradeoff between complexity and procyclicality in the SGP. Section 4 concludes.

1 The Stability and Growth Pact in a nutshell

The most important legal texts and guidelines constituting the Stability and Growth Pact are:

1. Articles 121 (preventive arm), 126 (corrective arm) and 136 of the Treaty on the Functioning of the European Union (TFEU) as well as Protocol No 12 annexed to the TFEU;
2. Council Regulations (EC) 1466/97 (preventive arm), 1467/97 (corrective arm) and 1173/2011 (additional sanctions regulation of the six-pack);
3. The Code of Conduct (European Commission, 2012a); and
4. Commission communications like the flexibility note (European Commission, 2015f).

This legal basis is complemented by Council Regulation (EC) No 479/2009 on the application of the Protocol on the EDP, Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States,[3] the two-pack regulations (Regulation (EU) No 472/2013 and Regulation (EU) No 473/2013) and the Fiscal Compact (fiscal part of the intergovernmental Treaty on Stability, Coordination and Governance, TSCG) of March 2012. Note that the mentioned articles of the TFEU as well as regulations and directives are legally binding while documents like Commission communications, the Vade mecum on the Stability and Growth Pact (European Commission, 2016b) or the SGP chapters in the annual Reports on Public finances in EMU of the European Commission are not.

The rules of the SGP are set out in *two arms,* the preventive and the corrective arm:

The *corrective arm* aims at correcting government headline deficit ratios or headline debt ratios deemed "excessive." It is based on the so-called Maastricht criteria requiring a government budget deficit of no more than 3% of GDP and a debt ratio which is either below 60% of GDP or sufficiently diminishing. If the Member State does not comply with these rules, an excessive deficit procedure (EDP) can be launched.

[3] *Directive 2011/85/EU, Regulation (EU) No 1173/2011, Regulation (EU) No 1175/2011 amending Council Regulation (EC) 1466/97 and Regulation (EU) No 1177/2011 amending Council Regulation 1467/97 as well as two regulations on the prevention and correction (Regulation (EU) No 1176/2011) and on the enforcement of the correction of macroeconomic imbalances (Regulation (EU) No 1174/2011) form the so-called six-pack.*

The *preventive arm* aims at preventing Member States from breaking their commitments to observe the deficit and debt requirements of the corrective arm. Hence, as long as a Member State is in an EDP, the preventive arm does not apply. It calls for "sound fiscal positions," which are achieved when a Member State respects its MTO, i.e. the country-specific budget balance target measured in structural terms. If the Member State does not comply, a significant deviation procedure (SDP) can be launched.

1.1 The preventive arm aims at long-term sustainability

The medium-term target for the structural balance is the cornerstone of the preventive arm

Pivotal to the preventive arm of the SGP is the *medium-term objective (MTO)* of achieving a *structurally balanced budget*.[4] Member States are to achieve and maintain a budgetary position that allows automatic stabilizers to play their full role in mitigating possible economic shocks. Generally, the minimal MTO is calculated every third year, taking into account the Member State's cyclical sensitivity and the sustainability risk measured by the current debt ratio and implicit liabilities arising from population aging (the calculation for Austria is sketched in box 1). Respecting these minimum requirements, Member States set their MTOs themselves. Most Member States have MTOs between –0.5% of GDP and a balanced budget.

Box 1

Calculation of Austria's MTO (using updated aging-related costs)

The new MTOs taking into account the 2015 Ageing Report (European Commission, 2015g) have not yet been published. Therefore, in early 2016, Austria's MTO was still set at –0.45% of GDP, respecting the calculated minimum for Austria of –0.5% of GDP based on the 2012 Ageing Report (European Commission, 2012d).

Applying information from the 2015 Ageing Report and from the Fiscal Sustainability Report 2015 (European Commission, 2015g and European Commission, 2016a) to the formulas used in the 2016 update of MTOs (European Commission, 2016b), Austria's minimum MTO still comes to –0.5% of GDP for 2017 onward. It is derived as the maximum of three different components:

1. *The first component provides a safety margin to the 3% of GDP deficit limit, taking into account output volatility and the budgetary sensitivity to output fluctuations of a country. For Austria, according to the European Commission (2016b), this amounts to about –1.8% of GDP.*
2. *The second component ensures the sustainability of public finances, taking into account the current debt ratio and future aging-related costs. For Austria, it amounts to –0.75% of GDP (based on publicly available data in the most recent Ageing and Fiscal Sustainability reports). This figure is lower than the one calculated for the 2013 update of MTOs, despite a considerably higher debt ratio. However, the lower projected increase in aging costs in the recent Ageing Report overcompensates the increase in the debt ratio compared to the 2013 update.*
3. *The last component sets a minimum of –0.5% of GDP for euro area countries with debt ratios of above 60% (based on the Fiscal Compact).*

[4] *The structural budget balance is calculated as the budget balance minus an estimated cyclical component minus one-off or other temporary measures. A more detailed explanation can be found in Reiss (2013).*

Member States must adjust until they reach the MTO

Member States have to improve their structural budgetary positions toward their MTO, with the amount of required adjustment depending on their debt level and their cyclical position. Adjustment thus allows for built-in *flexibility*. The matrix on adjustment requirements (table 1) was only published in early 2015 in the flexibility note (European Commission, 2015f):[5] Adjustment requirements (table 1) range from "no adjustment" in "exceptionally bad times" (negative real GDP growth and/or an output gap below –4%) to a structural adjustment of 1% of GDP in "good times" (for countries with debt ratios above 60%). However, overachievement of the MTO is not required. Moreover, *explicit exemption clauses* allow Member States to temporarily deviate from the MTO or the adjustment path toward the MTO (see next subsection).

The MTO is complemented by an *expenditure benchmark,* a major novelty of the six-pack reforms). The benchmark limits the growth rate of adjusted[6] real primary government spending to a country's medium-term potential economic growth rate or to below that rate. Expansionary (restrictive) discretionary measures on the revenue side decrease (increase) the allowed expenditure growth rate. If a country is on the adjustment path to its MTO, the applicable maximum expenditure growth rate is reduced in line with table 1: For example, for a Member State with a structural primary expenditure ratio of 50%, a required change in the structural balance of 0.6 percentage point would translate into a real expenditure growth requirement of 1.2 percentage points (= 0.6/50%) below potential.

