European governance framework for public finances : presentation and evaluation

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Introduction

In contrast to monetary policy, the fiscal policy of the euro area countries has remained a national competence. Since it is important that countries taking part in a monetary union should aim at fiscal discipline, the Maastricht Treaty and the Stability and Growth Pact made provision for establishing a European governance framework for public finances, accompanied by binding fiscal rules. That framework is one of the cornerstones of Economic and Monetary Union, and it is vital that Member States comply with the rules for that union to work well.

This article discusses the European governance framework for public finances and subjects it to a critical appraisal. Section 1 looks at the importance of fiscal rules in general, and in a monetary union in particular. Section 2 outlines the main stages in the creation of the European budgetary framework. Section 3 describes the current framework. Section 4 details the way in which the European budgetary framework has been applied in recent times. Section 5 presents an appraisal. The article ends with a number of conclusions.

1. Importance of fiscal rules, particularly in a monetary union

1.1 Usefulness of fiscal rules

The sound management of public finances is one of the essential preconditions for price stability and vigorous, sustainable growth conducive to employment. Experience has also shown how much damage an economy can suffer from a lack of fiscal discipline. In addition, it is generally recognised that a good budgetary framework comprising a set of procedures, institutions and fiscal rules can do much to promote a sound fiscal policy.

Fiscal rules impose restrictions on fiscal policy and can avert the tendency to deficit bias, i.e. the propensity for the democratic decision-making process to encourage deviations from what is regarded as good fiscal policy from the macroeconomic point of view. Thus, in recent decades, the governments of many countries have often allowed their expenditure to grow faster than their revenue – even in times of economic prosperity – resulting in ballooning budget deficits and soaring debt ratios. One reason for this tendency towards inadequate fiscal discipline is short-termism on the part of populations and politicians, as people seem to focus mainly on the short-term benefits of tax cuts or spending increases without being aware of the possible adverse consequences of an expansionary fiscal policy in the longer term. Politicians tend to exploit this in order to boost their chances of

re-election. Moreover, they may deliberately opt to favour current generations and shift the debt burden onto future generations. Another explanation for the deficit bias is what is known in game theory as the common pool problem. In regard to fiscal policy, this means that each 'player' or interest group pursues its own interests without taking account of the general budgetary restrictions. This common pool problem is sometimes linked to coalition governments.

In principle, financial markets can discourage an inappropriate fiscal policy – and hence reduce the need for fiscal rules – by incorporating a higher risk premium in interest rates for governments with looming budgetary problems. However, this disciplinary mechanism does not always work perfectly, as was evident in retrospect from the period preceding the eruption of the financial crisis in 2008.

In a monetary union where fiscal policy is fragmented, the arguments in favour of strict fiscal rules are even stronger, because in such a union an irresponsible fiscal policy on the part of one or more governments can have undesirable spillover effects, either between the countries forming part of the monetary union or between fiscal and monetary policy. Inefficient fiscal discipline can also pose a threat for financial stability. To minimise such contamination effects, the institutional architecture of a monetary union in which fiscal policies are fragmented therefore ought not only to provide the

Box 1 – Criteria for fiscal rules

Fiscal rules lay down targets or limits for key aggregates in public finances, such as the budget balance, public revenue and public expenditure, and the debt level. In the literature, there is a broad consensus on a number of requirements which must be met if fiscal rules are to operate successfully. There are frequent references to the criteria put forward by Kopits and Symansky (1998), who considered that the ideal fiscal rule should have the following characteristics: it should be clearly defined, transparent, relevant, consistent, simple, flexible, enforceable and efficient. These requirements are briefly explained below.

A fiscal rule must be clearly defined and transparent, i.e. its scope must be clearly specified and impossible to circumvent. It must also form the subject of clear reporting based on statistical conventions. The general government budget balance derived from the national accounts, which is the main fiscal target in Belgium as in other EU Member States, is an indicator that largely conforms to these principles. That is undoubtedly connected with the reference to this general government accounts aggregate in the Maastricht Treaty. Eurostat has developed case-law aimed at ensuring that these accounts reflect the economic reality as closely as possible.

A fiscal rule must also be relevant to the aim in view. This means that the rule must concern the budgetary outcomes *ex post*. Ideally, a fiscal rule should aim at the long-term sustainability of public finances, but it also has an economic stabilisation function in the short term. That aspect is important in a monetary union where the fiscal rules can thus prevent any excess burden on monetary policy.

A good fiscal rule must be consistent with other fiscal rules and with other policy objectives.

It should also preferably be simple so that it resonates with the political decision-makers and the general public, thus increasing its impact.

A fiscal rule must also be flexible. This means that its implementation should take account of unforeseen circumstances such as changes in the economic situation. Obviously, economic growth and its chief components may have a considerable influence on some aggregates, such as the general government budget balance. In order to neutralise the impact of the business cycle, fiscal targets are therefore commonly formulated on the basis of structural budget balances, from which the influence of cyclical and one-off factors is excluded. In that connection, it is usual to resort to a measure of the output gap, which indicates the difference between actual and potential economic activity.

Another feature of an ideal fiscal rule is that it should be enforceable, which implies that sanctions can be imposed in the event of failure to respect the rule. It is not absolutely necessary to have a formal system of sanctions; reputational damage may also be regarded as a sanction. Obviously, the tougher the sanction and the stricter its application, the greater the incentive to respect the fiscal rule.

Finally, a fiscal rule must be efficient in the sense that it leads to the implementation of the desired fiscal policy and the adoption of any structural measures necessary for that purpose. In addition, the criterion to which the rule relates must never be biased. On this subject, the specialist literature refers to Goodhart's law which states that a statistical indicator ceases to be useful once it becomes a policy instrument. In other words, once a criterion becomes a policy target, it is no longer a good indicator.

However, it should be noted that a rule cannot easily combine all these features. Thus, if a rule is made more flexible, it becomes less simple. Moreover, a simple rule which makes no distinction between the policy actually pursued and the fiscal impact of events which are beyond the government's direct sphere of influence is liable to be difficult to enforce. In addition, it is not easy to define simple, transparent rules to optimise the favourable effect that government measures have on growth. Fiscal rules are therefore inevitably the outcome of an imperfect compromise between all the various requirements mentioned above.

necessary guarantees ensuring that the central bank is independent and governments are not responsible for other governments' debts ('no-bail-out' clause), but should also lay down strict rules ensuring adequate fiscal discipline.

1.2 The position of fiscal rules in the European policy framework

European Monetary Union entailed the creation of a unique institutional structure in which monetary policy was unified while fiscal and structural policy remained largely decentralised. While historical proposals had aimed at more centralised economic coordination, there was insufficient political will to transfer these important powers to European level in the 1990s. In the absence of a form of economic government at European level, the coordination of fiscal policy and surveillance of public finances were laid down in binding rules to ensure the sustainability of public finances, namely in the articles of the EU Treaty concerning the need to avoid excessive deficits and the associated excessive deficit procedure (EDP)[1], and in the Stability and Growth Pact. This is a "hard" form of coordination since there are rules and a system of sanctions for non-compliance.

One of the lessons of the economic and financial crisis was that the European policy framework needed adjustment, as the existing framework had not adequately detected and addressed the macroeconomic and financial imbalances. Following the crisis, there were therefore various initiatives aimed at strengthening coordination and surveillance procedures. Thus, financial policy became more centralised with the creation of the banking union. That union will be based on three pillars, namely a single supervisory mechanism, a single resolution mechanism and a common deposit guarantee scheme, the aim being to safeguard the stability of the financial system. In addition, the coordination of macroeconomic policy was stepped up, e.g. by the macroeconomic imbalance procedure. That procedure concerns the identification, prevention and correction of macroeconomic imbalances and a system of sanctions. As in the case of fiscal policy, this constitutes a form of "hard" coordination. Conversely, in regard to structural economic policy, there is only provision for a "soft" form of coordination, without binding rules. This coordination is organised within the framework of the broad economic policy guidelines and the guidelines for employment, which are amalgamated into the integrated guidelines.

It should be noted that this article focuses on the European fiscal rules aimed at budgetary discipline. Those rules make no provision for extensive coordination of fiscal policy. Under the macroeconomic imbalance procedure, it is possible to make fiscal policy recommendations, but that aspect is not examined in detail here. Nor does the article consider the mechanisms for supporting Member States facing problems in financing their public debt on the financial markets.

(1) In this context, the term "excessive deficit" concerns both non-compliance with the budget deficit criterion and non-compliance with the debt criterion.

TABLE 1 OVERVIEW OF THE EUROPEAN POLICY FRAMEWORK

Sphere	Level	Instrument	Characteristics
Monetary	Common	ECB/ESCB	Aims at price stability
Financial	Common	Banking union: Single supervisory mechanism Single resolution mechanism (1) Proposal for a common deposit guarantee scheme (2)	Guarantees the stability of the financial system
Macroeconomic	National	*Hard coordination:* legislative framework and sanctions	Coordination of economic policy (3) (macroeconomic imbalance procedure)
Structural	National	*Soft coordination:* recommendations	Coordination of structural policy (based on integrated guidelines) (3) (4)
Fiscal	National	*Hard coordination:* legislative framework and sanctions	Aims at fiscal discipline (3) (Stability and Growth Pact and excessive deficit procedure)

Source: NBB.
(1) Composed of a European resolution authority – the Single Resolution Board – which started on 1 January 2015, and a Single Resolution Fund which is scheduled for inauguration on 1 January 2016.
(2) So far, progress towards the common deposit guarantee scheme has been confined to harmonisation of the national systems covering bank deposits up to a total of € 100 000.
(3) Integrated into the European Semester.
(4) Comes under "hard" coordination in the event of exceptional imbalances.

