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## **A stronger Preventive Arm of the Stability and Growth Pact – Realising the Medium Term Objectives**

### *Technical contribution to the Task Force on economic governance*

Experience has made evident that EU needs stronger economic policy coordination, notably a stronger implementation of the Stability and Growth Pact (SGP). Denmark welcomes the Commission communications on reinforced economic policy coordination and supports the orientations of the Task Force on economic governance as well as the broad thrust of the ideas brought forward by other Member States on reinforcing the fiscal policy framework. Focus should be on measures that can be implemented under the terms of the Lisbon Treaty. While supporting the overall direction in all areas of the work of the Task Force, Denmark hereby presents a technical contribution in the specific area of the SGP's preventive arm, notably the Medium-Term Objectives, which is found to be the key to a stronger fiscal policy framework for the European Union.

The Stability and Growth Pact has no doubt contributed to much sounder public finances since 1999 than probably would have been the case without the SGP. The root of today's public-finance challenges is a not lack of sound rules, but the fact that rules have not been implemented and enforced effectively. Accordingly, the challenge is not to fundamentally overhaul the rules, but to strengthen the implementation of the rules.

As a guiding principle, while there could be a need for specific provisions for the euro area, the work going forward should, however, seek not to widen the gap between rules applied to euro area Member States and non-participating Member States, given that rules and incentives for sound fiscal policy are relevant for all EU Member States.

#### **1. An "Excessive Deficit Procedure on the MTOs"**

One of the main problems regarding implementation of the SGP is Member States' lack of progress towards the Medium-Term Objectives (MTO) of structural budgets close to balance. Balanced budgets create the necessary room to accommodate economic downturns without excessive deficits and reduce public debt at a satisfactory pace and ensure rapid progress towards long-term fiscal sustainability. In particular, the main problem during the current crisis has not been the average fiscal expansions, but that expansions in many cases were based on starting points far from balance. The key to a stronger SGP is, therefore, initiatives that enhance incentives for stronger preventive efforts in fiscal policy.

This non-paper presents a concrete proposal on reinforcing the preventive arm of the SGP through the development of a procedure on MTO compliance. The idea is to have an “Excessive Deficit Procedure on the MTOs” that would improve incentives to consolidate public finances in economic good times and ensure progress towards the MTOs.

Deviations from the MTO and deviations from the SGP’s MTO adjustment path rules (the 0.5 % of GDP benchmark) should be based on overall assessments of the underlying fiscal positions, where the main indicator should be the structural balance (the commonly agreed EU method), while applying economic judgement. This would be in line with the methodology applied when assessing effective action in the Excessive Deficit Procedure. The overall assessment would take into account other indicators, including the direct revenue impact of discretionary measures (bottom-up) and analysis of level and change in the underlying fiscal position put forward by the Member State concerned.

The MTO deviation should be measured against the ‘minimum MTO’, i.e. the MTO that a Member State should have according to the agreed formula, in order not to discourage Member States from having MTOs more ambitious than their minimum MTOs.

An “Excessive Deficit Procedure on the MTOs” could be triggered in case of non-compliance with *two criteria* relating to the level and the change in the underlying fiscal position, notably the structural balance, compared to, respectively, the MTO and the MTO adjustment path:

<b>“Excessive Deficit Procedure on the Medium-Term Objectives (MTOs)”</b>			
<b>Criterion</b>	<b>Principle or ‘MTO rule’</b>	<b>Concrete proposal for a ‘trigger’</b>	<b>Example</b>
1	A Member State should avoid excessive deviations <b>from the MTO</b>	The structural balance is at least <b>2 % of GDP</b> lower than the MTO	A MS with MTO=0 and a structural deficit of e.g. 3 % of GDP will be subject to the procedure (even if criterion 2 is fulfilled)
2	A Member State not at its MTO should follow the benchmark <b>adjustment path towards the MTO</b>	The structural balance does not respect the MTO and is not strengthened by at least <b>0.5% of GDP</b> annually (more in good times ...)	A MS with MTO=0 and a structural deficit of e.g. 1.5 % of GDP that stays broadly constant will be subject to the procedure (even though criterion1 is fulfilled)

1: MTO means the ‘minimum MTO’ that the MS should have according to the MTO rules, and not the actual chosen MTO, in order not to create disincentives and prevent MS from choosing more ambitious MTOs.