Explicit exemption clauses allow for temporary deviations from the MTO or its adjustment path

Apart from cyclical conditions, several factors can temporarily reduce consolidation requirements under the preventive arm. The most notable exemptions

Table 1

Required annual fiscal adjustment under the preventive arm of the SGP

	Real GDP growth in %	Output gap (OG) in %	Debt ratio <60% AND low/ medium sustainability risks	Debt ratio >60% OR high sustainability risks[1]
Exceptionally bad times	real growth < 0 or OG < –4		no adjustment	
Very bad times	>0	–4<=OG<–3	0	0.25
Bad times	>0, <potential	–3<=OG<–1.5	0	0.25
	>0, >potential		0.25	0.50
Neither good nor bad times[2]	>0	–1.5<=OG<1.5	0.50	0.60
Good times[2]	>0, <potential	OG>=1.5	0.60	0.75
	>0, >potential		0.75	1.00

Source: European Commission.

[1] *Note that their high debt ratios put all larger euro area economies in this category.*
[2] *>0.5 is interpreted as >=0.6.*

[5] *Similar tables were used to assess the adjustment path toward the MTO from 2013; however, they were not published.*

[6] *Primary expenditure is adjusted for nondiscretionary changes in unemployment-related spending and expenditure matched by EU funds; furthermore, investment spending is smoothed over four years.*

are provided under the structural reform clause, the investment clause, and the general escape clause.

Structural reforms such as pension, healthcare or labor market reforms represent one important justification for allowing a temporary deviation from the adjustment path or the MTO under the s*tructural reform clause*. The allowed deviation is capped at 0.5% of GDP, except in the case of pension reforms.[7] Reforms (or reform packages) qualifying for these exemptions must

1. have a major impact,
2. have verifiable direct long-term positive budgetary effects, including raising potential growth in a sustainable way, and
3. must be fully implemented or, if not fully implemented, must be formulated in a detailed reform plan submitted to the European Commission.

The exemption can be applied only once until the Member State has reached the MTO. Furthermore, the structural reform clause can only be activated subject to the following *budgetary requirements:*

1. The Member State must remain in the preventive arm of the SGP;
2. The Member State must ensure a safety margin relative to the 3% limit for the headline deficit; and
3. The structural balance must be expected to return to the MTO four years after the submission of the Stability and Convergence Programme (SCP) requesting the structural reform clause.[8]

Under certain conditions, an *investment clause* may be invoked for investment expenditures co-funded by the EU to allow a temporary deviation from the adjustment path and the MTO. The deviation is limited by the total amount of cofinancing in the first year and is also capped at 0.5% of GDP. A Member State can invoke the investment clause

1. if it does not reduce public investment,
2. if it experiences bad economic times (with an output gap below –1.5%), and
3. if it meets the same budgetary requirements as for the structural reform clause.

The *cumulative deviation* allowed by invoking the structural reform clause and the investment clause is *capped at 0.75% of GDP* (European Commission, 2015a, page 74).

Also, unusual events outside the control of the Member State (e.g. natural disasters) allow for a temporary departure from the adjustment path or the MTO itself. Moreover, a *general escape clause* can be applied to all Member States in periods of severe economic downturn for the euro area or the EU as a whole. However, it can only be activated if fiscal sustainability in the medium term is not endangered. Activation suspends adjustment requirements in both the preventive and the corrective arm.

The European Commission can issue an early warning if countries significantly deviate from requirements

Deviations from the MTO or from the adjustment path toward it can trigger sanctions only if they are *significant,* coming to 0.5 percentage point over one year or cumulated over two years

[7] *Pension reforms in this context are typically reforms creating schemes classified outside the general government (typically via a mandatory private second pillar).*

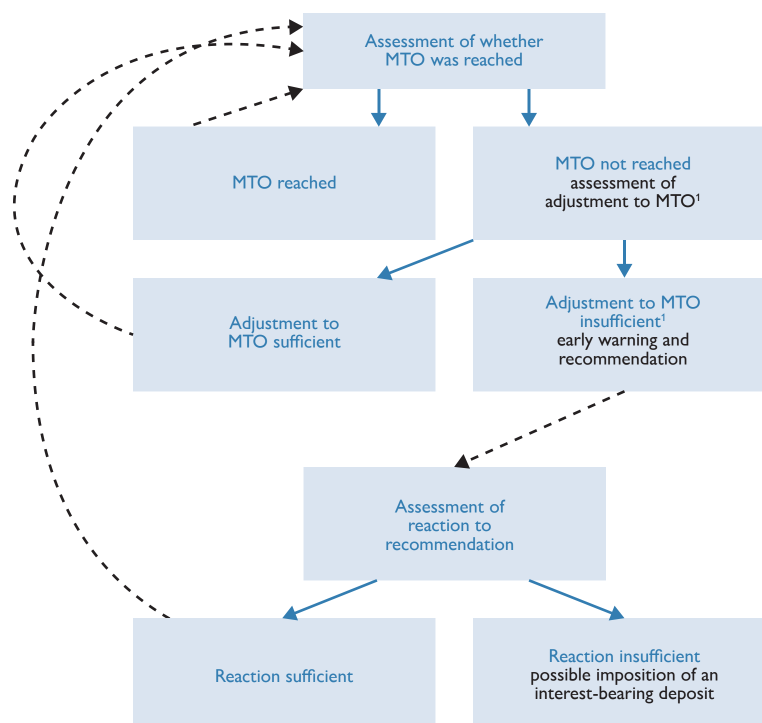
[8] *Boxes II.4.1 and II.4.2 in the Report on Public Finances in EMU 2015 (European Commission, 2015a) explain this issue in detail.*

(as specified in European Commission, 2012a). For example, a country with an adjustment requirement of 0.6% of GDP would hence only significantly[9] deviate from the required adjustment if the structural budget balance improved by less than 0.1 percentage point in one year (= 0.6–0.5) or by less than 0.7 percentage point over two years (= 2*0.6–0.5); the margins for the expenditure benchmark are calculated accordingly. Moreover, the MTO itself is considered as reached within a margin of 0.25 percentage point (European Commission, 2015a, page 42). This stands in contrast to conditions under the corrective arm, for which the Code of Conduct (European Commission, 2012a) does not specify such margins.