2. Creation and development of the European governance framework for public finances

In the beginning, the European governance framework for public finances was simple, but it has undergone regular adjustments over the years. Sometimes it was made more flexible while at other times it was tightened up, according to the available scope for discretionary decisions on the application of the framework. As a result of these successive reforms, the framework has been broadened and made "smarter", but it has also become far more complex. The main adjustments made since the establishment of the first fiscal rules under the Maastricht Treaty are set out below.

2.1 Maastricht Treaty

The basis for the current European governance framework for public finances was laid down by the Maastricht Treaty (officially called the Treaty on European Union), signed on 7 February 1992, which provided for the creation of a currency union in Europe by the end of the 1990s. The Treaty incorporated a number of safety mechanisms designed to prevent wasteful budgeting and ensure fiscal discipline: a ban on central banks providing monetary financing for governments, a ban on preferential public sector access to financial institutions, a no-bail-out clause and the requirement to avoid any excessive public deficit or excessive public debt.

Countries wishing to join the currency union had to meet a number of macroeconomic criteria – known as the "convergence criteria" – among other things in regard to public finances. For instance, the budget deficit must not in principle exceed 3 % of GDP, while the public debt may not be more than 60 % of GDP, unless the debt ratio is diminishing sufficiently and approaching that reference value at a satisfactory pace. The Treaty also linked a correction mechanism to these criteria: the "excessive deficit procedure" (EDP), aimed at guaranteeing the maintenance of fiscal discipline after the creation of the currency union. Failure to respect the criteria triggered implementation of a corrective procedure whereby, on a proposal from the European Commission (EC), the Ecofin Council could decide that the deficit was excessive, order the Member States concerned to adjust their fiscal policy,

TABLE 2 MILESTONES IN THE DEVELOPMENT OF THE EUROPEAN GOVERNANCE FRAMEWORK FOR PUBLIC FINANCES

	More flexible	Stricter	Smarter / More complex
1992 : Maastricht Treaty			
1997 : Stability and Growth Pact (SGP)		X	X
2005 : First reform of the SGP	X		X
2011-2013 : Second reform of the SGP		X	X
2015 : EC Communication on flexibility within the SGP	X		X

Source : NBB.

and even impose certain sanctions : thus, the European Investment Bank could be asked to reconsider loans to the countries concerned or unremunerated deposits and fines could be imposed. The Ecofin Council had very extensive decision-making powers in that regard, and had total autonomy to decide the measures to be taken.

2.2 Stability and Growth Pact

There were fears that fiscal discipline might weaken or even vanish following the creation of the currency union. In that connection, not all Member States considered that the Treaty's corrective procedure was sufficiently dissuasive. The German government of the day led calls for supplementary safeguards to ensure lasting fiscal discipline within the Monetary Union, and in 1995 it had already put forward initial proposals for clarifying and strengthening the fiscal rules. Those proposals soon gained the support of the small Member States. An agreement was concluded in December 1996 at the Dublin European Summit, and the new regime was dubbed the "Stability and Growth Pact". By this means, the European policymakers aimed to spell out the importance of lasting fiscal discipline accompanied by the price stability that the ECB was to monitor, in order to create the necessary conditions for balanced, sustainable activity growth. The Pact was signed in June 1997 at the Amsterdam Summit.

The key requirement of the Maastricht Treaty concerning the avoidance of excessive deficits was naturally incorporated in the Pact. The rules were extended to include a number of preventive measures. The Member States undertook to submit annual stability programmes (or convergence programmes in the case of Member States not taking part in EMU), geared to the attainment of the medium-term objective of a budget close to balance or in surplus, and to take the necessary fiscal measures for that purpose. These budget positions were meant to provide the Member States with sufficient scope to deal with normal cyclical fluctuations via the operation of the automatic stabilisers without their public deficit exceeding the limit of 3 % of GDP. The definition of an excessive deficit was also clarified. Finally, the Pact sharpened the corrective mechanisms that come into force when such a deficit is identified, and specified that failure to comply with the rules would, in principle, give rise to sanctions.

The Pact tightened up the fiscal rules to some degree. The preventive element of the Pact aimed both at the long-term sustainability of public finances and at the stabilising function of fiscal policy in the short term. The corrective arm was devised on the basis of strict rules of procedure which left little scope for interpretation in the event of missed targets, and which came into effect if the public deficit exceeded 3 % of GDP.

2.3 First reform of the Stability and Growth Pact

Even though the Stability and Growth Pact rules were tightened up, most Member States relaxed their fiscal discipline to some degree once they had joined the currency union. They were encouraged in that by the lack of specific detail in the preventive arm of the Pact and by over-optimistic growth forecasts at the start of the new millennium. The public deficits of some Member States, including Germany and France, exceeded 3 % of GDP and those countries risked being subjected to the strict rule of the corrective arm which stipulates that the excessive deficit must be eliminated within a year of being identified. Gradually, some people came to regard the Stability and Growth Pact as too strict a straitjacket, and it attracted increasing criticism : there were calls for some relaxation of the rules.

In March 2005, following lengthy debate, the Ecofin Council reached agreement on the reform of the Stability and Growth Pact, placing the emphasis on strengthening the economic fundamentals and on the Pact's flexibility. That reform modified both the preventive and the corrective arms. The main change to the preventive arm concerned the definition of the medium-term objective namely of a budget close to balance or in surplus. That objective was now expressed in structural terms, i.e. excluding the effects of the business cycle and one-off factors. Country-specific objectives were introduced, ranging from a deficit of 1 % of GDP for Member States with a low debt ratio and high potential growth to a budget in balance or in surplus for Member States with a high debt ratio and low potential growth. Member States which had not yet achieved their medium-term objective were to aim at improving their structural public balance. In that regard, an improvement averaging 0.5 percentage point of GDP per annum was the benchmark, and the effort must be stepped up in periods of favourable economic conditions. As for the Pact's corrective procedures, there was significant easing of the definition of the exceptional circumstances in which a public deficit of over 3 % of GDP is not considered excessive. Thus, any contraction in activity and any long period of growth which, though positive, is still well below its potential level might justify an exception. The "other relevant factors" which must be taken into account in assessing the excessive character of the public deficit were also defined. Account would likewise be taken of all other factors that the Member State concerned deemed relevant for a detailed qualitative assessment of the exceeding of the benchmark. In addition, the deadlines to be met in the various stages of the excessive public deficit correction procedure were extended.

More generally, this reform implied a marked shift from an institutional framework based on the application of strict rules towards a framework offering the Ecofin Council much greater scope for interpretation. In that respect, it meant in some ways a return to the situation prevailing before the introduction of the Pact. Furthermore, the increased complexity could hamper surveillance over compliance with the SGP rules. There was also evidence of a substantial, widespread relaxation of the existing rules, and the ultimate threat of sanctions tended to retreat into the background. Overall, this reform of the Pact therefore meant a relaxation of the existing rules.

2.4 Second reform of the Stability and Growth Pact

In 2010, the negative impact of the financial crisis on public finances and of the resulting economic recession led to a political consensus on the need to reinforce the European regulatory framework. The European Council was aware of the gravity of the situation and at the beginning of 2010 it had decided to strengthen the economic governance framework of the European Union, and its fiscal rules. For that purpose, a working group was set up which, in close consultation with the EC, produced proposals aimed at tightening up the European fiscal rules and extending the European macroeconomic surveillance and coordination procedures.

At the end of September 2010, the EC had already formulated six legislative proposals – subsequently termed the "Six Pack" – intended to modify the regulatory framework. They brought in a procedure concerning macroeconomic imbalances and made fundamental adjustments to the budgetary framework. In view of the sovereign debt crisis, the debt criterion was highlighted in the corrective arm of the Stability and Growth Pact. In addition, the system of sanctions under that part of the Pact was made a little more stringent. A rule on expenditure was added to the preventive arm, and the possibility of imposing sanctions was introduced. Apart from the changes to the preventive and corrective arms of the Stability and Growth Pact, the decision-making procedures and sanctions were also adapted to improve the application of the fiscal rules. Finally, minimum conditions were imposed in relation to the national budgetary frameworks of the EU Member States. Following some amendments, these six legislative proposals were formally approved in the autumn of 2011 by the European Parliament and the Ecofin Council. It was also decided to improve the synchronisation of the national reform programmes and the stability and convergence programmes in the framework of the European Semester which had been approved in the previous year.

At the end of November 2011, the EC proposed two new Regulations (the Two Pack) to further reinforce budgetary surveillance in the euro area. The first aimed to strengthen and harmonise budgetary procedures in the euro area countries, and to impose additional surveillance and reporting obligations in the event of an excessive deficit. The second introduced heightened surveillance in euro area countries requesting financial assistance from European emergency funds or those which, in the EC's opinion, face serious financial stability problems which could have adverse repercussions on other euro area countries.

At the December 2011 European Council, all EU Member States except the United Kingdom stated their willingness to conclude a new Fiscal Compact, which aimed to enhance fiscal discipline further with more automatic sanctions and stricter surveillance. The Member

States were also to improve the coordination of their economic policies. These agreements were defined in a new intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, signed during the European Council in early March 2012 by 25 EU Member States (all the Member States at that time except the United Kingdom and the Czech Republic).

The Fiscal Compact forms the budgetary section of the Treaty. Its substantive provisions conform to the requirements of the Stability and Growth Pact : the government budget must be in balance or in surplus. This rule is deemed to be respected if the structural budget balance for the year is in line with the country's particular medium-term objective. Rapid convergence towards that objective is required, via an adjustment path proposed by the EC. The main innovation of the Fiscal Compact is the obligation to transpose these rules into national law, preferably in the constitution or in another law ensuring full compliance with the rules.