2: All decisions are based on overall assessments on the basis of the structural balance (calculated according to the commonly agreed method) as the main indicator as well as other indicators and economic judgement.

Applying the concrete proposal on the two criteria to actual data, as shown in the annex, would imply that several countries would have been subject to the procedure at early stages due to criterion 1 and/or criterion 2, but the point is to prevent Member States from slipping into large structural deficits and especially avoid persistent deficits.

#### *Criterion 1: Avoiding excessive deviations from the MTO*

The idea is to strengthen incentives to avoid persistent and significant deviations from the MTO, e.g. avoiding deviations from the MTO exceeding 2 % of GDP. A breach of the criterion would open the MTO procedure implying recommendations (see section 2 on procedure) on the correction of the excessive structural deficit.

An MTO deviation of 2 % of GDP would imply a structural deficit of 2 % of GDP for a Member State with an MTO of ‘balance’, or at most a structural deficit of 3 % of GDP for euro area and ERMII Member States (that according to the SGP cannot have MTOs below -1 % of GDP). Such a structural deficit of 2-3 % of GDP would imply an actual deficit of around 1.5-2.5 % of GDP even in moderate good times (with an output gap of e.g. 1) and would with a high probability lead to an actual deficit above 3 % of GDP in bad times.

The choice of the trigger – e.g. 2 % of GDP – is necessarily somewhat arbitrary, but an MTO deviation of 2 % of GDP would imply that a Member State could reach an MTO of ‘balance’ or a small surplus within a “normal business cycle” of 5 years by respecting the 0.5 % of GDP benchmark adjustment path.

The annex (table 1) provides an example of how the criterion would have worked on the basis of the new minimum MTOs and EU Member States’ structural balances since 2003.

*Criterion 2: Respecting the 0.5 % benchmark adjustment path towards the MTO*

Past experience show that while many Member States avoided excessive actual deficits during good times, most Member States did not comply with their MTOs or did not achieve progress towards their MTOs in line with the SGP’s 0.5 % of GDP benchmark adjustment path. This, predictably, was leading to excessive deficits in subsequent bad times. Since the 2005 Reform of the SGP that introduced the adjustment path, there has been no substantial enforcement or peer pressure relating to the rule. Therefore, the “MTO Excessive Deficit Procedure” should be launched when the 0.5 % of GDP benchmark for strengthening the structural balance is not observed.

This trigger should not either be used in a mechanical way, but would have to be complemented with economic judgement. For instance, if a Member State has an MTO of ‘balance’, and a structural deficit that (in year t) equals 1.5 % of GDP and (in year t+1) stays constant at 1.5 % or improves marginally, but less than 0.5 % of GDP, according to the common structural balance method, a careful analysis would be made. If e.g. bottom-up measures of discretionary action indicate that the underlying fiscal position actually has been strengthened by around 0.5 % of GDP (but other factors had the effect that the structural balance improved by less), the MTO procedure would not be launched. If, on the other hand, bottom-up methods would confirm the structural balance method, the MTO procedure would be launched.

The annex (table 2) provides an example of how the criterion would have worked on the basis of the new minimum MTOs and EU Member States’ structural balances since 2003.

## **2. Procedural issues**

The procedural steps in an “Excessive Deficit Procedure on the MTOs” could – as in the Excessive Deficit Procedure – be initiated with the Commission issuing a report on non-compliance with the criteria (some sort of “Article 126.3 report”) including a draft “recommendation”. By including all Commission acts from the launch of the procedure to the Commission proposal for a Council “recommendation” in one document, the procedure could be relatively light and speedy compared to the Excessive Deficit Procedure.

The EFC would deliver its opinion and the Council would issue a “recommendation” with specific invitations regarding achievement of the MTO. The “recommendation” could include an annual structural effort (the 0.5 % of GDP benchmark or another adjustment path) and a deadline for achieving the MTO, aiming at getting close to or attaining the MTO before the next downturn. Furthermore, the “recommendation” could include invitations on structural reforms and a deadline for effective action to be taken, e.g. within 6 months following the Council “recommendation”.

