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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN CENTRAL BANK, THE ECONOMIC AND SOCIAL COMMITTEE, THE COMMITTEE OF THE REGIONS AND THE EUROPEAN INVESTMENT BANK

MAKING THE BEST USE OF THE FLEXIBILITY WITHIN THE EXISTING RULES OF THE STABILITY AND GROWTH PACT

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1. Introduction

In its 2015 Annual Growth Survey (AGS),[1] the Commission identified investment, structural reforms and fiscal responsibility as key elements of the European Union's economic policy strategy to create jobs and growth. It also presented a new Investment Plan for Europe in support of this strategy.[2] Both this overall economic approach and the concrete elements of the Investment Plan were endorsed by the European Council of 18-19 December 2014.

The Commission also announced that, in order to strengthen the link between investment, structural reforms and fiscal responsibility, it would provide further guidance on the best possible use of the flexibility that is built into the existing rules of the Stability and Growth Pact (hereafter "the Pact"),[3] without changing these rules. This follows a commitment from the Political Guidelines for the new Commission,[4] as well as previous discussions at the European Council[5] and in the European Parliament.[6]

This interpretative Communication[7] provides this additional guidance, without changing or replacing the existing rules. The Pact is a cornerstone of the EU's economic governance and of decisive importance for the proper functioning of Economic and Monetary Union. Its objective is to promote sound budgetary policies and to ensure the sustainability of public finances in the Member States. Since its inception in 1997, the Pact has been reformed by the EU legislator in 2005 and in 2011-13 and enriched by experience. In recent years, it has operated as part of a wider and strengthened annual cycle of economic policy coordination, known as the European Semester.

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[1] COM(2014) 902 of 28 November 2014.
[2] COM(2014) 903 of 26 November 2014.
[3] The Pact is anchored in the Treaty on the Functioning of the EU (TFEU) and consists of Council Regulation (EC) No 1466/97 (the "preventive arm", based on Art. 121 TFEU) and Council Regulation (EC) No 1467/97 (the "corrective arm", based on Art. 126 TFEU), as well as their subsequent amendments and related legislation. To access documents, see: http://ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm
[4] "*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.*" Jean-Claude Juncker, A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change Political Guidelines for the next European Commission, 15 July 2014. Available at: http://ec.europa.eu/priorities/docs/pg_en.pdf
[5] "*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.*" Conclusions of the European Council of 27 June 2014. Available at: http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/143478.pdf
[6] See in particular the resolution from the European Parliament on "the European Semester for economic policy coordination: implementation of 2014 priorities" (A8-0019/2014) of 22 October 2014.
[7] For another example of an interpretative Communication, see Commission interpretative Communication on certain aspects of the provisions on televised advertising in the 'Television without frontiers' Directive, OJC 101, 28.4.2004, p. 2.

The credibility of the agreed rules is key for the sustainability of public finances and for financial stability in the euro area and in the EU as a whole. The financial and sovereign debt crisis of the past years has shown how interdependent European economies are and the necessity of strong economic and fiscal coordination in the EU. The existence and respect of the rules have been essential to restore trust and confidence. Faced with escalating deficits and debt in several countries just a few years ago, the EU has achieved considerable progress in improving the soundness of its public finances overall.

At the heart of the application of the Pact must be the principle of equal treatment of all Member States. The Pact is a rules-based system setting a framework shared and applied by all Member States, where the Commission proposes and the Council decides. Equal treatment, however, does not mean “one-size-fits-all” and must be combined with the economic assessment that is required by every situation. It is on purpose that the Pact envisages flexibility in the way its rules should be applied, both over time and across countries. It is also on purpose that some discretion is left, within the agreed rules, for the Commission and the Council to assess the soundness of public finances in the light of country-specific circumstances, in order to recommend the best course of action based on the latest developments and information.

The flexibility varies depending on whether a Member State is in the preventive or the corrective arm of the Pact. The preventive arm aims at guaranteeing a sound budgetary position in all Member States: its core is the attainment by each Member State of its medium-term sound budgetary position (so-called Medium-Term Objective or MTO), which is set according to commonly agreed principles.[8] This MTO is formulated in structural terms, which means that it is adjusted to take account of the economic cycle and corrected to exclude the impact of one-off measures, and is specific to each country. The underlying logic is that Member States should achieve and maintain a budgetary position that will allow automatic stabilisers to play their full role in mitigating possible economic shocks. This should also serve to bring down debt to prudent levels, by taking account of the demographic profile of each country and of the budgetary cost of ageing populations. The corrective arm of the Pact deals with situations in which the government deficit and/or the debt are above the reference values set in the Treaty: in these cases, Member States are then subject to an Excessive Deficit Procedure (“EDP”), which entails stricter conditions and monitoring.[9]

The guidance presented here focuses on the margin of interpretation which is left to the Commission, in line with the rules of the Pact, without modifying existing legislation. It clarifies how three specific policy dimensions can best be taken into account in applying the rules. These relate to: (i) investment, in particular as regards the establishment of a new European Fund for Strategic Investments as part of the Investment Plan for Europe; (ii) structural reforms; and (iii) cyclical conditions.