In case of a *significant deviation based on ex post data,*[10] the European Commission (without involvement of the Ecofin Council) can issue an *early warning* and launch an *SDP*. The European Commission assesses both the expenditure benchmark and the (change in the) structural balance. It automatically launches an SDP if a Member State

Chart 1

Simplified sketch of steps in the preventive arm of the SGP



Source: European Commission (2016b, 2015a), OeNB.

[1] *If the MTO was reached previously, the European Commission assesses whether there was a significant deviation from the MTO (and whether the expenditure benchmark was met).*

[9] *The European Commission refers to a deviation as significant if it is larger than authorized by the margins. If not referred to as "significant," a deviation is below the threshold.*

[10] *Negative ex ante assessments conducted by the European Commission (based on Stability and Convergence Programs in spring or on Draft Budgetary Plans in autumn) cannot lead to an early warning.*

deviates significantly from the requirements on both indicators. In all other cases of deviation, an overall assessment is needed. Only if at least one of the deviations is found to be significant might an SDP be launched (for details, see section 2.3 in European Commission, 2015a).

An early warning is accompanied by a recommendation (chart 1) to which the Member State has to react within at most five months. If the reaction is deemed to be insufficient, a financial sanction may be imposed, namely an interest-bearing deposit of 0.2% of GDP (which was introduced via the six-pack) for euro area countries only.

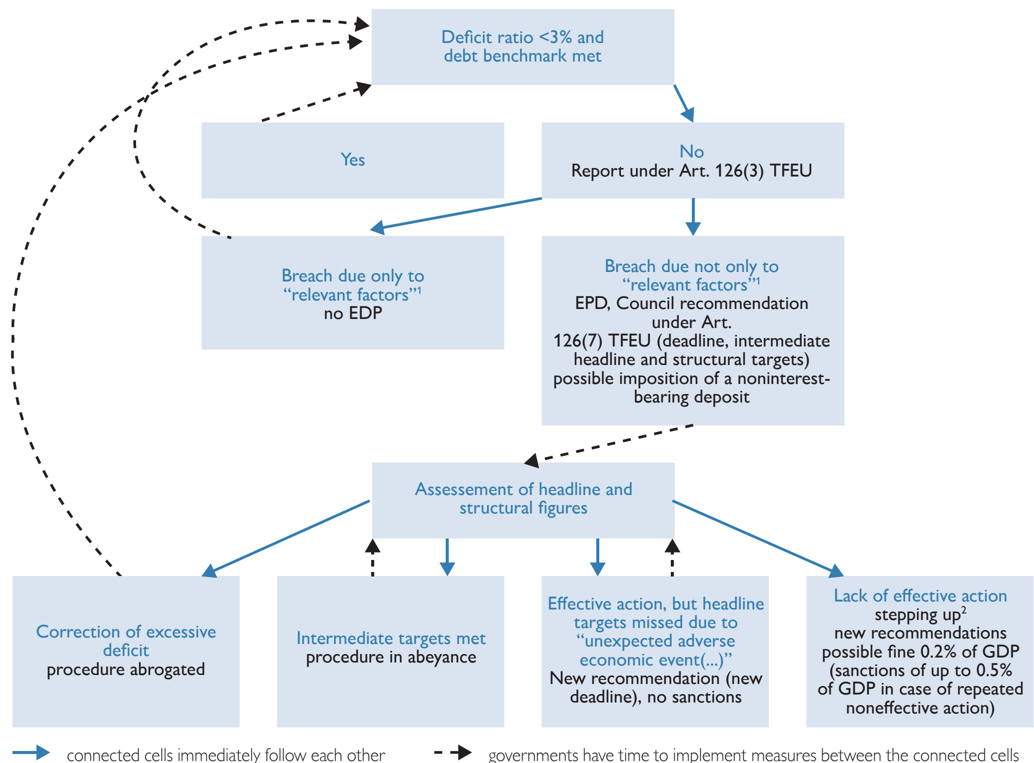
1.2 The corrective arm requires relatively large consolidation when Maastricht criteria are not met

An EDP may be launched for Member States deviating from deficit and debt benchmarks

While the Maastricht criteria of a maximum deficit of 3% and a debt ratio of 60% have been the unchanged core elements of the corrective arm since the beginning, the exact requirements for a *sufficient reduction in the debt ratio* for Member States above 60% of GDP were only laid down with the six-pack in 2011. Since then, the rules have required an average annual reduction in the debt ratio of 1/20th of the gap to 60%.

Chart 2

Simplified sketch of steps in the corrective arm of the SGP (euro area countries only)



Source: European Commission (2016b, 2015a), OeNB.

[1] *If the debt ratio >60% and the breach of the 3% limit is not temporary and is small, an EDP is opened in any case.*
[2] *Exception "in case of severe economic downturn in the euro area or the Union as a whole."*

In principle, the European Commission has to prepare a report under Article 126(3) when one of the two benchmarks is breached in notified data or is expected to be breached based on projections (chart 2). Note, however, that Article 126 of the Maastricht Treaty and Regulation (EC) 1467/1997 specify some exceptions:

No EDP needs to be launched[11] if the breach of the 3% limit is small, temporary and due to exceptional circumstances, the latter being either an "unusual event outside the control of the Member State" (e.g. a natural disaster) or a "severe economic downturn" (an output gap far below zero or negative GDP growth) (Council Regulation (EC) No 1467/97).

In case of the debt criterion, the benchmark is not only assessed over the past three years, but also over the projection horizon of the European Commission and in cyclically adjusted terms (for details, see European Commission, 2016b). The debt criterion is considered to be breached only if all benchmarks are missed. A transitional minimum linear structural adjustment (MLSA) requirement applies to countries which were subject to an EDP on November 8, 2011, when the six-pack entered into force. The MLSA sets a structural adjustment path for the deficit such that the debt criterion is met at the end of the three-year period after which the country has exited the EDP.[12]

When either the deficit or the debt criterion has been breached, the European Commission prepares an Article 126(3) report looking at *relevant factors* which might have contributed to these breaches and therefore *prevent* the *opening of an EDP*. These relevant factors comprise the medium-term economic (e.g. GDP growth, inflation) and budgetary positions (such as stock-flow adjustments) or other factors such as financial assistance to banks or to other Member States (e.g. bilateral loans to Greece). When a country with a debt ratio above 60% breaches the deficit criterion, relevant factors can only be taken into account when the excess over 3% is small and temporary.