These changes extended and strengthened the budgetary framework and prompted the Member States to pay more attention to adopting and adhering to the framework. In contrast to the 2005 reform, it was clearly a step in the right direction. At the same time, the framework again became more complex, so that it may be harder to implement.

2.5 EC Communication on flexibility

In its January 2015 Communication, the European Commission described how, in the context of its policy goals, it would use the existing rules of the Stability and Growth Pact in order to strengthen the link between structural reforms, investment and fiscal sustainability to support job creation and growth. The Communication will be discussed in detail in section 3.2.3. On the basis of the initial assessment of fiscal policy by the EC following the implementation of the Communication's guidance, it seems that the latter resulted in a relaxation of the application of the budgetary framework.

3. Current rules of the European budgetary framework

This section begins by placing the current European budgetary framework in context in the European policy coordination cycle. Next, it takes a closer look at the main European budgetary rules and their implementation. Finally, it outlines the rules that currently apply in Belgium.

3.1 Part of the broader European governance framework

One of the key lessons that Europe learnt from the recent economic and financial crisis is the need for greater surveillance and better coordination of the Member States' economic policies. The European Semester, an annual cycle for the coordination of economic policies, approved in 2010 and in force since 2011, ensures that the Member States' fiscal and economic policies remain in line with their European obligations : their public finances on the basis of the Stability and Growth Pact rules, and their economic reform plans on the basis of the country-specific recommendations and the long-term objectives for growth and employment under the Europe 2020 strategy.

The European policy coordination cycle begins in November when the EC publishes two reports. The Annual Growth Survey describes the economic challenges facing the EU and the political priorities. The Alert Mechanism Report examines the Member States and identifies the ones requiring more detailed analysis in order to determine whether they exhibit macroeconomic imbalances. In February, the EC publishes reports on each Member State analysing the economic situation, the reform programmes and – when deemed necessary by the Alert Mechanism Report – any imbalances to be corrected. In March, the European Council's spring summit presents a report on the general macroeconomic situation and on the progress made towards attaining the objectives of the Europe 2020 strategy. It sets out policy guidelines for the EU and the euro area on the basis of the Annual Growth Survey published by the EC. In April, the Member States submit their stability or convergence programmes, which aim to ensure the viability of their public finances, and their national reform programmes oriented at a smart, sustainable and inclusive growth in such areas as employment, education, research, innovation, energy and social inclusion. In May, after evaluating these programmes, the EC issues recommendations for each country. These set out the policy stance appropriate to each Member State in the areas deemed to take priority for the current year and the year following. Next, the various competent ministers in the Council of the EU examine these country-specific recommendations, and the European Council approves them. Finally, in late June or early July, the Ecofin Council formally adopts them. Where public finances are concerned, the Member States thus receive policy guidance before they finalise their draft budget plans for the ensuing year. Euro area countries must submit their draft budget plans for the next year by no later than 15 October. In November, the EC issues its opinion on each plan, and that is followed by discussion in the Ecofin Council. This assessment mainly investigates

TABLE 3 EUROPEAN FISCAL MONITORING WITHIN THE ANNUAL POLICY COORDINATION CYCLE

	European Commission	Council of the EU	European Council	European Parliament	Member States
November	Autumn forecasts Annual Growth Survey (AGS) Alert Mechanism Report (AMR) Decisions under the SGP				
December		Decisions under the SGP			
January		Adoption of the conclusions of the AGS / AMR	Agreement on spheres for coordination on the AGS / AMR		
February	Winter forecasts Country Report on each Member State (reform programme and imbalances)				
March			Adoption of the economic priorities of the AGS	Dialogue on the economic priorities	
April					Submission of stability and convergence programmes Submission of NRPs (1)
May	Spring forecasts Country-specific recommendations on fiscal, economic and social policy				
June	Decisions under the SGP	Discussion of the country-specific recommendations Decisions under the SGP			
July		Adoption of the country-specific recommendations	Approval of the country-specific recommendations		
August					
September				Debate on the European Semester and the country-specific recommendations	
October					Submission of draft budget plans (DBPs)
November	Autumn forecasts Opinions on the DPBs	Discussion of opinions on the DPBs			
December	Decisions under the SGP	Decisions under the SGP			Adoption of the budget

Budgetary surveillance (yellow): Decisions under the SGP, Submission of stability and convergence programmes, Submission of draft budget plans, Opinions on the DPBs, Discussion of opinions on the DPBs, Adoption of the budget. Macroeconomic surveillance (lavender): the other shaded cells; country-specific recommendations and the Semester debate are shown in a mix of both colours.

Budgetary surveillance
Macroeconomic surveillance

Sources: EC, NBB.
(1) National reform programmes.

whether the plans conform to the Stability and Growth Pact requirements.

If, in the course of the budgetary surveillance, it emerges that a Member State is not respecting the rules of the preventive or corrective arms of the Stability and Growth Pact, the EC and the Ecofin Council decide to initiate either a significant deviation procedure or an excessive deficit procedure against the Member State concerned. Such decisions are generally taken in December on the basis of the statistical notifications of the end of September and the EC's autumn forecasts or in June on the basis of the statistical notifications of the end of March and the EC's spring forecasts.

3.2 Main European fiscal rules

In the context of policy coordination, the fiscal policy of the Member States must conform to the European fiscal rules. As already mentioned, those rules comprise a preventive element that is meant to avert the development of unsustainable budget positions, and a corrective element that concerns the recovery measures for Member States facing an excessive public deficit or an excessive public debt.

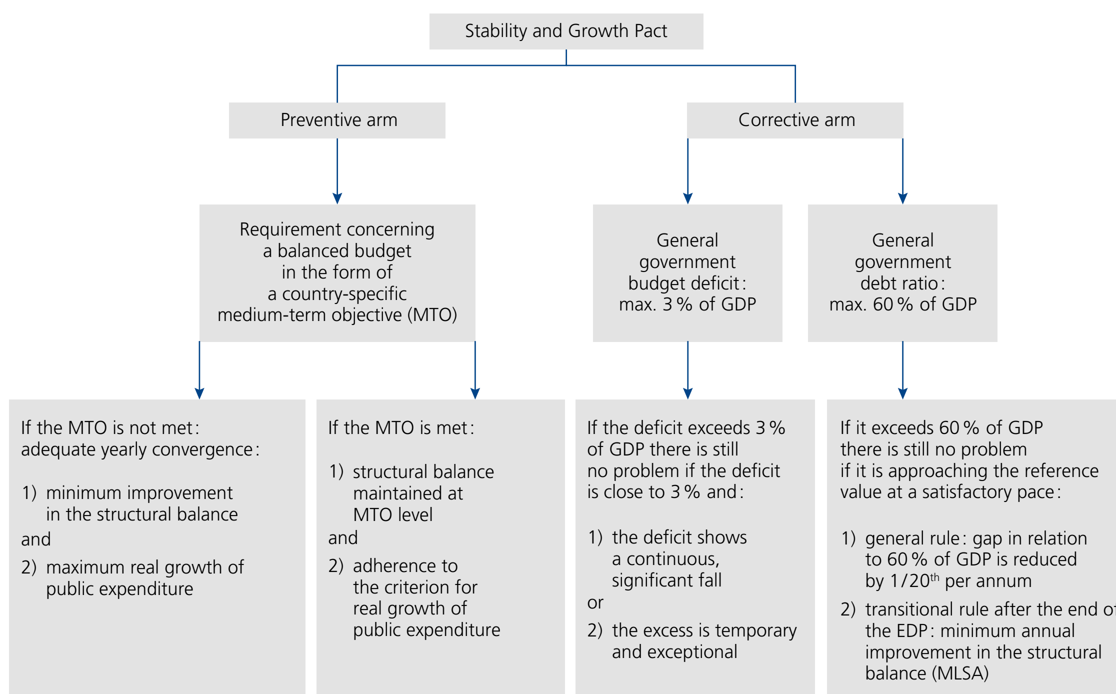
3.2.1 Rules of the preventive arm

3.2.1.1 Medium-term objective : definition and calculation

Pursuit of the medium-term objective is central to the preventive arm. That objective is a benchmark for the budget balance specific to each country, expressed in structural terms.

It is the Member States themselves that propose the medium-term objective in their stability or convergence programme. However, the objective must satisfy minimum requirements : it must maintain a safety margin in relation to the maximum deficit of 3 % of GDP, it must ensure rapid progress towards a sustainable budget position, and it must create sufficient scope in the budget for such things as public investment. In addition, in the case of the euro area countries the medium-term objective must be at least –0.5 % of GDP, while for countries with a debt ratio well below 60 % of GDP presenting minimal risks in terms of the

CHART 1 SUMMARY OF THE MAIN EUROPEAN FISCAL RULES

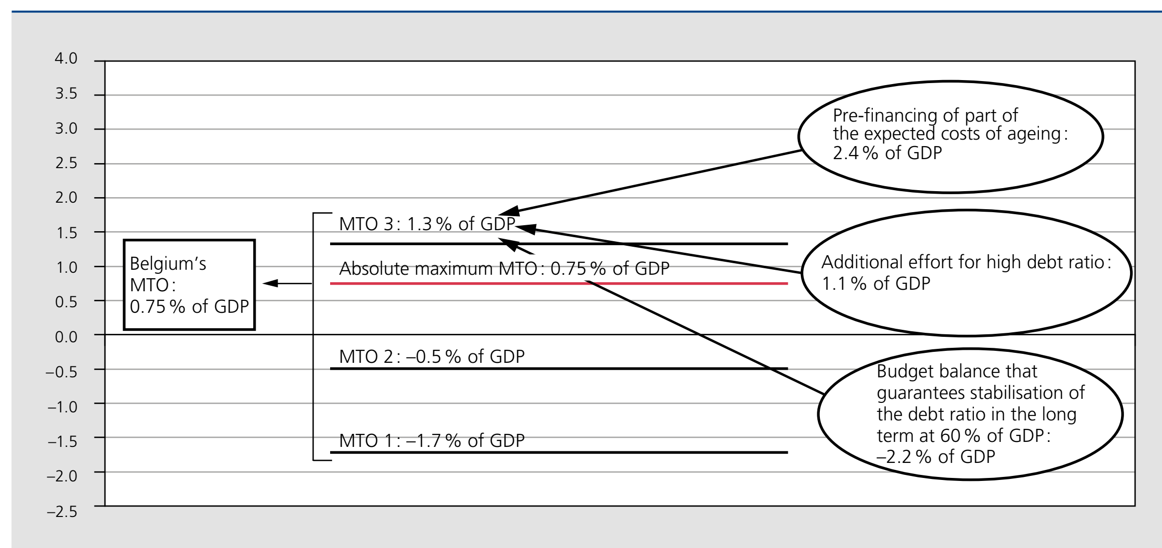


Source : EC.