[8] The MTO is calculated as a function of potential growth, general government debt and the cost of ageing.
[9] There are currently 11 Member States in the corrective arm of the Pact ("in EDP"), down from 24 in 2011.

This interpretative Communication is a contribution to developing a more growth-friendly fiscal stance in the euro area.[10] It is also part of the Commission's efforts to reinforce the effectiveness and understanding of the – sometimes necessarily complex – rules which it is responsible for applying. Transparency and predictability are essential for ownership of the rules by all actors.

2. Clarifications regarding investment

2.1. The new European Fund for Strategic Investments

A central aspect of the Investment Plan for Europe proposed by the Commission is the establishment of a new European Fund for Strategic Investments (EFSI) in partnership between the Commission and the European Investment Bank (EIB). Following endorsement by the European Council on 18-19 December 2014, the Commission has presented a proposal for a Regulation on the EFSI.[11]

The Fund will offer a new risk-bearing capacity which will allow the EIB to invest in equity, subordinated debt and higher risk tranches of senior debt, and to provide credit enhancements to eligible projects. An initial contribution to this risk-bearing capacity will be made from the EU budget, in the form of a new guarantee fund, and from the EIB's own resources. The use of this EU guarantee and of EIB funds has no impact on the deficit or debt levels of Member States.

The capacity of the EFSI can be further increased through additional financial contributions from Member States. In its Investment Plan for Europe, the Commission announced its intention take a “favourable position towards (such) capital contributions to the Fund in the context of its assessment of public finances under the Pact”. The European Council of 18-19 December 2014 took note of this intention.[12]

In addition to contributing to the EFSI, Member States will have the possibility to co-finance individual projects also co-financed by it. This section provides guidance on how these various contributions will be assessed under the Pact.

[10] On this, see ECB President Mario Draghi's speech in Jackson Hole on 22 August 2014: "*[I]t may be useful to have a discussion on the overall fiscal stance of the euro area. Unlike in other major advanced economies, our fiscal stance is not based on a single budget voted for by a single parliament, but on the aggregation of eighteen [as of 1 January 2015: 19] national budgets and the EU budget. Stronger coordination among the different national fiscal stances should in principle allow us to achieve a more growth-friendly overall fiscal stance for the euro area.*"

[11] COM(2015) 10 of 13 January 2015.

[12] "*The European Council takes note of the favourable position the Commission has indicated towards such capital contributions in the context of the assessment of public finances under the Stability and Growth Pact, necessarily in line with the flexibility that is built into its existing rules*". Conclusions of the European Council of 18-19 December 2014 at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/146411.pdf

2.1.1. Financial contributions from Member States to the EFSI

Two aspects need to be distinguished here: i) whether these contributions are recorded statistically as deficit and/or debt, in line with the established definitions of the European System of Account (ESA); and ii) the way in which the Commission will take account of such contributions in its assessment of compliance with the Pact.

Statistical recording

As regards statistical recording, this will depend on the specific nature of the contributions and their categorisation by the European Statistical Office (Eurostat), in full respect of its independence. Annex 1 provides more information, based on concrete examples.

Application of the Pact

Legal Framework

The Pact provides that, in the assessment of the necessary fiscal adjustment under its preventive and corrective arms, the Council specifies targets which are set in "structural" terms.

Preventive arm

Article 5 of Regulation (EC) No 1466/97 provides that *"Based on assessments by the Commission and the Economic and Financial Committee, the Council shall […] assess […] whether the measures being taken or proposed [by the Member State][…] are sufficient to achieve the medium-term budgetary objective over the cycle. The Council and the Commission, when assessing the adjustment path toward the medium-term budgetary objective, shall examine if the Member State concerned pursues an appropriate annual improvement of its cyclically-adjusted budget balance, net of one-off and other temporary measures, required to meet its medium-term budgetary objective, with 0.5 % of GDP as a benchmark […]."*

Corrective arm

Article 3 of Regulation (EC) No 1467/97 provides that *"[…] the Commission, if it considers that an excessive deficit exists, shall address an opinion and a proposal to the Council [...] and shall inform the European Parliament thereof.*

The Council shall decide on the existence of an excessive deficit […]. When it decides that an excessive deficit exists, the Council shall at the same time make recommendations to the Member State concerned […].