The assessment of effective action in EDPs: Consolidation requirements are relatively high, but the large number of indicators provides flexibility

Both debt-based and deficit-based EDPs begin with a recommendation that sets the minimum annual headline targets and structural adjustment requirements[13] and a deadline for the correction of the excessive deficit (i.e. for the year in which the deficit ratio is below 3% and the debt rule is met).[14] In most cases, the consolidation requirements required ex ante in EDPs will be above the requirements in the preventive arm (especially when accounting for the effect of the explicit margins used in the latter).

The European Commission assesses *compliance* with the *recommended targets* according to *four different indicators* (for a more detailed description of the time-

[11] There is also an exception for cases when "the (deficit) ratio has declined substantially and continuously and reached a level that comes close to the reference value" (Art. 126(2) of the TFEU). This clause was relevant only during the setup of EMU.

[12] See annex 6 of European Commission (2016b) for the calculation of MLSAs.

[13] Structural requirements are set both in terms of a required change in the structural balance and in terms of the size of discretionary measures to be taken compared to a no-policy-change scenario.

[14] Compliance with debt adjustment requirements might require a fiscal trajectory with nominal deficits of well below 3% of GDP. If the EDP was opened before November 2011, the debt benchmark does not need to be met for the abrogation of the EDP.

line of EDPs, see European Commission, 2016b):

1. the level of the headline budget balance,
2. the change in the structural budget balance,
3. the change in the structural budget balance adjusted for revisions of potential output growth and adjusted for unexpected revenue windfalls (or shortfalls, respectively),[15] and
4. the separate quantification of the effects of individual policy measures using a bottom-up approach.[16]

Compliance with any of these indicators determines the country's position in a complex decision tree, where the *possible outcomes* are:

1. If the excessive deficit has been corrected based on both realized headline figures and European Commission projections, the *EDP* is *abrogated*.
2. If the excessive deficit has not been corrected, but the intermediate headline target and the structural indicators are met, the *EDP* is held in *abeyance*.
3. If the Member State has conducted effective action (measured by indicators two through four) but has missed the headline (deficit) target due to unexpected adverse economic events, the Council issues a *new EDP recommendation* (likely with new consolidation targets and a new deadline) *without any sanctions*. This typically[17] also holds when a Member State misses its deadline for the correction of the excessive deficit, but has conducted effective action.
4. If the European Commission's assessment determines a lack of effective action, the *EDP* is *stepped up* and new recommendations are issued.

Stepping up an EDP can also be accompanied by a fine, which – when countries repeatedly fail to abide by the recommendations – may reach up to 0.5% of GDP (chart 2; for details see European Commission, 2016b). The most recently published decision tree for the assessment of effective action can be found in European Commission (2016b), which also states (page 91) that an EDP cannot be stepped up if an intermediate headline deficit target has been met, regardless of whether structural consolidation is sufficient or not.

Moreover, as in the preventive arm, adjustment requirements and sanctions are explicitly suspended "in case of severe economic downturn in the euro area or the Union as a whole, provided that this does not endanger fiscal sustainability in the medium-term" (Regulation (EC) No 1466/97).

1.3 The role of the Fiscal Compact and the two-pack

The ECB (2012a) describes the most important innovations of the Fiscal Compact. Most importantly, in the Fiscal Compact, euro area countries com-

[15] *Revenue windfalls (shortfalls) are developments of government revenue above (below) expectations based on a naïve projection using the amount of discretionary revenue measures, GDP developments and an aggregate revenue elasticity with regard to the output gap.*

[16] *Indicators two and three are compared to the required change in the structural balance and indicator four is compared to the required size of discretionary measures.*

[17] *The SGP Code of Conduct (European Commission, 2012a, page 12) states that "if effective action has been taken (...) and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that recommendation or notice, the Council may decide (...) to adopt a revised recommendation (...). However, if structural consolidation efforts were deemed sufficient but headline targets were still not met, this was likely due to events outside the control of Member States. The European Commission did not step up EDPs in any of the numerous cases of missed headline or EDP targets since 2011.*

mitted to amending national legislation to include a structural balance rule as well as some correction mechanism for noncompliance (i.e. parts of the preventive arm). They also agreed on a sanctioning mechanism with fines of up to 0.1% of GDP for cases in which this agreement is not implemented. Furthermore, the Fiscal Compact commits euro area Member States to following all European Commission recommendations in deficit-based EDPs unless a qualified majority of euro area countries are opposed to a recommendation.

The *two-pack* consists of two regulations, one which increases surveillance of euro area countries in potential serious difficulties (Regulation (EU) No 472/2013) and one which increases reporting requirements and asks for the setup of independent fiscal institutions (Regulation (EU) No 473/2013). Both are described in more detail by the ECB (2013a); most importantly, as the article points out, the latter regulation requires euro area countries to submit so-called draft budgetary plans in October. These documents provide general government fiscal projections for the current and the following year and are assessed by the European Commission to determine compliance with SGP requirements. No direct financial sanctions are attached to this new process, but noncompliance with an opinion or an autonomous recommendation[18] by the European Commission released in the context of the draft budgetary plan review can be an aggravating factor in an EDP.

2 Has the European fiscal framework really become stricter since 2011?

One would assume that the SGP has become much stricter after the publication of the six-pack (see section 1 and, for example, European Commission, 2011, page 91, or ECB, 2011a[19]), especially due to the above-mentioned reforms to the preventive arm (particularly the expenditure benchmark and sanctioning possibilities), the introduction of the debt benchmark and the strengthening of the European Commission in EDPs via reverse qualified majority voting (also through the Fiscal Compact). At the same time, fiscal consolidation in the euro area has been very large since 2010. Chart 3 shows that according to the OECD,[20] the underlying (structural) primary balance of the euro area improved by about 3½ percentage points from 2009 to 2014. How much of this improvement can be attributed to the substantial changes of the EU fiscal rules over that timespan?