Box 2 – Calculation of Belgium's medium-term objective

Belgium's medium-term objective is currently equivalent to a structural surplus of 0.75 % of GDP and results from the application of the rules described in this section to Belgium in 2012.

CALCULATION OF BELGIUM'S MEDIUM-TERM OBJECTIVE (MTO)
(in % of GDP)



Sources: EC, NBB.

In principle, the minimum level of this objective should be equal to a surplus of 1.3 % of GDP, namely the maximum of the following three values:

(1) a value guaranteeing a safety margin in relation to the maximum deficit of 3 % of GDP: it is calculated on the basis of a measure of the output gap and the output elasticity of the budget balance. For Belgium, this was equal to a deficit of –1.7 % of GDP (MTO 1);

(2) an absolute minimum which, in Belgium's case, is equal to a deficit of –0.5 % of GDP, since the debt ratio exceeds 60 % of GDP (MTO 2);

(3) a value guaranteeing the sustainability of public finances or rapid convergence towards sustainability: it is equivalent to a surplus of 1.3 % of GDP and corresponds to the sum of the following three components (MTO 3):

   a. the first component calculates the nominal budget balance necessary to stabilise the debt ratio at 60 % of GDP in the long term (in 2060). That calculation is based on the average nominal growth over the period from 2013 to 2060 as estimated in the 2012 Ageing Report. For Belgium, the calculation indicates a budget deficit of 2.2 % of GDP. That figure is obtained by multiplying the debt ratio (60 % of GDP) by the expected nominal GDP growth (3.6 %);

   b. the second component represents an additional effort for countries with a debt ratio higher than 60 % of GDP. That effort increases in a straight line, starting at 0.2 % of GDP for a debt ratio of 60 %. For Belgium, this effort came to 1.1 % of GDP in 2012;

c. the last component defines the budgetary effort necessary to pre-finance one-third of the expected budgetary cost of ageing. For Belgium, that cost was estimated in 2012 at 7.2 % of GDP : this component is therefore equivalent to 2.4 % of GDP.

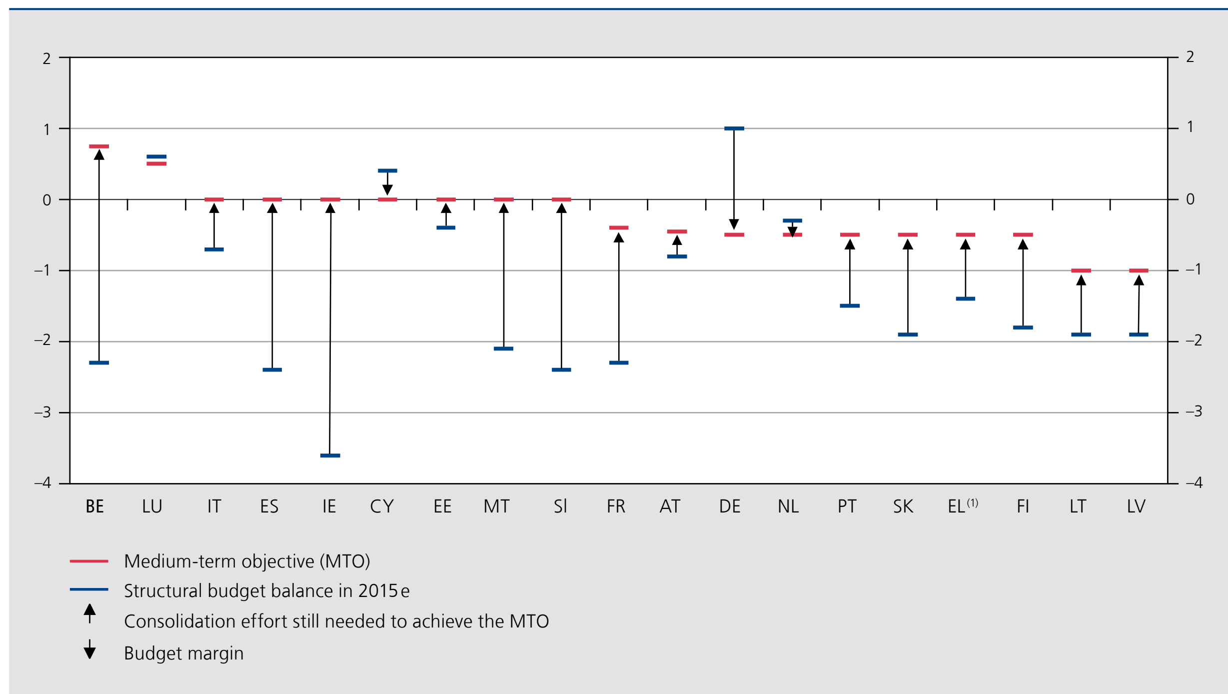
However, the minimum level of the medium-term objective, namely 1.3 % of GDP, is subject to an absolute maximum calculated on the basis of a structural balance corresponding to a primary balance of 5.5 % of GDP, namely a structural budget surplus of 0.75 % of GDP.

Belgium's medium-term objective is the highest for any euro area country, owing to its heavy public debt and the substantial budgetary costs of ageing, as estimated in 2012. Luxembourg was the only other country with a medium-term objective corresponding to a structural budget surplus.

long-term sustainability of their public finances the medium-term objective may be at least –1 % of GDP. Finally, a country may invoke an exception clause if the resulting minimum medium-term objective corresponds to an unrealistically large primary surplus. Since no country has ever succeeded in maintaining a primary surplus much above 5.5 % of GDP over a long period, it was decided to set an absolute maximum limit for the medium-term objective corresponding to a primary surplus of that size.

Every three years, the EC calculates the minimum levels of the country-specific medium-term objectives, taking account of the latest data on the expected budgetary costs of ageing as published in the triennial Ageing Report produced by the Ageing Working Group and by the EC under

CHART 2 MEDIUM-TERM OBJECTIVES OF THE EURO AREA MEMBER STATES
(in % of GDP)



Sources: EC, NBB.
(1) Apart from Belgium, Greece is the only country for which the obligation to limit the primary balance to 5.5% of GDP had to be taken into account in setting the minimum medium-term objective in 2012. In the case of Greece, that led to application of the minimum medium-term objective for euro area countries with a debt ratio in excess of 60 % of GDP, namely a deficit of 0.5 % of GDP.

the auspices of the Economic Policy Committee. However, the calculations may be performed more frequently if a Member State embarks on a structural reform which could have a substantial impact on the sustainability of its public finances. The calculations were last performed in 2012, and the figures will be adjusted during 2015.

3.2.1.2 Progress towards the medium-term objective

Countries which have not yet achieved their medium-term objective must follow an adjustment path in order to move towards that objective at an appropriate pace. That applies to most of the Member States, including Belgium. In 2015, Belgium is projected to have a structural deficit of 2.3 % of GDP, and is therefore still a long way from its medium-term objective (see Box 2).

The progress that these countries achieve is assessed on the basis of two indicators, namely the change in the structural budget balance and the change in real public expenditure.

The required improvement in the structural balance is determined on the basis of the Member State's economic situation and its public finances. The benchmark is an improvement in the structural budget balance equal to 0.5 percentage point of GDP. For countries with a debt ratio of more than 60 % of GDP, the required improvement exceeds 0.5 percentage point of GDP. In a favourable economic climate, those countries have to strive for a bigger improvement, while they can reduce their efforts when economic conditions are tougher. The application of these rules was specified in more detail by means of a decision-making matrix, the latest version of which is set out in the EC Communication of January 2015 (see table 4).

Each Member State was given a benchmark for the permitted annual change in real government expenditure. That benchmark is below the medium-term potential GDP growth, and is consistent with the required improvement in the structural budget balance. The expenditure concept excludes interest charges, the cyclical component of unemployment expenditure, and all spending related to EU programmes financed by European funds. Furthermore, public expenditure is adjusted for the budgetary impact of discretionary measures on the revenue side. The advantage of the expenditure rule – as opposed to the required improvement in the structural balance – is that public expenditure can be readily monitored and can therefore be controlled by the government.

Countries with a structural budget balance corresponding to their medium-term objective have to keep that balance stable, and their public expenditure must not outpace medium-term potential GDP growth.

3.2.2 Rules of the corrective arm

The two original criteria relating to public finances under the Maastricht Treaty are still central to this part of the Stability and Growth Pact, but their application has since been clarified. The nominal public deficit must not exceed 3 % of GDP, unless the deficit is declining considerably and continuously and is approaching the reference value, or the excess is exceptional and temporary and the deficit remains close to the reference value.