The Council recommendation […] shall establish a maximum deadline of six months for effective action to be taken by the Member State concerned […]. The Council recommendation shall also establish a deadline for the correction of the excessive deficit, which shall be completed in the year following its identification unless there are special circumstances. In its recommendation, the Council shall request that the Member State achieve annual budgetary targets which, on the basis of the forecast underpinning the recommendation, are consistent with a minimum annual improvement of at least 0.5 % of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the *recommendation. […]"*

Without prejudice to the statistical recording by Eurostat of contributions to the EFSI, the Commission can already provide guidance on how the existing rules of the Pact will apply in these cases.
In its assessment of the necessary fiscal adjustment under the preventive and corrective arms, the Council specifies targets in structural terms. Such targets exclude exceptional one-off measures, which have no bearing on the underlying fiscal position. This would typically be the case for initial cash contributions to the Fund.[13]

Specifically, the Commission will consider that:

- Under the preventive arm of the Pact, neither the attainment of the MTO nor the required fiscal adjustment towards it would be affected, since both are set in structural terms. The structural balance is by definition not affected by one-off expenditures, such as the contributions to the Fund.

- Under the corrective arm of the Pact (the EDP), compliance with the fiscal adjustment effort recommended by the Council would not be affected, since this is also measured in structural terms. A contribution to the EFSI should therefore not lead to a Member State being found non-compliant with its EDP recommendation.

- In case of a non-respect of the deficit reference value, when preparing the report envisaged under Article 126(3) TFEU, the Commission will consider the contribution to the EFSI to be a "relevant factor" in line with Article 2(3) of Regulation (EC) No 1467/97. This means that an EDP will not be launched if this non-respect is due to the contribution, and if the excess over the reference value is small and is expected to be temporary.

- In case of a non-respect of the debt reference value, when preparing the report envisaged under Article 126(3) TFEU, the Commission will consider the contribution to the EFSI to be a "relevant factor" in line with Article 2(3) of Regulation (EC) No 1467/97. This means that an EDP will not be launched if the non-respect is due to the contribution.

<u>2.1.2. Co-financing by Member States of investment projects also co-financed by the EFSI</u>

The EFSI will contribute to a variety of investment projects and will serve to secure additional private and/or public investments for these projects. Co-financing by Member States of individual projects, including possible investment platforms, will typically take the form of innovative financial instruments, such as loans, debt instruments or equity participation. The statistical recording varies according to the instrument (see Annex 1).

[13] The same treatment will apply to guarantees to the extent they have an impact on deficit and/or debt.

From the point of view of the implementation of the Pact, the Commission will take into account national co-financing of investment projects also co-financed by the EFSI in the application of the so-called "investment clause" spelled out in Section 2.2 below.

Summary regarding the European Fund for Strategic Investments

National contributions to the EFSI will not be taken into account by the Commission when defining the fiscal adjustment under either the preventive or the corrective arm of the Pact.

In case of an excess over the deficit reference value, the Commission will not launch an EDP if this excess is only due to the contribution and is small and expected to be temporary. When assessing an excess over the debt reference value, contributions to the EFSI will not be taken into account by the Commission.

2.2 Other investments under the preventive arm of the Pact

Legal Framework

Article 5 of Regulation (EC) No 1466/97 provides that *"[…] the Council and the Commission shall take into account the implementation of major structural reforms which have direct long-term positive budgetary effects, including by raising potential sustainable growth […]."* This Article is reproduced in greater detail in the *Legal Framework* box in Section 3.1 below.

Under the preventive arm of the Pact, some investments deemed to be equivalent to major structural reforms may, under certain conditions, justify a temporary deviation from the MTO of the concerned Member State or from the adjustment path towards it.

The Commission has provided first guidance in the past on how these provisions apply to public investments with positive, direct and verifiable long-term budgetary effects on growth and on the sustainability of public finances.[14] This guidance (commonly referred to as the "investment clause") is specified and formalised through this Communication to take better account of country-specific situations, in line with the text and spirit of the Pact. Henceforth, a Member State will benefit from the "investment clause" if the following conditions are met:

(i) its GDP growth is negative or GDP remains well below its potential (resulting in a negative output gap greater than 1.5 % of GDP);

(ii) the deviation from the MTO or the agreed fiscal adjustment path towards it does not lead to an excess over the reference value of 3 % of GDP deficit and an appropriate safety margin is preserved;

[14] Letter of 3 July 2013 by former Commission Vice-President Olli Rehn to EU Finance Ministers on the implementation of Art. 5(1) of Regulation (EC) No 1466/97. This approach was applied in 2013 for Bulgaria and in 2014 for Bulgaria, Romania and Slovakia.