The Member State concerned would then have to present a plan on “effective action” in order to achieve the MTO where details on medium-term plans, specific consolidation and reform measures, and commitments go beyond the current standards regarding MTOs in the Stability and Convergence programmes. The Commission would then present an assessment of the plan and the effective action taken, and if the Member State does not comply with the “recommendation”, the Council could issue a new Council “recommendation” with invitations for a stronger plan in order to achieve the MTO. Further steps in the procedure could imply steps in the new sanctions regime. The Commission should continue to monitor the compliance with the “recommendation” on a regular basis. Abrogation of the procedure would be based on compliance with criteria 1 and 2.

### **3. Legal aspects**

The legal basis for the “MTO Excessive Deficit Procedure” could be a revised or new regulation in the Stability and Growth Pact or TFEU Article 121 (4).

## Annex

The suggested trigger thresholds are based on a simple analysis of the structural balances in the EU countries since 2003. If a trigger of an MTO divergence larger than 2 % of GDP and a trigger related to the 0.5 % of GDP adjustment path is applied, a number of countries now facing significant challenges could have been subject to the procedure at an early stage.

**Table 0: The structural balances of the EU countries**

	2003	2004	2005	2006	2007	2008	2009	2010	MTO
BE	-1.0	-0.9	-1.0	-1.3	-1.3	-2.1	-3.9	-3.8	0.50
BG	-0.9	1.0	1.0	1.8	-1.5	0.0	-2.8	-1.1	-1.75
CZ	-5.5	-1.3	-2.7	-3.9	-2.9	-4.5	-5.4	-4.9	-1.00
DK	1.0	2.5	4.7	3.5	3.1	3.3	0.6	-2.7	-0.50
DE	-3.2	-3.0	-2.9	-2.2	-1.2	-1.1	-1.7	-3.6	-0.50
EE	2.4	1.6	0.2	-0.9	-1.1	-4.3	-0.6	-2.1	-1.00
IE	-0.2	2.1	1.2	2.1	-1.6	-7.0	-9.4	-9.3	-0.50
EL	-6.4	-8.0	-5.7	-5.2	-6.8	-8.7	-13.0	-8.5	0.75
ES	-0.1	-0.2	1.1	1.6	1.2	-4.1	-8.9	-7.8	-0.50
FR	-4.1	-3.8	-4.1	-3.2	-3.8	-3.8	-6.2	-6.2	-1.00
IT	-5.1	-4.7	-5.2	-4.0	-3.2	-3.5	-4.0	-3.7	-0.25
CY	-7.9	-4.9	-3.2	-1.3	2.5	-0.4	-5.8	-6.3	-0.25
LV	-1.3	-0.8	-1.7	-3.2	-4.5	-6.4	-6.9	-6.7	-1.00
LT	-1.8	-2.1	-1.8	-2.1	-3.1	-5.6	-7.1	-6.8	-1.00
LU	1.3	-0.9	-0.4	0.1	1.1	2.0	1.2	-1.4	1.50
HU	-6.7	-6.9	-8.9	-10.6	-5.5	-4.7	-2.2	-2.3	-1.25
MT	-6.4	-4.2	-3.9	-3.1	-3.1	-5.2	-3.8	-4.0	0.00
NL	-2.2	-1.1	0.2	0.3	-1.0	-0.5	-3.6	-4.9	-0.50
AT	-0.9	-3.1	-1.4	-1.9	-1.6	-1.7	-2.4	-3.6	-1.00
PL	-5.7	-5.9	-4.4	-4.0	-2.8	-4.6	-7.2	-6.3	-1.50
PT	-4.8	-4.9	-5.5	-3.7	-3.1	-3.8	-8.1	-7.7	-1.00
RO	-0.6	-1.8	-1.8	-3.5	-4.7	-7.7	-8.3	-7.1	-0.75
SI	-2.0	-1.6	-1.3	-2.6	-2.9	-4.8	-3.7	-4.4	0.75
SK	-1.5	-1.4	-1.8	-3.6	-3.7	-4.7	-6.6	-5.4	-1.00
FI	3.4	2.9	2.9	2.8	2.6	2.1	0.4	-1.3	-0.75
SE	0.2	0.2	1.3	0.3	1.6	1.1	1.9	-0.2	-1.00
UK	-3.2	-3.7	-4.0	-3.5	-3.9	-5.2	-9.5	-10.4	-1.25

Note: MTO is the minimum MTO with 33 % of the cost of ageing covered.