The outstanding public debt must not exceed 60 % of GDP, or if it does so, it must approach that reference value at a satisfactory pace. The guideline here is an average annual reduction in the debt ratio of one-twentieth of the difference between the reference value and 60 % of GDP. That reduction must occur in the last three years for which the figures are available or in the last year for which the figures are available and in the two ensuing years (according to the EC's estimates).

For countries which, like Belgium, were subject to an excessive deficit procedure when this rule was approved on 8 November 2011, transitional provisions apply for three years following the correction of their excessive deficit. During the transitional period, they must make sufficient progress to meet the debt criterion at the end of that period. Their progress is measured by the adjustment in the structural budget balance, also known as the minimum linear structural adjustment (MLSA).

3.2.3 EC Communication on making the best use of the flexibility within the rules of the Stability and Growth Pact

After the rules of the European governance framework concerning public finances had been strengthened in 2011-2013, the European Council and Commission became convinced that the application of the fiscal rules should aim to promote potential growth and job creation. Thus, the June 2014 European Council stated in its conclusions that the flexibility offered by the Stability and Growth Pact should be used to support the EU growth strategy. In January 2015, the EC issued a Communication explaining how it intended to make best use of the flexibility offered by the existing rules of the Stability and Growth Pact in order to promote a growth-friendly fiscal policy. That is to be achieved by taking greater account of the economic circumstances in the Member States when defining the efforts to be made under the preventive arm, but also by stimulating investment and by encouraging effective implementation of structural reforms. The Communication spells out a number of proposals for promoting growth and employment derived from the policy programme of the new EC President, Jean-Claude

TABLE 4 DETERMINATION OF THE REQUIRED ANNUAL IMPROVEMENT IN THE STRUCTURAL BUDGET BALANCE FOR COUNTRIES WHICH HAVE NOT YET ATTAINED THEIR MEDIUM-TERM OBJECTIVE

(in percentage points of GDP)

Economic conditions	Gross debt < 60 % of GDP and no risk to the sustainability of public finances	Gross debt > 60 % of GDP or risk to the sustainability of public finances
Exceptionally bad :		
real growth < 0 % or output gap [1] < –4 %	No adjustment	
Very bad :		
–4 % ≤ output gap < –3 %	0.0	0.25
Bad :		
–3 % ≤ output gap < –1.5 %		
a) real growth < potential growth	0.0	0.25
b) real growth > potential growth	0.25	0.5
Normal :		
–1.5 % ≤ output gap < 1.5 %	0.5	> 0.5 [2]
Good :		
output gap ≥ 1.5 %		
a) real growth < potential growth	> 0.5 [2]	≥ 0.75
b) real growth > potential growth	≥ 0.75	≥ 1.0

Source : EC.
(1) The output gap corresponds to the difference between actual GDP and its potential level, expressed in % of that level.
(2) An improvement of more than 0.5 percentage point of GDP in the structural balance is regarded by convention as at least equal to 0.6 percentage point of GDP.

Juncker, which the European Parliament took as the basis for endorsing the new Commission.

3.2.3.1 Taking greater account of economic circumstances

To take better account of cyclical fluctuations, the EC will from now on use a matrix describing the appropriate fiscal adjustments that countries are expected to make under the preventive arm of the Stability and Growth Pact. This means that the Member States which have not yet attained their medium-term objective will be required to step up their consolidation efforts in better times. Countries whose macroeconomic situation is considered to be extremely bad because their real GDP growth is negative or because their negative output gap exceeds 4 % of GDP need not make any adjustments. The required improvement in the structural balance is also modulated according to the level of the public debt. In any case, the new matrix makes the EC's application of the fiscal rules more transparent.

3.2.3.2 Investment clause

In order to encourage investment, Member States subject to the preventive arm of the Stability and Growth Pact may deviate temporarily from their medium-term objective or their fiscal adjustment path. Member States are only permitted to apply the investment clause under strict conditions. The clause is only valid for Member States whose real GDP growth is negative or whose GDP falls far short of its potential level, resulting in a negative output gap of more than 1.5 % of GDP. In addition, national investment expenditure only qualifies if the projects are co-funded by the EU under the structural and cohesion policy, the Trans-European Network and the Connecting Europe Facility, or if they are co-financed by the European Fund for Strategic Investments. The result must be an actual increase in investment levels. The deviation must not drive the budget deficit above the 3 % limit and a safety margin must be provided. The deviation must also be corrected during the period of the Member State's stability or convergence programme i.e. within four years following the entry into force of the investment clause. The EC implements this last criterion by stipulating that the difference between the structural budget balance and the medium-term objective may not exceed 1.5 percentage points of GDP. These conditions can be considered strict in that only a few countries satisfy them.

3.2.3.3 Structural reform clause

Member States subject to the preventive arm of the Stability and Growth Pact may also deviate temporarily

CHART 3 APPLICATION OF THE INVESTMENT CLAUSE CRITERIA TO EURO AREA COUNTRIES
(figures for 2015, in % of potential GDP, unless otherwise stated)

Source: EC.
(1) In percentage points of GDP.
(2) In 2016, the negative output gap should be less than 1.5 % of GDP in Cyprus, the Netherlands and Portugal, so that those countries will no longer meet the conditions of the investment clause.

from their medium-term objective or from their adjustment path leading to that objective in order to take account of the effect of structural reforms. These deviations may not exceed 0.5 percentage point of GDP and must be corrected during the period of the stability or convergence programme. This last condition implies that only Member States whose structural budget balance is no more than 1.5 percentage points of GDP short of their medium-term objective are eligible for the structural reform clause. The EC will assess the reforms and check whether they are substantial, whether they have verifiable long-term positive effects on the budget – including an increase in potential growth – and whether they are actually implemented.

In the case of Member States subject to an excessive deficit procedure, the EC may recommend a longer period for correcting the excessive deficit if there is a specific structural reform plan that meets the said conditions. When a decision is to be taken on whether or not to initiate an excessive deficit procedure, the implementation of structural reforms may be regarded as a relevant factor.

3.2.4 Application of the regulatory framework : monitoring, tolerance margins and non-compliance procedures

As part of its multilateral budgetary surveillance, the EC systematically examines whether the Member States' fiscal policies meet the requirements of the Stability and Growth Pact.

3.2.4.1 Preventive arm

The examination of compliance with the preventive arm of the Stability and Growth Pact centres on adherence to the medium-term objective and the required progress towards that objective. That assessment entails an *ex-ante* analysis of the budget plans and an *ex-post* analysis based on statistical data for the previous year notified by the

Member States to Eurostat and validated by that institution. It is only the results of the *ex-post* analysis that may form the basis for initiating a procedure which could give rise to sanctions.

The *ex-ante* analysis includes an assessment of the budget targets and measures set out in the stability and convergence programmes to be submitted to the EC by the Member States each year. The EC bases its assessment on the macroeconomic and budgetary data from its spring forecasts. It begins by checking whether the medium-term objective satisfies the requirements. Next, it examines whether the Member State's structural budget balance corresponds to that objective or – if that is not the case – whether the Member State is achieving the required improvement in that balance and is adhering to the adjustment path. Finally, it checks whether the planned increase in public expenditure conforms to the benchmark. A Member State respects the preventive arm if it complies with both the rules on the structural budget balance and the rules on public expenditure. If it fails to satisfy one or both of the rules, the EC will conduct an overall assessment.

A key innovation introduced by the Two Pack is that the EC also examines the draft budgetary plans that the euro area Member States have to publish by 15 October and issues an opinion on those plans. If the EC finds serious breaches of the Stability and Growth Pact rules, it requests the Member States concerned to revise their plans.

The *ex-post* analysis examines the previous year's budget figures and checks whether they deviate from the medium-term objective or the path for attaining it. For that purpose, the EC assesses whether any deviations from the adjustment path towards the medium-term objective are "significant" or not[1]. They are significant if the following two conditions apply, or if either of them is met and a general analysis reveals that the other is present to some degree. First, the deviation between the movement in the structural balance and the predefined path amounts to at least 0.5 percentage point of GDP for a given year or an annual average of at least 0.25 percentage point of GDP for two consecutive years. Second, the growth of public expenditure deviates from the set target and has an impact on the general government balance of at least 0.5 percentage point of GDP in a given year or cumulatively over two consecutive years.

However, deviations are not considered significant if they are due to abnormal circumstances which are beyond the control of the Member State and have a marked adverse effect on the government's financial situation or during periods of particularly negative growth within the EU or the euro area as a whole.

If the EC finds a significant deviation, it issues a warning to the Member State. If the Member State fails to produce an adequate response and does not correct the deviation promptly, the Ecofin Council may decide to initiate the significant deviation procedure prescribed by the preventive arm of the Stability and Growth Pact. That procedure may lead to a sanction in the form of an interest-bearing deposit of 0.2 % of GDP.

3.2.4.2 Corrective arm

If the statistical data on public finances indicate that the budget deficit exceeds the reference value of 3 % of GDP, or that the rules on the public debt have been breached, or if the outlook implies that such a risk exists, the EC produces a report determining whether an excessive deficit procedure should be launched. In that connection, the EC takes account of the level of public investment and all other relevant factors, including the medium-term economic and fiscal developments.

As already stated, the deficit criterion is accompanied by two exception clauses which may prevent the launch of an excessive deficit procedure, namely if the deficit has fallen significantly and continuously and is approaching the reference value of 3 % of GDP, or if the excess is exceptional and temporary and the deficit is close to the reference value.