Chart 3 indicates that countries in macroeconomic adjustment programs (Greece, Portugal, Ireland; gray squares in chart 3) and/or subject to (temporarily) high sovereign risk premia (Spain, Italy) made the *largest consolidation progress* from 2010 to 2014. These countries were all in EDPs during these programs or during this time of market stress. Most consolidation in the remaining larger euro area countries was also conducted during times in which they were subject to an EDP, as fiscal adjustments outside EDPs (relevant for

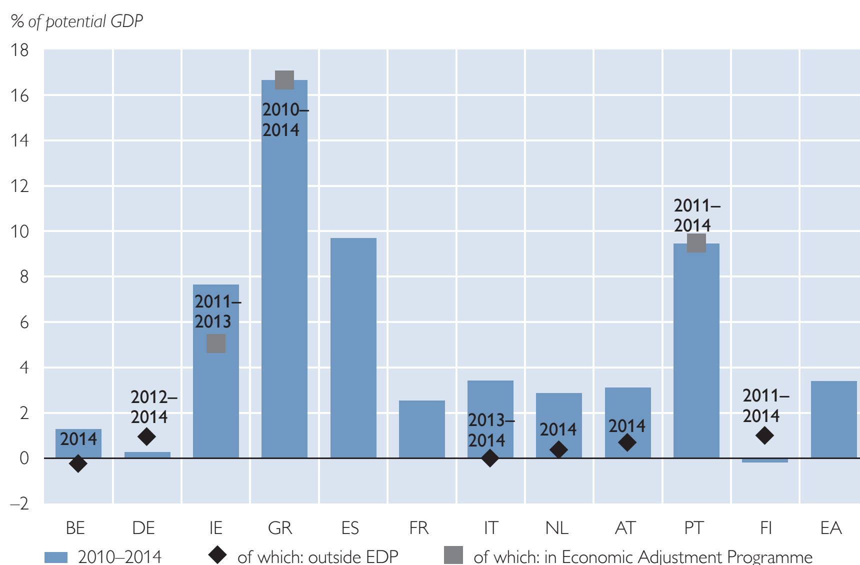
[18] *These are recommendations issued by the European Commission which, unlike country-specific recommendations, have not been endorsed by the Council of the European Union.*

[19] *Note, however, that the ECB publication qualified the assumption of greater strictness by pointing to some shortcomings of the reforms.*

[20] *We used OECD estimates, as the European Commission has not published structural (primary) balance estimates for 2009.*

Chart 3

Fiscal consolidation in large euro area countries from 2010 to 2014



Source: OECD (Economic Outlook, November 2015), European Commission, OeNB.

Note: Consolidation is measured by the change in the underlying primary balance as defined by the OECD (the European Commission did not publish its estimates of the change in the structural primary balance in 2010). Years above the gray (black) squares show which years of consolidation from 2010 to 2014 were covered by an adjustment program (outside the EDP).

Belgium, Germany, Italy, the Netherlands, Austria and Finland; black squares in chart 3) were comparatively small. In the following, we will argue that only a small portion of the very large consolidation in 2010 to 2013 can be attributed to the changes to the European fiscal framework. In some countries, adjustment requirements were even reduced by innovations to the SGP.

2.1 The preventive arm is clearly stronger than before 2011, but has so far been responsible only for a small fraction of consolidation in the euro area

It remains to be seen whether there will be any sanctions (including the nonmonetary sanction of an early warning) in the preventive arm; as of early 2016, there have been no sanctions since 2011. However, the preventive arm was practically nonexistent until 2011, so the reform steps of the six-pack and the implementation of structural balance rules into national legislation to meet Fiscal Compact requirements definitely strengthened the preventive arm.

The stronger preventive arm had an impact on countries like the Netherlands and Austria (chart 3 and box 2); both continued their consolidation course in 2014 even though their EDPs had already been abrogated. The case is similar for Germany and Finland, whose EDPs ended earlier. However, note that Germany significantly overachieved its MTO in 2013 and 2014 (i.e. less adjustment would have sufficed to meet EU fiscal rules). In 2015, the Netherlands (European Commission, 2015e) and Belgium (European Commission, 2015c) benefited from the fact that the European Commission looks at both the change in the structural balance and the expenditure benchmark in assessing the adjustment path toward the MTO. The European

Commission (European Commission, 2015c and 2015e) assessed that the expenditure benchmark (which points to a higher adjustment in both cases) provides more reliable figures for these two countries because revenue developments were weak. One year earlier, the European Commission (European Commission, 2014b) assessed the projected progress of Austria toward its MTO solely based on the change in the structural balance, as the expenditure benchmark was distorted by several large one-off measures from 2013 to 2015.[21]

Italy, whose EDP was abrogated already in early 2013, was de facto less restricted by the strengthened preventive arm. The margin to the 3% deficit limit has remained small after 2012 because of the country's continued adverse macroeconomic performance. Therefore, the room for fiscal maneuver was determined by the restrictions of the corrective arm of the SGP. Furthermore, because Italy's estimated output gaps were far below zero, consolidation requirements under the preventive arm were substantially reduced by the new flexibility elements of the SGP (section 1). More recently, Italy was also able to activate the structural reform clause; it applied for the investment clause described in section 1.1, too (European Commission, 2015d). Therefore, Italy might de facto be allowed to have an expansionary fiscal stance in 2016 and thereby further postpone the adjustment toward its MTO.

Box 2

SGP implementation for Austria from 2009 to 2015

According to spring 2009 data, Austria recorded a headline budget balance of –0.4% of GDP (later revised to –1.4% of GDP) in 2008. In autumn 2009, due to a strong drop in tax revenue on account of a decline in real GDP and an income tax cut, both the Austrian government and the European Commission projected deficits of significantly more than 3% of GDP for 2009 (Ministry of Finance projection of the budget balance: –3.9% of GDP, European Commission projection: –4.3% of GDP). Furthermore, the European Commission also expected that the deficit would deteriorate further in 2010 and 2011. Therefore, the Council – based on a European Commission recommendation – opened an EDP for Austria with a deadline of 2013.

This illustrates two important aspects of EDPs. While EDPs can only be abrogated based on ex post data (e.g. if the deficit ratio was below 3% in the last year), they can be opened based on projections. Furthermore, when deciding on whether to open a deficit-based EDP for a country with a debt ratio of more than 60%, relevant factors can only be taken into account when the excess over 3% is small, temporary and due to exceptional circumstances. And while the latter was definitely the case, the European Commission projected (correctly) that the breach of the 3% criterion was neither small nor temporary. This stands in contrast to the debt benchmark implemented in 2011, where relevant factors can always be taken into account.

Another important aspect of EDPs was illustrated in 2012 and 2013, namely that EDPs can only be abrogated if compliance with the corrective arm is expected to hold over the forecast horizon (European Commission, 2012a, page 12). Therefore, Austria stayed in an EDP until spring 2014, even though the headline deficit ratio was well below 3% in both 2011 and 2012, as according to the European Commission, there were large uncertainties related to the possible deficit effect of support to the financial sector (see, for example, European Commission, 2013b).