(iii) the deviation is linked to national expenditure on projects co-funded by the EU under the Structural and Cohesion policy,[15] Trans-European Networks and Connecting Europe Facility, and to national co-financing of investment projects also co-financed by the EFSI, which have direct long-term positive and verifiable budgetary effects;

(iv) co-financed expenditure should not substitute for nationally financed investments, so that total public investments are not decreased;

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

Compared to previous guidance, this means that the Commission will apply the "investment clause" irrespective of the economic condition of the euro area or EU as a whole, in order to link it only to the cyclical conditions faced by individual Member States. Allowing Member States to benefit from this clause when their own growth is negative, or output is well below its potential, will permit a broader application of the clause than in the past, and one which better reflects country-specific conditions.[16]

Summary for the "investment clause" under the preventive arm of the Pact

Member States in the preventive arm of the Pact can deviate temporarily from their MTO or adjustment path towards it to accommodate investment, provided that: their GDP growth is negative or GDP remains well below its potential; the deviation does not lead to an excess over the 3 % deficit reference value and an appropriate safety margin is preserved; investment levels are effectively increased as a result; the deviation is compensated within the timeframe of the Member State's Stability or Convergence Programme. Eligible investments are national expenditures on projects co-funded by the EU under the Structural and Cohesion policy, Trans-European Networks and the Connecting Europe Facility, as well as national co-financing of projects also co-financed by the European Fund for Strategic Investments.

3. Clarifications regarding structural reforms

3.1. Structural reforms under the preventive arm of the Pact

Legal Framework

Article 5 of Regulation (EC) No 1466/97 specifies how Member States should progress towards a sound budgetary position. In particular, it provides that "*[…] When defining the adjustment path to the medium-term budgetary objective for Member States that have not yet reached this objective, and in allowing a temporary deviation from this objective for Member States that have already reached it,*

[15] Including projects co-financed through the Youth Employment Initiative.
[16] See also Section 4 below.

provided that an appropriate safety margin with respect to the deficit reference value is preserved and that the budgetary position is expected to return to the medium-term budgetary objective within the programme period, the Council and the Commission shall take into account the implementation of major structural reforms which have direct long-term positive budgetary effects, including by raising potential sustainable growth, and therefore a verifiable impact on the long-term sustainability of public finances.

Particular attention shall be paid to pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar. Member States implementing such reforms shall be allowed to deviate from the adjustment path to their medium-term budgetary objective or from the objective itself, with the deviation reflecting the amount of the direct incremental impact of the reform on the general government balance, provided that an appropriate safety margin with respect to the deficit reference value is preserved."

Article 9 of the same Regulation provides for the same rule to apply to non-euro area Member States.

This section provides guidance on how structural reforms can be taken into account under the preventive arm of the Pact, i.e. the so-called "structural reform clause".[17]

In line with the existing rules of the Pact, Member States implementing major structural reforms are allowed to deviate temporarily from their 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.

"*Structural reforms*" *which can be taken into account under the Pact*

To be fully operational, the "structural reform clause" has to rely on well-defined principles regarding the eligibility of such reforms. The Commission will base its assessment on the following criteria:

(i) The reforms must be **major**. While there are some individual reforms with a major positive impact on growth and the long-term sustainability of public finances, such as pension reforms, well-designed and comprehensive packages of reforms addressing structural weaknesses may also have a major positive impact. This is notably the case when the reforms reinforce each other's impact through an appropriate choice of policy mix and sequencing of implementation.

(ii) The reforms must have direct **long-term positive budgetary effects**, including by raising potential sustainable growth, and therefore a verifiable impact on the long-term sustainability of public finances. The sustainability effects can stem either from direct budgetary savings from the reforms (such as in pensions or healthcare), or from the increased revenues drawn in the medium to long-run from a more efficient economy with a higher potential output (e.g.

[17] On this, see ECB President Mario Draghi's speech in Jackson Hole on 22 August 2014: "*[T]he existing flexibility within the rules could be used to better address the weak recovery and to make room for the cost of needed structural reforms.*"

due to lower structural unemployment or an increased labour force), or from a combination of both kinds of effects.[18]

(iii) The reforms must be **fully implemented**. While it is understood that all the reforms should be adopted before being considered as eligible for the clause, it is also true that the effective implementation of adopted reforms may take time and may be subject to delays and setbacks. This raises the question of introducing strong safeguards against the risk of implementation failures. While the Pact does not provide the tools for monitoring the enforcement of structural reforms, the legal framework in which the Pact operates – notably the European Semester process and the new Excessive Imbalances Procedure (EIP)[19] – allows the Commission and the Council to assess challenges and imbalances requiring structural reforms, and for monitoring action taken by the Member States.

Activation of the "*structural reform clause*"

The Commission will consider that the criterion related to the implementation of reforms is fulfilled *ex ante* when:

- The Member State presents a medium-term structural reform plan which is comprehensive and detailed (for instance as part of the National Reform Programme published alongside the Stability or Convergence Programme) and includes well-specified measures and credible timelines for their adoption and delivery. The implementation of the reforms will be monitored closely in the context of the European Semester.

- In the specific case of a Member State in the Excessive Imbalances Procedure (EIP), it has submitted a Corrective Action Plan (CAP) providing the necessary information. The implementation of the reforms will then be monitored through the EIP.

In both cases, Member States will be expected to provide in-depth and transparent documentation, and to quantify the reforms in terms of both their medium-term budgetary and potential growth impact. This must also include details on the timetable of implementation of the reforms.