There is also provision for a tolerance margin in the case of the minimum linear structural adjustment to be respected by countries subject to the excessive deficit procedure on 8 November 2011 in order to satisfy the debt criterion by the end of the three-year transitional period. Thus, the difference between the actual adjustment of the structural budget balance and the required improvement must not exceed 0.25 percentage point of GDP.

If, on the basis of the EC's opinion, the Ecofin Council considers that an excessive deficit exists, then it issues recommendations to the Member State concerning the elimination of that deficit within a specified period via a minimum required improvement in the structural budget balance, and may impose sanctions. However, if the Member State has subsequently taken effective action, in that it has achieved the required improvement in the structural budget balance but has not managed to cut the deficit below 3 % of GDP, the Ecofin Council may extend the deadline, in principle by one year. Conversely, if the Member State in question fails

(1) The notion "significant deviation" is the central concept in the *ex-post* analysis but is also used in the *ex-ante* analysis.

to implement the Ecofin Council's recommendations, it becomes subject to the next step in the procedure laid down by the Maastricht Treaty, which may eventually culminate in a fine of up to 0.5 % of GDP. An excessive deficit procedure may be halted if the excessive deficit has been corrected in a sustainable way. That is assessed on the basis of both the statistical data and the outlook, assuming that there is no change of policy.

The submission of inaccurate statistics on the budget deficit or the public debt also attracts a fine of up to 0.2 % of GDP.

3.3 European fiscal rules applicable to Belgium

Since the June 2014 decision by the Ecofin Council lifting the excessive deficit procedure initiated against Belgium in December 2009, Belgium has been subject to the preventive arm of the Stability and Growth Pact. It also has to comply with the provisions under the corrective arm.

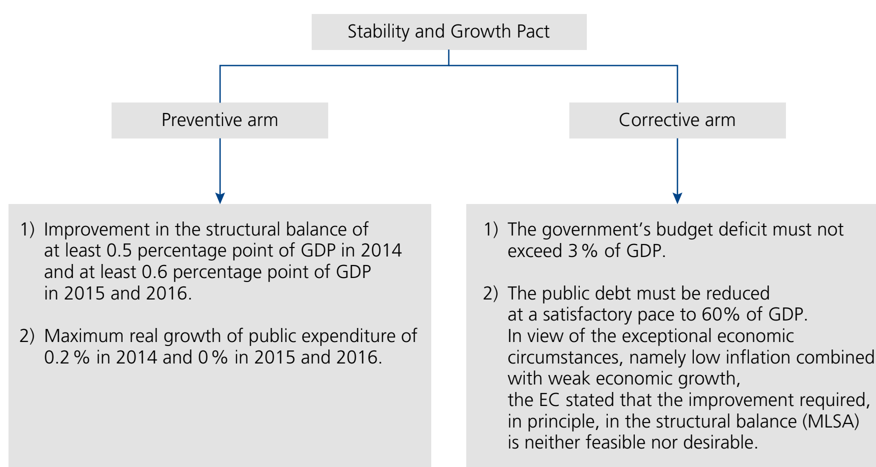
As already mentioned, in regard to the preventive arm, the medium-term objective for Belgium was set at a structural surplus of 0.75 % of GDP. Belgium has to move towards that objective at an appropriate pace. The required improvement for 2014 was set at a minimum of 0.5 percentage point of GDP, and on the basis of the adjusted decision-making matrix and the 2015 spring forecasts of the EC, it was set at a minimum of 0.6 percentage point of GDP for 2015 and 2016. As regards the annual permissible increase in real public expenditure, Belgium was recommended to restrict the growth to a maximum of 0.2 % in 2014 and 0 % in 2015 and 2016.

In regard to the corrective arm, the nominal public deficit must not exceed 3 % of GDP, and the public debt must be reduced at a satisfactory pace below the reference value of 60 % of GDP. Transitional provisions apply to Belgium during 2014-2016. In order to meet the debt criterion at the end of that transitional period, the structural budget balance has to improve by at least 0.7 percentage point of GDP each year. However, since there was no improvement in 2014, that figure has been increased for 2015 and 2016 to at least 1.1 percentage point of GDP. Nevertheless, owing to the exceptional economic circumstances, namely low inflation combined with weak economic growth, the EC considered in its February 2015 opinion that the improvement required, in principle, in the structural budget balance is neither feasible nor desirable.

4. Recent applications of the European budgetary framework to Belgium and to other euro area countries

The assessment of the draft budgets for 2015 and the latest stability programmes offers a clear view of the way in which the EC applies the current European budgetary framework, taking account of the new rules on flexibility.

CHART 4 SUMMARY OF THE EUROPEAN FISCAL RULES APPLICABLE TO BELGIUM IN 2014, 2015 AND 2016



Source: EC.

4.1 Assessment of the draft budgets for 2015

The draft budgets for 2015 of the euro area Member States not subject to an adjustment programme were examined by the EC during November 2014 [1]. The general conclusion of the initial analysis of those budgets was that five countries fully conformed to the Stability and Growth Pact recommendations; four countries largely conformed and the other seven countries risked failing to comply. These last two groups of countries were asked to take the necessary fiscal measures to ensure that the 2015 budget conformed to the Stability and Growth Pact. In the case of France, Italy and Belgium, the view was that the risk of non-compliance could have consequences for the excessive deficit procedure. The EC announced that it would conduct a new assessment by March 2015.

At the end of February 2015, the EC published the results of its scheduled follow-up analysis of the application of the Stability and Growth Pact in France, Italy and Belgium. That analysis took account of new information on the finalisation of the budget laws, the structural reform programmes and the EC's own winter forecasts. Since Belgium and Italy were situated under the preventive arm, the EC checked – on the basis of a report produced in accordance with Article 126(3) of the Treaty on the Functioning of the European Union – whether those countries breached either the deficit or debt criterion. The EC's 2015 winter forecasts had shown that Belgium would have a budget deficit of 3.2 % of GDP in 2014 and that insufficient progress had been made to satisfy the debt criterion. The latter also applied to Italy. In the case of France, a report was produced as part of the ongoing excessive deficit procedure in accordance with Article 126(7) of the Treaty on the Functioning of the European Union to determine whether additional action was needed under that procedure.

Belgium

In the case of Belgium, the report's main conclusion was that, taking account of all relevant factors, the country respected both the deficit criterion and the debt criterion, and that there was therefore no need to initiate an excessive deficit procedure.

Those conclusions were based on an in-depth analysis which found that, while the budget deficit of 3.2 % of GDP expected for 2014 did exceed the reference value of 3 % of GDP, that excess was small, exceptional and temporary. It was attributable partly to unusual circumstances, more specifically the statistical adjustments concerning the switchover to the ESA 2010 methodology for the national accounts. The impact of that factor on the public deficit was estimated at 0.3 % of GDP for 2013, and a comparable effect for 2014 was taken into account. The EC also pinpointed lower than expected revenues, which could have been foreseen in some cases.

In analysing the debt criterion, it found that the expected improvement in the structural balance was insufficient to satisfy that criterion in 2016, at the end of the transitional period. However, the assessment took account of some relevant factors. First it was considered that the required adjustment towards the medium-term objective was largely guaranteed. Account was also taken of the structural reforms announced in connection with pensions, labour cost competitiveness and labour market participation, which help to comply partly with the country-specific recommendations that the EC had formulated in 2014. Finally, the economic circumstances were considered exceptional, combining low inflation with weak growth, making it very difficult to satisfy the debt criterion conditions during the 2014-2016 transitional period. In the light of these circumstances, the EC considered that the stipulated substantial improvement in the structural budget balance was neither feasible nor desirable.

The striking point about this EC assessment of Belgian fiscal policy is that the debt criterion rule was not stringently applied during the transitional period and that the EC also clearly took account of the economic context and a wide range of other relevant factors.

Italy

While the report on Italy identified the presence of a significant deviation from the prescribed path for reducing the debt, it concluded that – taking account of all the relevant factors – Italy did respect the debt criterion. As the conditions concerning the deficit were also met, there was no justification for initiating an excessive deficit procedure.

The EC reached that conclusion on the basis of a number of relevant factors which were also considered for the purposes of the analysis for Belgium: the exceptional economic circumstances, namely low inflation combined with weak growth, which make it very difficult to respect the debt criterion conditions during the transitional period, the likelihood that the required improvement in the structural budget balance under the preventive arm of

(1) Greece and Cyprus are currently subject to an adjustment programme.

the Stability and Growth Pact would be achieved (that improvement was revised downwards for Italy following the EC's January 2015 Communication on flexibility, which enabled Italy to fulfil the stipulated conditions), and the expected implementation of ambitious measures which would promote growth.

France

In the course of the ongoing excessive deficit procedure against France, the EC examined whether effective action had been taken to correct the excessive deficit by 2015. The analysis showed that France did not plan to respect the Ecofin Council's June 2013 recommendations concerning its nominal and structural budget targets. However, the EC concluded that, on the basis of the assessment for 2013-2014, it could not be said that France had not taken any effective action, and proposed extending the deadline for correcting the excessive deficit by two years, namely until 2017.

But contrary to normal practice, this analysis took no account of the projections for the current year, which is the deadline for correcting the excessive deficit. Moreover, the assessment for 2014 was based on unvalidated data, and the deadline is normally only extended by one year. The EC's conclusions were confirmed by the Ecofin Council on 10 March 2015. At the end of March, the provisional figures for 2014 showed that effective action had been taken in the period 2013-2014.

In the end, the EC decided not to reject the 2015 draft budget plans of any of these three countries, even though – on the basis of these results combined with those for the previous years – they seemed to deviate from the Stability and Growth Pact rules in a number of respects. The reason for that decision is that a high level of flexibility and different relevant factors were taken into account.