Source: Commission Forecasts 2005-2010.

**Table 1: Figures show structural balance deviations from minimum MTO**  
**Trigger 1 - Structural balance more than 2 % weaker than the minimum MTO**

	2003	2004	2005	2006	2007	2008	2009	2010
BE	-1.50	-1.40	-1.50	-1.80	-1.80	-2.60	-4.40	-4.30
BG	0.85	2.75	2.75	3.55	0.25	1.75	-1.05	0.65
CZ	-4.50	-0.30	-1.70	-2.90	-1.90	-3.50	-4.40	-3.90
DK	1.50	3.00	5.20	4.00	3.60	3.80	1.10	-2.20
DE	-2.70	-2.50	-2.40	-1.70	-0.70	-0.60	-1.20	-3.10
EE	3.40	2.60	1.20	0.10	-0.10	-3.30	0.40	-1.10
IE	0.30	2.60	1.70	2.60	-1.10	-6.50	-8.90	-8.80
EL	-7.15	-8.75	-6.45	-5.95	-7.55	-9.45	-13.75	-9.25
ES	0.40	0.30	1.60	2.10	1.70	-3.60	-8.40	-7.30
FR	-3.10	-2.80	-3.10	-2.20	-2.80	-2.80	-5.20	-5.20
IT	-4.85	-4.45	-4.95	-3.75	-2.95	-3.25	-3.75	-3.45
CY	-7.65	-4.65	-2.95	-1.05	2.75	-0.15	-5.55	-6.05
LV	-0.30	0.20	-0.70	-2.20	-3.50	-5.40	-5.90	-5.70
LT	-0.80	-1.10	-0.80	-1.10	-2.10	-4.60	-6.10	-5.80
LU	-0.20	-2.40	-1.90	-1.40	-0.40	0.50	-0.30	-2.90
HU	-5.45	-5.65	-7.65	-9.35	-4.25	-3.45	-0.95	-1.05
MT	-6.40	-4.20	-3.90	-3.10	-3.10	-5.20	-3.80	-4.00
NL	-1.70	-0.60	0.70	0.80	-0.50	0.00	-3.10	-4.40
AT	0.10	-2.10	-0.40	-0.90	-0.60	-0.70	-1.40	-2.60
PL	-4.20	-4.40	-2.90	-2.50	-1.30	-3.10	-5.70	-4.80
PT	-3.80	-3.90	-4.50	-2.70	-2.10	-2.80	-7.10	-6.70
RO	0.15	-1.05	-1.05	-2.75	-3.95	-6.95	-7.55	-6.35
SI	-2.75	-2.35	-2.05	-3.35	-3.65	-5.55	-4.45	-5.15
SK	-0.50	-0.40	-0.80	-2.60	-2.70	-3.70	-5.60	-4.40
FI	4.15	3.65	3.65	3.55	3.35	2.85	1.15	-0.55
SE	1.20	1.20	2.30	1.30	2.60	2.10	2.90	0.80
UK	-1.95	-2.45	-2.75	-2.25	-2.65	-3.95	-8.25	-9.15

Note: Red coloured cells indicate that the structural balance is at least 2 % weaker than the minimum MTO and that the MS is therefore captured by trigger 1.

Source: Commission forecasts 2005-2010.