Application of the "*structural reform clause*"

In the specific case of pension reforms consisting in introducing a multi-pillar system that includes a mandatory, fully-funded pillar, the methodology to allow them to be taken into account in the preventive arm of the Pact is outlined in Article 5 of Regulation (EC) No 1466/97 (see box at the beginning of this Section).[20]

For other structural reforms, the Commission will base itself on the information contained in the dedicated structural reform plan (or Corrective Action Plan). In this case, it will recommend granting eligible Member States additional time to reach the MTO, hence

[18] For a discussion of the effect of reforms, see European Economy, Economic Papers 541, December 2014: "The potential growth impact of structural reforms in the EU – a benchmarking exercise", published by the Directorate General for Economic and Financial Affairs, European Commission.
[19] See Regulation (EU) No 1176/2011.
[20] This methodology has been applied for instance to take account of the pension reform introduced in Latvia in 2013.

allowing temporary deviations from the structural adjustment path towards it, or to deviate temporarily from the MTO for Member States that have reached it, provided that:

(i) the reforms meet the above criteria;

(ii) the temporary deviation does not exceed 0.5 % of GDP, and the MTO is reached within the four year horizon of the Stability or Convergence Programme of the year in which the clause is activated;

(iii) an appropriate safety margin is continuously preserved so that the deviation from the MTO or the agreed fiscal adjustment path does not lead to an excess over the 3 % of GDP reference value for the deficit.

In case a Member State fails to implement the agreed reforms, the temporary deviation from the MTO, or from the adjustment path towards it, will no longer be considered as warranted. If such a failure results in a significant deviation from the MTO or the path towards it, the Commission will apply the procedure envisaged in Article 6(2) and Article 10(2) of Regulation (EC) No 1466/97. This means that the Commission will issue a warning to that Member State, followed by a proposal for a Council recommendation, to ensure that the Member State takes the appropriate policy measures within five months to address that deviation. For euro area Member States, continued failure to comply can ultimately lead to a requirement to lodge an interest-bearing deposit.[21]

Summary for the "structural reform clause" under the preventive arm of the Pact

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 verifiable direct long-term positive budgetary effects, including by raising potential sustainable growth, and (iii) are fully implemented.

For reform measures to qualify "ex ante", Member States will be expected to present a dedicated structural reform plan providing detailed and verifiable information, as well as credible timelines for adoption and delivery. The Commission will assess the relevant reform plan before recommending allowing a temporary deviation from the MTO or the path towards it. The Commission will closely monitor the implementation of the reforms. In case of failure to implement, the Commission will take the necessary action.

3.2 Structural reforms under the corrective arm of the Pact

Legal Framework

Article 2 of Regulation (EC) No 1467/97 provides that *"[…] The Commission, when preparing a*

[21] Article 4 of Regulation (EU) No 1173/2011.

report [requested] under Article 126(3) TFEU [i.e. when a Member State does not fulfil the requirements under the deficit or the debt criterion, or both], shall take into account all relevant factors as indicated in that Article, in so far as they significantly affect the assessment of compliance with the deficit and debt criteria by the Member State concerned. The report shall reflect, as appropriate: (a) the developments in the medium-term economic position […]; (b) the developments in the medium-term budgetary positions, including, in particular, the record of adjustment towards the medium-term budgetary objective, the level of the primary balance and developments in primary expenditure, both current and capital, the implementation of policies in the context of the prevention and correction of excessive macroeconomic imbalances, the implementation of policies in the context of the common growth strategy of the Union, and the overall quality of public finances, in particular the effectiveness of national budgetary frameworks; (c) the developments in the medium-term government debt position […].

The Commission shall give due and express consideration to any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess compliance with deficit and debt criteria and which the Member State has put forward to the Council and the Commission.[…]

The Council and the Commission shall make a balanced overall assessment of all the relevant factors [...]. When assessing compliance on the basis of the deficit criterion, if the ratio of the government debt to GDP exceeds the reference value, those factors shall be taken into account in the steps leading to the decision on the existence of an excessive deficit provided for in paragraphs 4, 5 and 6 of Article 126 TFEU only if the double condition of the overarching principle - that, before these relevant factors are taken into account, the general government deficit remains close to the reference value and its excess over the reference value is temporary - is fully met [...].

If the Council […] decides that an excessive deficit exists in a Member State, the Council and the Commission shall, in the subsequent procedural steps of that Article of the TFEU, take into account the relevant factors referred to in paragraph 3 of this Article [...], in particular in establishing a deadline for the correction of the excessive deficit and eventually extending that deadline.[…]"

The main purpose of the corrective arm of the Pact 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 Member State has taken effective action in response to the Council recommendations to correct the excessive deficit. However, structural reforms do have a recognised place in the corrective arm of the Pact when deciding different steps in the EDP.[22]

First, at the point of examining whether an EDP needs to be opened for a given Member State, the Commission analyses carefully all relevant medium-term developments regarding the economic, budgetary and debt positions. These "relevant factors" include the implementation of structural reforms in the context of the European Semester, such as within the Excessive Imbalances Procedure. The Commission considers that a lack of implementation of structural reforms constitutes an aggravating relevant factor.