4.2 Assessment of the 2015 stability programmes

4.2.1 Assessment of the euro area countries

In May 2015, the EC published its country-specific recommendations and its recommendations under the Stability and Growth Pact. Those last recommendations are based on the stability programmes of the EU Member States for 2015, and take account of the EC's 2015 spring forecasts. The analysis below focuses on compliance with the fiscal rules.

In the first instance, the EC checked whether the countries subject to the excessive deficit procedure respected the recommendations issued to them by the Ecofin Council. This concerned seven euro area countries, as the Council decided in June 2015 to end the procedure against Malta.

In addition, in the case of countries not subject to an excessive deficit procedure, the EC checked whether they met the conditions of the corrective arm, namely the deficit criterion and the debt criterion. The general figures in the EC's 2015 spring forecasts pointed to an improvement in the fiscal situation of most euro area Member States. In Finland's case, a report was prepared in accordance with Article 126(3) of the Treaty on European Union which concluded that Finland was failing to respect the deficit and debt criteria. Nevertheless, no excessive deficit procedure has been initiated for the moment, in the expectation that Finland will submit a modified stability programme in the autumn of 2015. The fiscal position of the other euro area countries did not require any further action.

Finally, for the twelve euro area countries not subject to an excessive deficit procedure, the EC examined compliance with the conditions under the preventive arm. For

TABLE 5 SITUATION OF THE EURO AREA MEMBER STATES UNDER THE STABILITY AND GROWTH PACT

Countries subject to the preventive arm	Countries subject to the corrective arm [1]
Germany, Estonia, Finland, Latvia, Lithuania, Luxembourg, Malta, Slovakia	Ireland (2015), France (2017), Portugal (2015), Slovenia (2015), Spain (2016)
Austria, Belgium, Italy, Netherlands (countries also subject to the transitional provisions concerning the debt criterion)	Cyprus (2016), Greece (2016) (programme countries)

Sources: EC, NBB.
(1) The years in brackets indicate the deadline for correcting the excessive public deficits.

TABLE 6 PREVENTIVE ARM: SUMMARY OF THE RESULTS OF THE EC ANALYSIS FOR EURO AREA MEMBER STATES (MAY 2015)

	2014	2015	2016
Germany	Compliant	Compliant	Compliant
Luxembourg	Compliant	Compliant	Compliant
Netherlands	Compliant	Compliant	Compliant
Lithuania	Compliant	Some deviation	Significant deviation
Slovakia	Compliant (1)	Compliant	Compliant (1)
Italy	Compliant (1)	Compliant (1)	Some deviation
Latvia	Compliant (1)	Compliant	Significant deviation
Estonia	Compliant (1)	Some deviation	Significant deviation
Austria	Compliant (1)	Some deviation	Significant deviation
Belgium	Some deviation	Some deviation	Significant deviation
Finland	Some deviation	Significant deviation	Significant deviation
Malta	– (2)	Some deviation	Some deviation

Source: EC.
(1) A deviation was identified in relation to the target for the change in the structural balance and/or public expenditure, but the EC's overall assessment showed that these countries satisfied the conditions of the preventive arm of the Stability and Growth Pact.
(2) Not applicable since Malta was subject to an excessive deficit procedure.

that purpose, on the basis of its spring forecasts 2015, it examined whether the medium-term objective had been met and, if that was not the case, the progress made towards achieving it. In the latter case, it analysed developments during the year and the average for the current year and the preceding year. This revealed that only three countries would attain their medium-term objective throughout the period or would make the necessary progress towards achieving it. The other countries would comply with the set rules to a lesser degree. Apart from Finland, Belgium is the only country failing to comply with the rules in any of the years.

4.2.2 Assessment for Belgium

In Belgium's case, the February 2015 conclusion concerning respect for the deficit criterion and the debt criterion was broadly confirmed in May 2015, as the relevant factors used to reach that conclusion still applied in the light of new information from the Belgian government and the EC's 2015 spring forecasts.

The assessment of compliance with the preventive arm of the Stability and Growth Pact yielded mixed results. For 2014, the EC's overall *ex-post* assessment shows some deviation from the prescribed path for moving towards the medium-term objective. For 2015 and 2016, the progress towards that objective according to Belgium's stability programme satisfies the conditions of the Stability and Growth Pact. However, according to the EC's 2015 spring forecasts, there is a risk of some deviation for 2015 and a risk of a significant deviation for 2016 if the policy remains unchanged.

5. Assessment of the European budgetary framework

This section assesses the current European governance framework in regard to public finances with reference to the criteria that the fiscal rules should ideally meet, and examines proposals for reforming the European budgetary framework.

5.1 Effectiveness of the Stability and Growth Pact

It is hard to assess the degree to which the fiscal rules and the associated procedures laid down by the Maastricht Treaty and by the Stability and Growth Pact have contributed to a sound fiscal policy, because it is impossible to make a comparison with a situation in which the euro area countries were not subject to this budgetary framework. That said, a number of interesting lessons can be drawn from the assessment of compliance with the

TABLE 7 EC'S ASSESSMENT OF BELGIUM'S 2015 STABILITY PROGRAMME (MAY 2015) – PREVENTIVE ARM

	2014	2015		2016	
	EC [1]	SP [2]	EC [1]	SP [2]	EC [1]
1. Change in the structural balance (in percentage points of GDP compared to the previous year, unless otherwise stated)					
Required (minimum) change (I)	0.5	0.6		0.6	
Actual/expected change (II)	–0.1	0.6	0.5	0.6	0.2
Deviation over one year (in percentage points of GDP) (III) = (II) – (I)	–0.6	0.0	–0.1	0.0	–0.4
Average deviation over two years (in percentage points of GDP)	– [3]	–0.3	–0.4	0.0	–0.3
2. Change in real public expenditure (in % compared to the previous year, unless otherwise stated)					
Required (maximum) change	0.2	0.0		0.0	
Actual/expected change	0.5	–1.3	–0.1	0.1	1.3
Deviation over one year (in percentage points of GDP) [4]	–0.2	0.6	0.0	0.0	–0.6
Average deviation over two years (in percentage points of GDP) [4]	– [3]	0.2	–0.1	0.3	–0.3
3. Conclusion					
Over one year	Overall assessment	Compliant	Overall assessment	Compliant	Overall assessment
On average over two years	– [3]	Overall assessment	Overall assessment	Compliant	Significant deviation
General conclusion	Some deviation	Compliant	Some deviation	Compliant	Significant deviation

Source: EC.
(1) EC's 2015 spring forecasts.
(2) April 2015 stability programme.
(3) Not applicable since Belgium was subject to an excessive deficit procedure in 2013.
(4) Impact on the structural balance of the difference between the actual/expected change and the required change.

European fiscal rules and the movement in public finances in the euro area countries.

In a recent study [1], staff members of the IMF assessed compliance with the Stability and Growth Pact rules since 1999. The study clearly shows that failure to comply with the fiscal rules in the strict sense was the rule rather than the exception. The aim of the Stability and Growth Pact, namely that all Member States should achieve structurally balanced budget positions, was not attained in quite a number of countries and certainly not for the euro area as a whole. In that respect, the application of the rules cannot be considered successful.

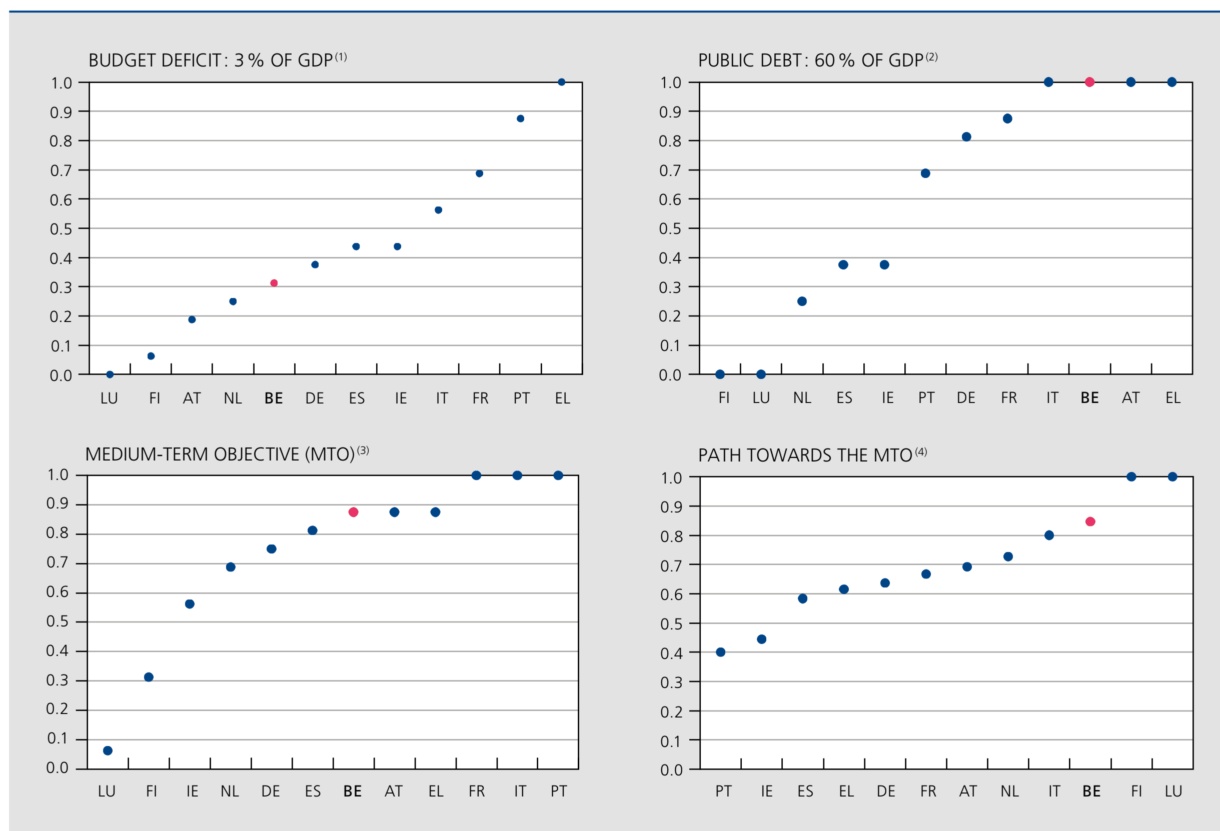
While the European fiscal rules had been properly respected in the run-up to European Monetary Union, that was decidedly less the case once the countries formed the Union. During the years following the approval of accession to EMU, a deterioration in the structural budget balance was evident in most countries, whereas that balance had generally improved strongly in the preceding years. This relaxation of fiscal policy is a very clear sign of "fiscal fatigue". While any country failing to comply with the Maastricht criteria would have incurred an extremely severe penalty, namely refusal of accession to the Monetary Union, the Stability and Growth Pact sanction mechanisms were in any case considered much less coercive.