**Table 2: Figures show structural balance changes**  
**Trigger 2 - Structural balance weaker than the minimum MTO combined with an improvement in the structural balance less than 0.5 % in the given year**

	2004	2005	2006	2007	2008	2009	2010
BE	0.10	-0.10	-0.30	0.00	-0.80	-1.80	0.10
BG	1.90	0.00	0.80	-3.30	1.50	-2.80	1.70
CZ	4.20	-1.40	-1.20	1.00	-1.60	-0.90	0.50
DK	1.50	2.20	-1.20	-0.40	0.20	-2.70	-3.30
DE	0.20	0.10	0.70	1.00	0.10	-0.60	-1.90
EE	-0.80	-1.40	-1.10	-0.20	-3.20	3.70	-1.50
IE	2.30	-0.90	0.90	-3.70	-5.40	-2.40	0.10
EL	-1.60	2.30	0.50	-1.60	-1.90	-4.30	4.50
ES	-0.10	1.30	0.50	-0.40	-5.30	-4.80	1.10
FR	0.30	-0.30	0.90	-0.60	0.00	-2.40	0.00
IT	0.40	-0.50	1.20	0.80	-0.30	-0.50	0.30
CY	3.00	1.70	1.90	3.80	-2.90	-5.40	-0.50
LV	0.50	-0.90	-1.50	-1.30	-1.90	-0.50	0.20
LT	-0.30	0.30	-0.30	-1.00	-2.50	-1.50	0.30
LU	-2.20	0.50	0.50	1.00	0.90	-0.80	-2.60
HU	-0.20	-2.00	-1.70	5.10	0.80	2.50	-0.10
MT	2.20	0.30	0.80	0.00	-2.10	1.40	-0.20
NL	1.10	1.30	0.10	-1.30	0.50	-3.10	-1.30
AT	-2.20	1.70	-0.50	0.30	-0.10	-0.70	-1.20
PL	-0.20	1.50	0.40	1.20	-1.80	-2.60	0.90
PT	-0.10	-0.60	1.80	0.60	-0.70	-4.30	0.40
RO	-1.20	0.00	-1.70	-1.20	-3.00	-0.60	1.20
SI	0.40	0.30	-1.30	-0.30	-1.90	1.10	-0.70
SK	0.10	-0.40	-1.80	-0.10	-1.00	-1.90	1.20
FI	-0.50	0.00	-0.10	-0.20	-0.50	-1.70	-1.70
SE	0.00	1.10	-1.00	1.30	-0.50	0.80	-2.10
UK	-0.50	-0.30	0.50	-0.40	-1.30	-4.30	-0.90

Note: Turquoise coloured cells indicate that the structural balance is weaker than the minimum MTO and the annual structural improvement less than 0.5 %.

Source: Commission forecasts 2005-2010.



Table 3: Combination of trigger 1 and 2

	2003	2004	2005	2006	2007	2008	2009	2010
BE		Turquoise	Turquoise	Turquoise	Turquoise	Turquoise	Turquoise	Turquoise
BG							Turquoise	
CZ	Red		Turquoise	Striped		Striped		Red
DK								Striped
DE	Red	Striped	Striped			Turquoise		
EE					Turquoise	Striped		Turquoise
IE						Striped	Striped	
EL	Red	Striped	Red	Red	Striped	Striped	Striped	Red
ES								Red
FR	Red	Striped	Striped	Red				
IT	Red	Red	Red	Red	Red			
CY	Red	Red	Red			Turquoise		
LV			Turquoise	Striped	Striped	Striped	Striped	Striped
LT		Turquoise	Turquoise	Turquoise				
LU		Striped					Turquoise	
HU	Red	Striped	Striped	Striped	Red	Red	Red	Turquoise
MT	Red	Red	Striped	Red	Striped	Striped	Red	Striped
NL					Turquoise			
AT		Striped		Turquoise	Turquoise	Turquoise	Turquoise	Striped
PL	Red	Striped	Red	Striped		Striped	Striped	Red
PT	Red	Striped	Striped	Red	Red	Striped	Striped	Striped
RO		Turquoise	Turquoise	Striped	Striped	Striped	Striped	Red
SI	Red	Striped	Striped	Striped	Striped	Striped	Red	Striped
SK		Turquoise	Turquoise	Striped	Striped	Striped	Striped	Red
FI								Turquoise
SE								
UK		Striped	Striped	Red	Striped	Striped	Striped	Striped

Note: Red coloured cells indicate that the MS is solely captured by trigger 1, turquoise coloured cells indicate that the MS is solely captured by trigger 2 and red and turquoise striped cells indicate that the MS is captured by both trigger 1 and 2.