[22] Moreover, when placed in an Excessive Deficit Procedure, all euro area Member States shall present an economic partnership programme describing the policy measures and structural reforms that are needed to ensure an effective and lasting correction of the excessive deficit. See Article 9 of Regulation (EU) No 473/2013.

Second, relevant factors are also taken into account when setting the deadline for the correction of the excessive deficit. While the correction of an excessive deficit is expected to take place within the year following its identification, the implementation of major structural reforms constitutes a key factor taken into account when considering instead a multiannual path for the correction of the excessive deficit.

To make operational this provision for reforms not yet fully implemented, the Commission will consider that they can be taken into account *ex ante*, provided that the Member State presents a dedicated structural reform plan, adopted by the government and/or the national Parliament, containing detailed and verifiable information, as well as credible timelines for implementation and delivery, under the same conditions as for the activation of the "structural reform clause" described in Section 3.1. This is without prejudice to the minimum annual improvement of 0.5 % of GDP as a benchmark envisaged by Article 3(4) of Regulation (EC) No 1467/97.
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.[23] For euro area Member States, this means that the Commission will recommend to the Council the imposition of a fine.[24]

Third, at the point of closing the EDP, the Commission gives due consideration, where relevant, to the direct cost of pension reforms introducing a multi-pillar system that includes a mandatory fully funded pillar. Concretely, an EDP may be closed even if the deficit is over 3 % of GDP, provided that the excess is wholly due to the costs of implementing the pension reform and the deficit has declined substantially and continuously and has reached a level that comes close to the reference value.

Summary for structural reforms under the corrective arm of the Pact

The Commission will take into account the existence of a dedicated structural reform plan, providing detailed and verifiable information, as well as credible timelines for adoption and delivery, when recommending a deadline for the correction of the excessive deficit or the length of any extension to that deadline. The Commission will closely monitor the implementation of the reforms. In case of failure to implement, the Commission will take the necessary action.

[23] Article 23 of Regulation (EU) No 1303/2013.
[24] Article 6 of Regulation (EU) No 1173/2011.

4. Clarifications regarding cyclical conditions

4.1 Modulation of fiscal effort over the economic cycle under the preventive arm of the Pact

Legal Framework

Article 5 of Regulation (EC) No 1466/97 specifies how the Member States should progress towards a sound budgetary position. In particular, Article 5 provides that *"[…] The Council and the Commission, when assessing the adjustment path toward the medium-term budgetary objective, shall examine if the Member State concerned pursues an appropriate annual improvement of its cyclically-adjusted budget balance, net of one-off and other temporary measures, required to meet its medium-term budgetary objective, with 0.5 % of GDP as a benchmark. For Member States faced with a debt level exceeding 60 % of GDP or with pronounced risks of overall debt sustainability, the Council and the Commission shall examine whether the annual improvement of the cyclically-adjusted budget balance, net of one-off and other temporary measures is higher than 0.5 % of GDP. The Council and the Commission shall take into account whether a higher adjustment effort is made in economic good times, whereas the effort might be more limited in economic bad times. In particular, revenue windfalls and shortfalls shall be taken into account.[…]"*

In order to assess the appropriate adjustment path for each Member State towards its respective MTO, the Pact requires that due consideration be given to the economic situation as well as the sustainability conditions. In principle, Member States not having yet reached their MTO are required, as a benchmark, to pursue an annual improvement in the structural budget balance of 0.5 % of GDP. The rules also provide that the Commission needs to take into account whether a higher adjustment effort is made in good economic times, whereas effort may be more limited in bad times.

The Commission has thus designed a matrix (see Annex 2) which clarifies and specifies the fiscal adjustment requirements under the preventive arm of the Pact. This matrix is symmetrical, differentiating between larger fiscal effort to be undertaken during better times and a smaller fiscal effort to be undertaken during difficult economic conditions. This should make it possible to better capture cyclical conditions. It should also smoothen the required fiscal effort over time and avoid unwarranted discontinuities as economic circumstances change.

<u>Summary for the modulation of effort over the economic cycle under the preventive arm</u>

From now on, the Commission will apply a matrix (set out in Annex 2) to specify the appropriate fiscal adjustment and take better account of the cyclical situation of individual Member States under the preventive arm of the Pact.

4.2 Accommodating an unexpected fall in economic activity under the corrective arm of the Pact

Legal Framework

The Pact caters for unexpected negative economic conditions at Member State level in the corrective arm of the Pact. Article 3 of Regulation (EC) No 1467/97 provides that the Council, if it considers that an excessive deficit exists, issues a recommendation for taking effective action and containing a deadline for correcting the excessive deficit and annual budgetary targets for the Member State. The Member State concerned has the obligation to take effective action to this purpose within the deadline set by the Council.

