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From:	General Secretariat of the Council
To:	Permanent Representatives Committee/Council
Subject:	Assessment of Effective Action under the Excessive Deficit Procedure

Delegations will find attached the revised version of ST 10945/14 INIT.



ECONOMIC AND FINANCIAL COMMITTEE

THE SECRETARIAT

Brussels, 12 June 2014
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NON-TECHNICAL SUMMARY OF ASSESSMENT OF EFFECTIVE ACTION UNDER THE EXCESSIVE DEFICIT PROCEDURE

(Note for the ECOFIN)

1. INTRODUCTION

Under the Excessive Deficit Procedure (EDP), the Council makes recommendations to Member States whose General Government deficit exceeds 3% of GDP or whose General Government debt is higher than 60% of GDP and not decreasing at a sufficient pace, with a view to correcting the excessive deficit.

The Economic and Financial Committee has reviewed the tools and methods which the Commission uses when assessing whether a Member State in EDP has complied with these Council recommendations. The methodology, including certain refinements to the existing methodology, is specified in the attached background document¹. One of the main improvements brought about by this exercise was the enhancement of transparency. To this end all relevant data, including data about the yields of discretionary fiscal measures, used by the Commission will be shared with the Member States in a timely manner, enabling them to replicate the calculation underlying the Commission's assessments and recommendations in the context of the EDP.

This note provides a non-technical summary of the methodology. It is meant to highlight the main elements of the Commission assessment.

2. COMPLIANCE WITH THE EDP RECOMMENDATION²

The 2005 reform of the SGP recognised that Member States taking policy measures designed to bring their deficit back below 3% of GDP may struggle to meet the headline fiscal targets as given by Council Recommendations if economic circumstances were worse than anticipated, or conversely, have an easier time to meet them when the circumstances turn out better than expected. In cases where the nominal targets have not been met, we need to assess whether a Member State had taken sufficient policy measures to meet its obligations, or whether the failure was due to insufficient action. This concept is known as the *assessment of effective action* and is important as it will essentially determine whether an EDP will be stepped-up.

The structural budget balance was introduced as a measure of the action taken by a Member State. The structural balance attempts to remove the changes in a budget balance that are due to the movements of the economic cycle and one-off measures, revealing the underlying budgetary position. Hence, changes in the structural balance better reflect, in principle, policy actions, not economic circumstances.

When assessing the efforts of a Member State to correct its excessive deficit, the Commission examines both the changes in the headline deficit and the structural balance against the annual (intermediary) targets that are set in the EDP recommendation.

¹ 'Improving the Assessment of effective action in the context of the excessive deficit procedure – A specification of the methodology' (ecfin.cef.cpe(2014)1736337).

² See section 1 (page 4) of the background note.

3. THE STRUCTURAL BALANCE AND THE 'TOP-DOWN' AND 'BOTTOM UP' APPROACH

A sanctions-based system would be difficult to credibly implement if Member States were penalised for factors that are beyond their control. Therefore the change in the structural balance needs to be further analysed to see whether such factors play a role. Two tools have been developed to show the effective policy efforts taken by a Member State. These are the 'top-down' and 'bottom-up' approaches.

Top-Down Assessment of Effective Action³

While the estimation of changes in the structural balance is intended to help identify genuine fiscal policy efforts on the part of Member States, its measurement is not problem-free. The purpose of the top down approach is to correct differential growth and revenue outturns relative to expectations at the time of Recommendation.

First, potential GDP growth may turn out lower or higher than foreseen in the forecast underlying the Council Recommendations for correcting the excessive deficit. As a result, the observed change in the structural balance will then be affected in the same direction, for a given level of the "real" policy action. Consequently, in cases of negative growth surprises, the Commission adjusts upward the observed change in the structural balance, and vice versa for positive growth surprises.

Second, there may be unexpected changes in revenues. Revenues can turn out higher or lower than could be foreseen based on economic growth developments. The Commission forecasts underlying the Council Recommendations are based on projections for revenue developments that assume a certain relationship between revenues and growth, i.e. the elasticity of revenues to growth. However, these elasticities can vary over time, and can also change when the composition of growth changes. For instance, if growth turns out to be fuelled more by domestic demand than was expected, a revenue windfall is likely to occur. The change in the structural balance is therefore also adjusted for such windfalls or shortfalls in revenue compared to what was expected at the time of the Council Recommendations. In exceptional cases, the change in the structural balance is also adjusted to take account of large-scale unexpected events requiring a budgetary response, such as natural disasters.