[21] *In contrast to the other consolidation indicators in the SGP, the expenditure benchmark does not correct for the impact of one-off effects.*

After the EDP was abrogated in spring 2014, Austria became subject to the new debt benchmark and the preventive arm. Unlike an EDP, a significant deviation procedure (SDP) can only be opened "based on outcomes as opposed to plans" (European Commission, 2012a, page 7), i.e. ex post. Due to a negative bias in recent structural balance projections of both the Ministry of Finance and the European Commission, the European Commission indicated several times that Austria might breach the preventive arm (e.g. in draft budgetary plan reviews 2013 and 2014), but ex post significant deviations have not been assessed or detected so far. Based on the MLSA for the period for 2014 to 2016, the requirements of the debt rule were less demanding than the requirements of the preventive arm. From 2017 onward, the standard debt benchmark will be applied to Austria.

Five larger euro area countries (France, Greece, Ireland, Portugal, and Spain) have not been affected by the reforms of the preventive arm, as they are still in an EDP as of early 2016.

2.2 The debt rule may seem strict on paper, but it has many exceptions and leaves large room for discretion to the European Commission

France, Greece, Ireland, Portugal, and Spain are not yet bound by the new debt benchmark: It has not applied to countries with an ongoing EDP since 2011. Assuming non-negative deficit-debt adjustments, reducing the difference of the debt ratio to 60% by 1/20th per year should typically be much harder to achieve than a deficit ratio smaller than or equal to 3% (unless nominal GDP growth is higher than around 5½%; see Holler and Reiss, 2011). This is especially true for countries with high debt ratios and/or low nominal GDP growth. However, while breaches of the 3% deficit limit will typically lead to the opening of an EDP, breaches of the 1/20th benchmark for reduction of the headline debt ratio might not, mainly for the following two reasons:

1. The debt criterion is only considered to have been breached if the 1/20th benchmark is met neither in backward-looking nor in forward-looking terms; moreover, a deviation from the benchmark must not be attributable to the impact of the (real) economic cycle.
2. If the debt criterion is breached, relevant factors can always be taken into account. Conversely, in breaches of the deficit criterion, relevant factors can be taken into account (for countries with a debt ratio of larger than 60%) only when the breach is both small and temporary.

Italy, ostensibly one of the main target countries for the relevance of the debt benchmark thanks to its traditionally low trend GDP growth and high debt ratio, benefited from relevant factors: According to a European Commission assessment of early 2015 (European Commission, 2015b), Italy was projected to fall about 2 percentage points short of the adjustment required by the MLSA. However, invoking relevant factors like compliance with the preventive arm (thanks to the increase in flexibility of the preventive arm) and the weak economic situation (including a projected increase in the GDP deflator by only around ½% in 2014 and 2015), the European Commission did not recommend that the Council open an EDP. Similarly, the European Commission also assessed a deviation from the MLSA for Belgium, but based on relevant factors, it did not suggest opening an EDP (ECB, 2015a).

While it may seem reasonable that a country is not put into an EDP because

poor cyclical developments cause a debt rule breach, note that there is a discrepancy compared to what can and has to be done if the deficit criterion is breached. Most notably, in late 2009, an EDP was opened against Germany, as it was (correctly) projected to overshoot the 3% limit in 2009 and 2010, even though the breach could be mainly attributed to factors related to the Great Recession (Germany's headline budget balances were close to zero in both 2007 and 2008). The case was similar for Austria (box 2).

2.3 The European Commission's role in EDPs has been strengthened, but an enlarged decision tree makes it easier to avoid a stepping-up

The initial presentations of the six-pack and Fiscal Compact reforms of the excessive deficit procedures tended to focus on increasing the relative role of the European Commission (as opposed to the Council) and on introducing new sanctions. In particular, the implementation of reverse qualified majority voting has increased automaticity in decision-making and has strengthened the role of the European Commission. For example, Commission recommendations for imposing financial sanctions in EDPs are deemed to be adopted unless the Council decides, by qualified majority, to reject them. So far, the European Commission has not proposed any financial sanctions under the new regime. The relevance of these reforms is hard to assess, as we have no counterfactual. Still, if the six-pack and the Fiscal Compact had been the only reforms, the corrective arm of the SGP would at least be as strict as before 2011.

However, at least two other *important changes under the six-pack* de facto tended to ease consolidation requirements for countries in EDPs:

1. The amended Article 3(4) of Regulation (EC) No 1467/1997 states that EDP recommendations should include annual budgetary targets; and
2. The new Article 3(5) of the same regulation as amended now states that EDP deadline extensions should be "one year as a rule" rather than "one year."

According to the European Commission, reaching the *annual budgetary targets* introduced in Article 3(4) is

Table 2

Fiscal developments in Spain since 2013

	2013	2014	2015	2016
	%			
EDP scenario (spring 2013)				
Real GDP growth	–1.5	–0.5	+0.7	+0.9
Headline budget balance	–6.5	–5.8	–4.2	–2.8
Change in structural balance	+1.1	+0.8	+0.8	+1.2
European Commission projection (autumn 2015)				
Real GDP growth	–1.7	+1.4	+3.1	+2.7
Headline budget balance	–6.9	–5.9	–4.7	–3.6
Change in structural balance	+1.4	+0.1	–0.7	–0.1
Cumulative difference				
Real GDP growth	–0.2	+1.7	+4.1	+5.9
Change in structural balance	+0.3	–0.4	–1.9	–3.2

Source: European Commission.

sufficient for not stepping up an EDP (see section 1.2). This provision can turn out to be highly relevant for multiyear EDPs, as in the case of Spain. As of early 2016, the most recent EDP recommendation for Spain was issued in spring 2013 (European Commission, 2013c), when the European Commission assumed rather weak real GDP growth for Spain (table 2). Therefore, the relatively large structural requirements translated into relatively modest required improvements in the headline balance in the EDP scenario. In 2014, Spain fell short of structural requirements and did not bring its deficit ratio below 3%, but thanks to much better than expected GDP growth (table 2), it met its headline target (in real time) and the EDP was not stepped up. Thus, short-run consolidation requirements were actually significantly reduced by a very procyclical six-pack innovation.