In particular, Article 3 of Regulation (EC) No 1467/97 provides that *"If effective action has been taken in compliance with a recommendation under Article 126(7) TFEU and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that recommendation, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 126(7) TFEU. The revised recommendation, taking into account the relevant factors referred to in Article 2(3) of this Regulation may, in particular, extend the deadline for the correction of the excessive deficit by one year as a rule. […]"*

Acknowledging the need to distinguish between fiscal consolidation actions and fiscal consolidation outcomes, with the latter often being influenced by developments outside the control of the authorities concerned, the rules envisage the possibility to take into account an unexpected deterioration of the economic situation.
If a country has taken effective action by delivering the structural fiscal effort recommended by the Council, it may be given additional time to correct the excessive nominal deficit without incurring financial sanctions (euro area Member States), or a suspension of commitments/payments of European Structural and Investment Funds (all Member States).[25]

The Commission has developed a systematic approach to assessing the delivery of the required structural fiscal effort, which the Council endorsed recently.[26] 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 attributable to an unexpected fall in economic activity.

<u>Summary for the accommodation of the economic cycle under the corrective arm</u>

The Commission will continue to assess effective action under the corrective arm of the Pact on the basis of a measurement of structural fiscal effort, excluding budgetary developments which are outside the control of governments.

[25] Article 23 of Regulation (EU) No 1303/2013.
[26] See conclusions of the 20 June 2014 ECOFIN Council at: http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/143293.pdf

4.3 Severe economic downturn in the euro area or in the Union as a whole

Legal Framework

The Pact caters for cases of unusually negative economic conditions at the EU or euro area level both in the preventive arm and in the corrective arm.

Preventive arm

As explained in the *Legal Framework* boxes in Sections 2.1.1, 3.1 and 4.1, the Council examines whether Member States in the preventive arm of the Pact take sufficient measures to achieve its medium-term budgetary objective over the cycle. In this context due account is taken of relevant factors and of structural reforms implemented. Moreover, Article 5 of Regulation (EC) No 1466/97 covers the case of negative, unusual economic conditions.

In particular, Article 5 provides that *"[…] in the case of an unusual event outside the control of the Member State concerned which has a major impact on the financial position of the general government or in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective referred to in the third subparagraph, provided that this does not endanger fiscal sustainability in the medium term. […]"*

Corrective arm

As explained in the *Legal Framework* boxes in Sections 2.1. and 4.2, Article 3 of Regulation (EC) No 1467/97 provides that the Council, if it considers that an excessive deficit exists, issues a recommendation for taking effective action and containing a deadline for correcting the excessive deficit and annual budgetary targets for the Member State. The Member State concerned has the obligation to take effective action to this purpose within the deadline set by the Council. Article 3 also caters for taking into account the possibility of unusually negative economic conditions.

In particular, Article 3 states that *"[…] In the case of a severe economic downturn in the euro area or in the Union as a whole, the Council may also decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 126(7) TFEU provided that this does not endanger fiscal sustainability in the medium term."*

Since 2011, the Pact has provided, in cases of a severe economic downturn in the euro area or the Union as a whole, for the pace of fiscal consolidation to be adapted for all Member States, as long as this does not endanger fiscal sustainability in the medium-term.

This provision has so far never been applied – although it *de facto* reflects the logic used at the time of the 2008 financial crisis when the adjustment paths were re-designed for several Member States. The activation of this provision would not mean putting on hold 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, to take into account the exceptional circumstances of the severe economic downturn in the euro area or the Union as a whole. The use of this provision should remain limited to exceptional, carefully circumscribed situations to minimise the risk of moral hazard.

<u>Summary in the case of severe economic downturn</u>

The Commission considers that the provisions of the Pact addressing a severe economic downturn in the euro area or in the EU as a whole should be used when necessary.

5. Conclusion

This interpretative Communication provides additional guidance on how the Commission will apply its margin of interpretation in implementing the existing rules of the Stability and Growth Pact.

The Commission will apply this guidance immediately. It will engage with Member States and the Council to provide any necessary explanations ahead of forthcoming milestones, notably the presentation of the Stability or Convergence Programmes and National Reform Programmes expected in spring 2015. The Commission will also present this Communication to the European Parliament.

This Communication gives clarity to Member States on how to ensure that the common fiscal framework is supportive of the EU's jobs and growth agenda, in particular as regards investment and structural reforms, while better reflecting the cyclical situations in individual Member States.

It does not replace the existing rules of the Pact, nor the need for an overall assessment by the Commission and the Council of the broader economic and fiscal situation of each Member State, the euro area and the EU as a whole, in line with the spirit of the Treaty and its overall objective of ensuring sound public finances. Moreover, adequate safeguards and conditions are in place to make sure that while the best use is made of the flexibility within the existing rules, their credibility and effectiveness in ensuring fiscal responsibility is maintained.