Bottom-Up Assessment of Effective Action⁴

While the top-down approach takes the change in the structural balance as a starting point, the bottom-up approach revolves around the actual fiscal policy measures the Member State has taken. This is done by estimating the budgetary impact of (new) measures the Member State has

³ See section 3 (page 9) of the background note.

⁴ See section 4 (page 12) of the background note.

introduced to raise revenue⁵ and the savings it has made on public expenditure since the Recommendations was issued. The total revenue package is measured by adding up all the individual revenue measures. The expenditure savings are measured by estimating the impact of the measures on total expenditure (excluding expenditures which are not under the control of the government, in particular the changes in interest expenditure, expenditures linked to cyclical unemployment and public investment matched by EU funds) in the no-policy change scenario, i.e. the expenditure impact in case no additional policy measures had been taken.

4. THE STEPS OF THE ASSESSMENT OF EFFECTIVE ACTION⁶

For the assessment of effective action, a decision-tree sets out the order of logical and procedural steps (see annex for a schematic overview). First, the changes in the nominal and structural balances are assessed. When a Member State achieves both its headline deficit target and the recommended improvement in the structural balance, the Member State is considered to have delivered effective action and the EDP is put into abeyance – meaning it is put on hold until the excessive deficit is eventually corrected, as long as it continues to comply with the headline and structural targets. When this is not achieved, the Commission engages in a more detailed examination, known as a careful analysis, based on (i) the 'top-down' approach, which is used to gauge the corrected change of the structural fiscal balance (S^*), and (ii) the 'bottom-up' approach, which is an instrument evaluating the effect of concrete fiscal measures (FE).

In the case where both approaches indicate that the Member State delivered the required policy effort, there is a presumption that effective action has been taken. Conversely, if both the top-down and bottom-up approaches indicate that the policy effort was insufficient, then there is a presumption of non-delivery of effective action. In the case where the top-down and bottom-up approaches come to different conclusions there is no prior presumption. In case of unexpected revenue shortfalls due to forecasting errors of the budgetary impact of (new) revenue measures, the estimates of their budgetary impact as well as the adequacy of their implementation will be assessed and taken into account in the conclusions of the careful analysis. Moreover, to enhance the quality of the revenue measures' budgetary impact estimates, the National Fiscal Councils are invited to conduct and send their estimates – when available- to the Commission.

The Commission uses qualitative economic judgement in making its final assessment where relevant, in particular where the top-down and bottom-up approaches come to different conclusions, as part of the “careful analysis” which the Commission uses to determine whether the Member State concerned has delivered or not on its policy commitments. In case the Commission concludes, on the basis of the careful analysis, that the policy commitments have not been delivered, then the procedure will be stepped-up.

⁵ Prudent revenue estimates by the Commission are key in this context.

⁶ See section 2 (page 6) of the background note.

For legal reasons, a deficit-based EDP cannot be stepped up if the Member State achieves its intermediate headline deficit target, even when the recommended change in the structural balance is not achieved. At the same time, though, a careful analysis should still be conducted to better understand the nature of the underlying budgetary developments. The decision tree is used to illustrate the procedural steps undertaken.