Using the new Article 3(5) of Regulation (EC) No 1467/1997 as amended, the European Commission has recommended several multiyear deadline extensions for countries in EDPs that missed their previous deadline for the correction of the excessive deficit but conducted effective action (section 1.2). The most notable cases were France in 2013 (from 2013 to 2015; ECB, 2013b) and 2015 (from 2015 to 2017; European Commission, 2015a) and Spain in 2013 (from 2014 to 2016; ECB, 2013b). The time of year in which European Commission is supposed to assess consolidation efforts in EDPs (i.e. winter, spring or autumn) is not clearly specified, nor are the periods it should include in the assessment (i.e. whether it should include projections). This vagueness gives the European Commission considerable leeway, especially in the case of multiyear deadlines. For example, in its spring 2013 assessment, the European Commission included 2013 figures for its assessment of effective action in France, whereas it did not include 2015 figures in its assessment of early 2015 (ECB, 2015a). If the European Commission had done the opposite – exclude 2013 data in the 2013 assessment and include 2015 data in the 2015 assessment – France would have clearly missed its respective targets for effective action in both cases (ECB, 2015a).

Furthermore, after introduction of the six-pack, the European Commission *changed* its *method of measuring the size of consolidation efforts* (effective action) in EDPs. It complemented the unadjusted change in the structural balance by the adjusted change in the structural balance and the bottom-up fiscal effort (section 1.2 and European Commission, 2014a).[22] The two new indicators both adjust for revisions of potential growth and of revenue windfalls/shortfalls between the time of the EDP recommendation and the assessment of effective action.[23] These changes were particularly helpful for Spain, whose fiscal adjustment in 2011/2012 was deflated by the performance of tax revenue, which was poor even when controlling for the weakness of GDP growth and whose potential growth was revised downward around that time (European Commission, 2012c and 2013c).

The two new indicators also increase the predictability of the European Commission's assessments, as governments are not penalized for downward revisions of potential growth

[22] *This publication also explains the most important differences between these two indicators.*

[23] *These two new indicators are conceptually similar to the expenditure benchmark in the preventive arm, which also tackles the issues of potential output uncertainty and revenue windfalls/shortfalls.*

or for upward revisions of revenue shortfalls. Furthermore, similarly to the new headline targets, they make a positive assessment of effective action more likely, as the European Commission apparently tends not to make a negative assessment if at least one indicator points to sufficient action.

2.4 Breaching the rules is a necessary but not sufficient condition for sanctions

The six-pack and the Fiscal Compact have considerably reduced the room for maneuver of the Council in both the preventive and the corrective arm. However, the Council is still in a position to reject all European Commission recommendations in the corrective arm (recommendations on the existence of an EDP, adjustment requirements in the EDP, deadlines on stepping up the EDP, etc.) via (reversed) qualified majorities.[24]

Generally, noninterest-bearing deposits under the EDP can be imposed only if the Member State has already lodged an interest-bearing deposit following noncompliance with recommendations in the preventive arm, or in case of severe noncompliance with EDP requirements. However, the European Commission may also recommend that the Council refrain from lodging a deposit or reduce the amount on grounds of exceptional economic circumstances or upon reasoned request by the Member State.

So far, no financial sanctions have been imposed since the six-pack. For example, the European Commission (European Commission, 2013e) assessed in 2013 that Belgium did not conduct effective action, but the relevant EDP recommendation was issued before the six-pack reforms. So Belgium's EDP was only stepped up, and no financial sanction has been recommended.

3 The tradeoff between complexity and procyclicality in the reformed SGP

The SGP is subject to substantial criticism both for its complexity and its procyclicality. In principle, there is a tradeoff between these two aspects, as acyclical or countercyclical fiscal rules require at least an estimation of the trend (potential) growth rate of an economy to determine what degree of spending growth should be considered expansionary.

This tradeoff can be easily exemplified in the 2004/2005 reform of the Stability and Growth Pact. Since this reform, it has been explicitly stated in the SGP that countries are not to be made subject to a stepping-up of an EDP when they have missed their deadline for bringing the deficit ratio below 3% due to unexpected adverse events, but have reached their structural consolidation targets (see, for example, Morris et al., 2006, page 21). This reform clearly reduced the procyclicality of the SGP, but at the same time it increased its complexity by strengthening the role of the unobservable structural balance, whose calculation requires an estimate of the output gap.

However, we will also argue that certain aspects of the SGP are both very complex and highly procyclical, especially the debt benchmark.

[24] *For details, see ECB (2012a) and Annex 7 in European Commission (2016b).*

3.1 The preventive arm has become both more complicated and less procyclical

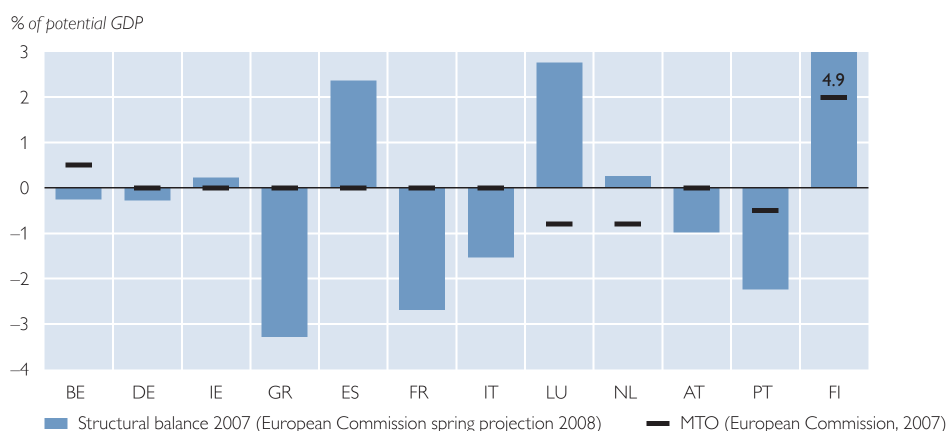
The reforms since 2011 have increased the complexity of the preventive arm by introducing a new indicator (the expenditure benchmark) while keeping the old indicators (the level of, and change in, the structural balance) and by introducing various provisions that de facto reduce consolidation requirements when the output gap is low (see previous sections). The latter innovation has clearly reduced the procyclicality of the preventive arm, as should the introduction of the expenditure benchmark, though to a smaller extent.[25]

Furthermore, the overall strengthening of the preventive arm should also decrease the overall procyclicality of the European fiscal framework, as the preventive arm is by nature much less procyclical than the corrective arm. Not only is the MTO under the preventive arm defined in structural terms (while limits under the corrective arm are set for the headline deficit and debt), consolidation requirements are also lower in bad times if the MTO has not been met.