Over and above this Communication, the Commission will also engage with stakeholders at all levels to define further steps to ensure closer coordination of economic policy and progress towards the deepening of the Economic and Monetary Union.

As agreed by the European Council, the President of the Commission, in close cooperation with the President of the Euro Summit, the President of the Eurogroup and the President of the European Central Bank, will report on these matters to the June 2015 European Council.

As part of its Work Programme for 2015, [27] the Commission is also committed to developing proposals on further steps towards pooled sovereignty in economic governance.

[27] COM(2014) 910 of 16 December 2014.

ANNEX 1 - THE STATISTICAL RECORDING OF CONTRIBUTIONS IN RELATION TO THE EUROPEAN FUND FOR STRATEGIC INVESTMENTS

Below are some illustrative examples of how various types of contributions may be recorded from a statistical point of view by Eurostat. This statistical recording is a separate step and without prejudice to the Commission's assessment of such contributions under the relevant provisions of the Stability and Growth Pact.

Example 1. Member States' cash contributions at the level of the EFSI

Whether Member States' cash contributions to the EFSI have a statistical impact on their deficit cannot be established with full certainty until the detailed legal and governance arrangements of the Fund are in place. If a Member State does not have the funds available for such contributions and will borrow them, this will increase the government debt.

Example 2. Use of guarantees by the Member States at the level of the EFSI

In the case Member States provide guarantees to the EFSI, there should be no immediate impact on deficit or debt until the moment the guarantee is called, for the amount called, if it is called.

Example 3. Member States' co-financing to individual projects

Direct contributions from Member States to projects, including investment platforms, may take several forms, such as equity participation, loans, guarantees etc. The statistical recording will vary according to the form of the instrument:

- For guarantees, the statistical recording will follow the same principles as in example 2.
- For equity participation, this will depend on whether a market rate of return can be expected (similar to that of a private investor). If this is the case, it will not have an impact on the deficit. It may have an impact on debt levels if financed through government borrowing.
- For loans, this will not have an impact on the deficit unless there will be evidence that the loan will not be returned. It may have an impact on debt levels if financed through government borrowing.
- For grants, this will have a direct impact on the deficit and an indirect impact on the debt, if financed via government borrowing.
- If the Member States use resources from the European Structural and Investment Funds, the national co-financing part will have an impact on the deficit. It may have an impact on debt levels if financed through government borrowing. The European co-financing part is recorded as a financial transaction and thus has no impact on the accounts of governments.

Example 4. Contributions via National Promotional Banks

A Member State may consider contributions via a National Promotional Bank (NPB), both at the level of the EFSI and at the level of individual projects, including investment platforms. The impact will depend first and foremost on whether the National Promotional Banks are classified inside or outside government. If the banks are classified inside government, the impact will be exactly the same as if the government itself carries out the investment. If the banks are classified outside government, the recording will depend on whether the National Promotional Banks will be undertaking the investment or will contribute to the project on behalf of government. If it is concluded that this is the case, the operation will be counted as part of government accounts, which means that the money spent on behalf of the government will be treated as government expenditure, and the liabilities incurred for obtaining this money will be treated as government debt.

ANNEX 2 - 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.

Explanations:

The matrix ensures that Member States can adapt their fiscal adjustments over the economic cycle while taking into account their fiscal consolidation needs.

The larger the positive (negative) output gap, the greater (lower) the required adjustment effort. The matrix takes into account the direction into which the economy is moving, i.e. whether the economic situation is improving or deteriorating, by distinguishing whether the real GDP exceeds or falls short of a country-specific potential growth rate.

The required effort is also greater for Member States with unfavourable overall fiscal positions, i.e. where fiscal sustainability is at risk or the debt-to-GDP ratio is above the 60 % of GDP reference value of the Treaty.

All Member States are expected to accumulate savings in good times so as to be able to have sufficient latitude for the operation of the so-called automatic stabilisers (e.g. higher welfare spending and lower tax revenues) during the downturns. In good times, the revenues of the state increase due to more vigorous economic activity and expenditure related to the unemployment falls. Therefore, the matrix envisages a higher fiscal adjustment for the Member States identified as experiencing good times, i.e. when their output gap is estimated to be ≥ 1.5 %. This is particularly important for the Member States with fiscal sustainability risks or debt-to-GDP ratios exceeding the 60 % and therefore such Member States would be required to provide a structural fiscal adjustment of ≥ 0.75 % of GDP or ≥1 % of GDP, depending on whether their good economic situation continues to improve further or not.

In normal times, interpreted as an output gap between -1.5 % and +1.5 %, all 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, and a fiscal adjustment of zero would be temporarily allowed when their economies grow below the potential.

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.

The output gap thresholds set at -3 % and -4 % are supported by past data: since the 1980s, output gaps in EU countries have been below -4 % in only one year out of twenty, while they reached -3 % in one year out of ten, hence these two values are truly indicating very bad and exceptionally bad times.