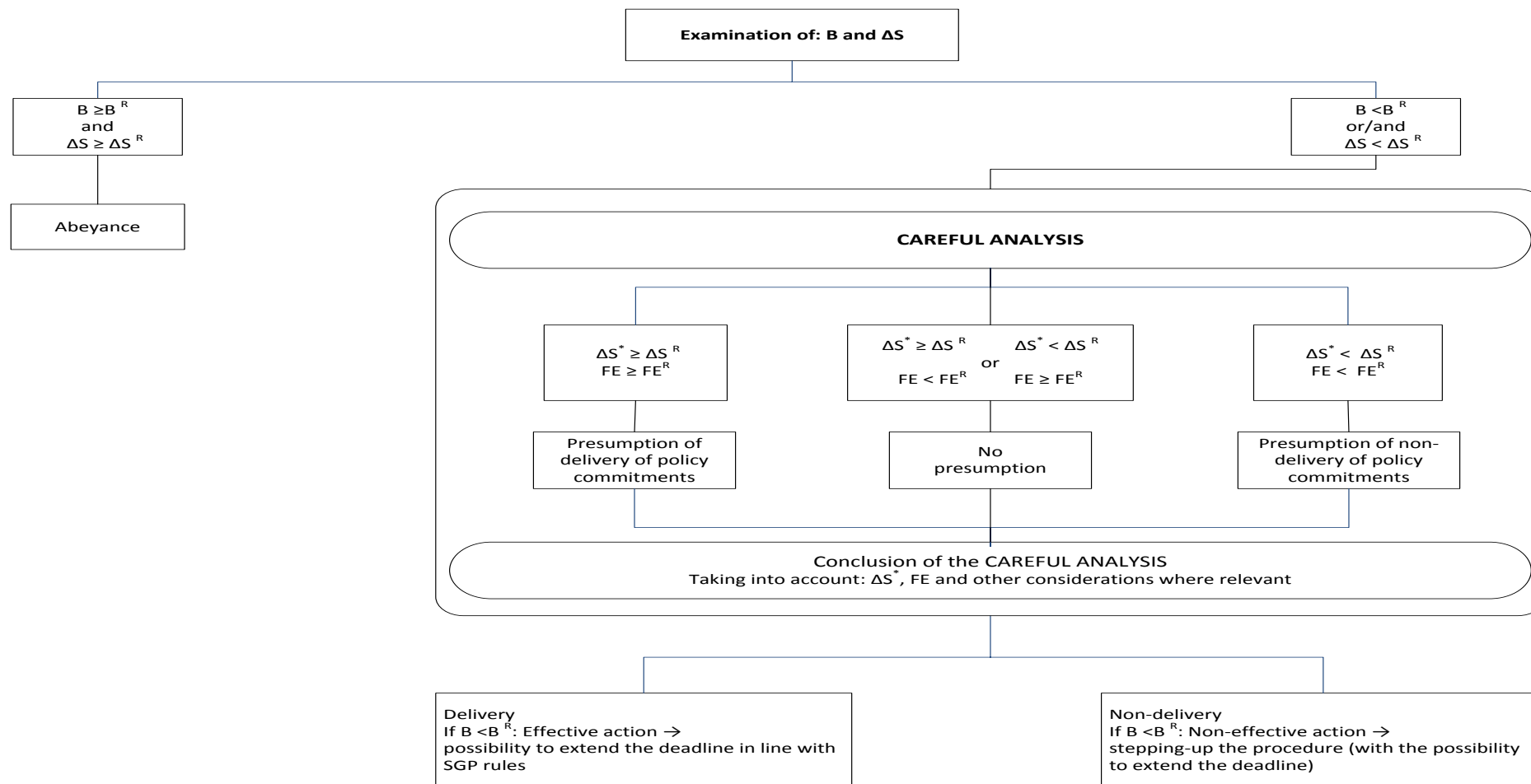
An effective action assessment based only on a forecast showing compliance with nominal targets in real-time should be considered as preliminary and needs to be reassessed based on actual outcomes. If ex-post the reassessment of effective action based on notified data points to non-compliance with the headline deficit target in addition to insufficient structural effort, the procedure could be stepped-up.

With respect to multi-annual EDPs it was considered more appropriate to assess the fiscal policy effort over the entire correction period. In this way, a Member State cannot be unduly punished for a front-loaded effort. At the same time, it ensures that a Member State meeting its nominal target in the first year without delivering the recommended annual fiscal policy effort would only be found compliant with the recommendation in the later years if it delivers the cumulative fiscal effort over the correction period concerned, in case the nominal deficit falls short of the targets later on.

5. CONCLUSIONS

The methodology as summarised above and as described in detail in the attached note will from now on be used by the Commission when assessing effective action in the context of the Excessive Deficit Procedure.

ANNEX: Decision-Tree Used for Assessing Effective Action



Definitions

Observed Budget balance (deficit) = B

Recommended Budget balance (deficit) = B^R

Top-down approach:

Required change in the structural budget balance = ΔS^R

Observed change in the structural budget balance = ΔS

Corrected observed change in the structural budget balance = ΔS^*

Bottom-up approach:

Required new fiscal measures = FE^R

Observed budget impact of the new measures implemented = FE