As explained above, reaching the MTO should in most cases shield countries from large consolidation requirements stemming from the corrective arm. One important reason for the large consolidation in many euro area countries was that structural fiscal positions were exceptionally bad before the crisis (chart 4). This is particularly true for France, Italy, Greece and Portugal, whose structural budget balances were far below their MTOs (even when measured in real time).[26] Ireland and Spain had structural balances that were in line with the respective MTOs in 2007, but these two countries were hit especially hard in 2008/2009, especially Ireland, where the cost of finan-

Chart 4

Structural balances and MTOs in 2007



Source: European Commission.

[25] *The reliance on a medium-term average of potential growth rates should decrease procyclicality, while the effect of nonadjustment for one-offs and use of revenue measures (instead of the change in structural revenue) is less clear. The latter effect depends on whether the budgetary semi-elasticity used to calculate the structural balance and its change is smaller or larger than the true semi-elasticity.*

[26] *Note that in Portugal and especially Greece, the 2007 structural balances changed ex post not only because of revisions of output gaps and budgetary elasticities, but also because of revisions of headline budget balances.*

cial sector support was exceptionally large. Also, these countries' pre-2008 structural balances were inflated by revenue windfalls, so post-2009 consolidation was still above the euro area average.

3.2 The newly operationalized debt rule is both more procyclical and more complicated than the other SGP rules

Changes in the unadjusted debt ratio are not necessarily economically meaningful over the time span of three years. Thanks to the denominator effect, the debt ratio reacts much more strongly to nominal GDP developments than the budget balance does.[27] Furthermore, changes in the debt ratio are also driven by certain deficit-debt adjustments for which governments should be neither punished nor rewarded, e.g. the accumulation or withdrawal of cash reserves, privatizations or nationalizations, the issuance (redemption) of bonds above (below) par, the build-up or reduction of trade credits. The current specification of the *debt rule* acknowledges these caveats by *accounting for cyclical developments as well as other relevant factors* (sections 1.2 and 2.2).

Note that these factors make the debt rule extremely complicated and give the European Commission substantial leeway. As the debt benchmark is also assessed in forward-looking terms, it is highly sensitive to the accuracy of the European Commission's projections, and the change in the debt ratio is inherently difficult to predict because of deficit-debt adjustments (see also Prammer and Reiss, 2014). Moreover, accounting for the cycle means that potential output estimates are needed, which – thanks to the denominator effect – play a much larger role for the cyclical adjustment of the change in the debt ratio than for the change in the structural budget balance. Further complexity is added by the MLSA for countries in their first three years after the abrogation of an EDP that started before 2011.

Compounding the drawbacks of the debt rule, the *debt benchmark* is also both *more procyclical and more asymmetric than other SGP rules:*

1. While a debt-based EDP may not be opened if the breach of the headline criterion is due only to poor cyclical developments or (certain) large positive deficit-debt adjustments, it cannot be opened when meeting the headline criterion is due only to good cyclical developments or large negative deficit-debt adjustments.
2. Given that relevant factors can always be taken into account and as the recent cases of Italy and Belgium have shown, countries do not have to comply with any of the different benchmarks of the debt rule to avoid being put into debt-based EDP. However, compliance with the forward-looking benchmark is a necessary condition for abrogating an EDP (European Commission, 2012a, page 12).

Note that the rules for the headline deficit do not include such extreme asymmetries (especially for countries with debt ratios above 60%). The European Commission seems to have partly acknowledged these problems, de facto sidelining the debt rule (at least temporarily) with its 2015 decisions on Belgium and Italy (section 2.2), where even large deviations from the bench-

[27] *When starting from a debt ratio of close to zero (possibly even with significant cash reserves), the case may be different. However, this is not relevant in this context, as the 1/20th rule only applies when the debt ratio is above 60%.*

marks did not lead to an EDP. In Italy, sidelining the debt rule included specifying the budgetary requirements for the activation of the structural reform clause or investment clause, which calls for a safety margin vis-à-vis the 3%-limit for the headline deficit, but does not require compliance with the debt benchmark.

3.3 Reforms of the effective action assessment have an ambiguous effect on procyclicality

The assessment of effective action in EDPs has also become more complex by virtue of having four indicators to look at now: the level of the headline balance, the unadjusted change in the structural balance, the adjusted change in the structural balance, and the bottom-up fiscal effort. As mentioned in section 2.3, the introduction of the latter two indicators has definitely increased predictability for governments. Furthermore, these new consolidation indicators also tend to *decrease procyclicality* of EDPs, as they account for unexpected revenue shortfalls (which tend to pop up in economically bad times) and possible downward revisions to potential output (especially relevant when actual GDP growth is revised downwards). The same is true for the possibility of multiyear deadline extensions if macroeconomic conditions deteriorate strongly compared to previous EDP recommendations (as for Spain in 2013). However, meeting the intermediate headline targets as a sufficient condition for not stepping up an EDP clearly *increases procyclicality*. Spain exemplified such a process in 2014 (see section 2.3 for details): After making a large consolidation effort from 2010 to 2013 during which GDP contracted substantially, Spain was not required to consolidate further in 2014 thanks to its much better than expected GDP growth.

4 Conclusions

Reforms since 2011 have definitely made the European fiscal framework *more complex;* whether they have made it stricter and less procyclical depends on which part of the SGP is analyzed: The new intermediate headline targets in EDPs have de facto contributed to making the fiscal framework *less strict and more procyclical in certain cases.* Furthermore, the six-pack and the flexibility note have made the preventive arm of the SGP more complex, but also less procyclical (even allowing small fiscal expansions for countries in bad economic times). The newly operationalized debt rule stands out by being both highly procyclical (especially in times of low inflation) and complex at the same time, but has recently been (at least temporarily) sidelined by the European Commission via its decisions on Belgium and Italy.

Furthermore, complementing the rather crude unadjusted change in the structural budget balance by additional consolidation indicators has increased predictability for governments (and has decreased procyclicality), but having three indicators (expenditure benchmark, adjusted change in structural balance, bottom-up fiscal effort) to correct for the same problems (potential output revisions, revenue windfalls/shortfalls) may have added unnecessary complexity to the SGP.

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