Following the financial crisis and the ensuing economic recession, the Stability and Growth Pact rules were strengthened, and that undoubtedly helped to improve

(1) See Eyraud L. and T. Wu (2015).

CHART 5 NON-COMPLIANCE WITH THE MAIN RULES OF THE STABILITY AND GROWTH PACT

(frequency of non-compliance with the rule during 1999-2014)



Sources: EC, NBB.

(1) Number of years when the government budget deficit exceeded 3 % of GDP, divided by the total number of years.

(2) Number of years when the public debt exceeded 60 % of GDP, divided by the total number of years.

(3) Number of years when the structural budget balance was less than -0.5 % of GDP, divided by the total number of years.

(4) In the years when the structural budget balance was less than -0.5 % of GDP, proportion of years in which the annual improvement in the structural budget balance was less than 0.5 percentage point of GDP.

the situation of public finances in the euro area. That improvement can be seen primarily in the marked reduction in budget deficits of most Member States compared to 2009. For the euro area as a whole, the budget deficit was brought below 3 % of GDP in 2013, for the first time since 2008, dropping to 2.4 % of GDP in 2014. This tendency to improve should continue in the coming years.

However, many euro area countries – including Belgium – have yet to attain their medium-term objective. They therefore need to take further measures to reduce their structural budget deficit. That applies in particular to countries with a still excessive budget deficit or a public debt which is too high and not diminishing at a satisfactory pace.

The economic and financial crisis also caused a ballooning public debt in most of the euro area countries. Only six countries managed to keep their debt ratio below 60 % of GDP. In 2014, the average debt ratio was 94.2 % of GDP.

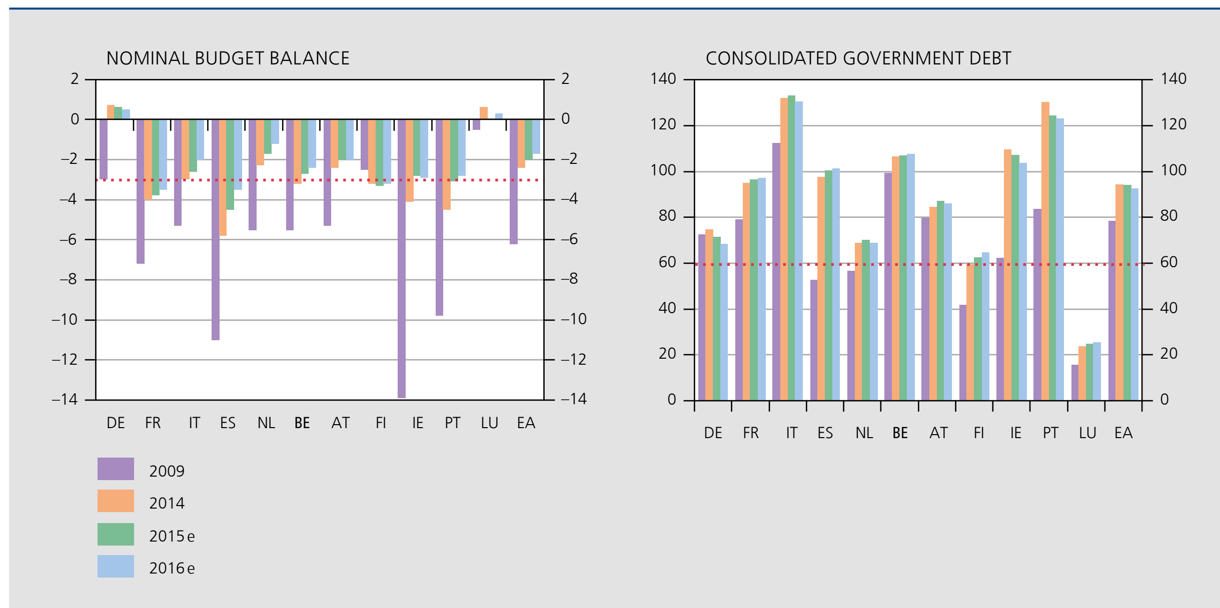
It is therefore clear that the sustainability of public finances in the long term is still not guaranteed in many countries, especially as social benefit expenditure is expected to rise in the future as a result of population ageing. Reducing the risks entailed and achieving sound public finances requires proper application of the rules of the European fiscal framework.

5.2 Fiscal rules

As a result of the successive amendments to the rules since the original version, the Stability and Growth Pact has become more appropriate or smarter.

First, it is undeniable that if a country respects the Stability and Growth Pact rules, its public finances will be sustainable in the long term. Indeed, the definition of the medium-term objective takes account of the budgetary

CHART 6 BUDGET BALANCE AND PUBLIC DEBT IN A NUMBER OF EURO AREA COUNTRIES
(in % of GDP)



Sources: EC, NBB.

cost of ageing and the debt ratio, two factors which largely determine the long-term sustainability of public finances. It is therefore good to see the renewed attention to the debt criterion and the implementation of that criterion following the approval of the Six Pack.

Second, as a result of the reforms, the rules take increasing account of the government's function in stabilising the economy in the short term. Thus, the medium-term objectives and budgetary efforts are expressed in structural terms, enabling the automatic stabilisers to smooth out cyclical fluctuations. Moreover, since the EC's January 2015 Communication, the rules offer greater scope for pursuing a counter-cyclical policy. However, in regard to the latitude for a counter-cyclical policy within the governance framework, there could admittedly be a conflict between the rules on the structural budget balance and the debt ratio. When economic activity is sluggish, the debt ratio is liable to rise automatically owing to the denominator effect of low nominal GDP, thus increasing the structural effort required. If the low nominal GDP is due to inflation remaining well below the ECB's expected target, it seems advisable to make an adjustment for that when assessing the debt criterion.

Finally, the investment clause and the structural reform clause are used as a means of encouraging measures to promote potential growth. Although that intention is laudable, the clauses are open to criticism in their present form. For instance, the structural reform clause does not comprise any method for calculating the budgetary impact of the structural reforms and the corresponding tolerance margin, so that the application of the clause is not transparent. As for the investment clause, it is very restrictively worded so that only a very few member countries are eligible to apply it in its current form.

The successive adjustments have resulted in an increasingly precise definition of the rules. Apart from the clear statistical definitions of the budget balance and the public debt, the application of which is monitored ever more effectively by Eurostat, various budgetary surveillance concepts have been given a more specific interpretation. The medium-term objective and the required adjustment path to attain it are expressed in structural terms. Similarly, the concept of the adequate degree of convergence towards a debt ratio of 60 % of GDP has been clarified. While these are welcome developments, some of the concepts could nevertheless be improved. For instance, the formula for calculating the medium-term objective is based partly on justifiable economic principles, but it is also determined partly *ad hoc*, and that impairs its credibility. Moreover, there are some practical constraints inherent in the calculation of structural budget balances, because it is very difficult to calculate the balances in a stable way owing to problems in measuring long-term potential

growth and the output gap. Since the estimated output gap sometimes undergoes major revision, the estimated structural budget balances also change significantly as time goes by. The levels of the structural budget balances are particularly sensitive to revision of the figures, even if the year-on-year changes are less susceptible. In practice, the structural budget balances therefore need to be applied with due caution, and the methods used to calculate them require further refinement. Nonetheless, a budgetary framework based on imperfect structural balances is preferable to one based on nominal balances, as the latter takes absolutely no account of the economic situation.

The current fiscal rules represent considerable progress compared to the original pact, and form a good basis for budgetary agreements within a monetary union. However, the increasingly smart fiscal rules automatically entail greater complexity. Owing to the successive adjustments to the European budgetary framework, it has become difficult to gain a clear view of the rules in force. For policy-makers, even now, it is hard to ascertain which rules must be applied and what conclusions the EC will draw from its assessment. That could undermine support for the European fiscal rules and their democratic legitimacy, and reduce the motivation for strict adherence to the rules. The rules currently in force ought to be collated into a single document that is updated : that would considerably improve the transparency of the budgetary framework and enhance its effectiveness. For the same reasons, it is also desirable to develop the fiscal rules into a stable regime subject to only occasional amendment.

5.3 Application of the fiscal rules

The success and effectiveness of any fiscal framework depends not only on the quality of the rules themselves but also on their application, which may be strict or flexible.

The European fiscal rules can only produce the desired results if there is a broad consensus on the wisdom of applying them, and if the policy-makers are prepared, if necessary, to take the measures required to respect them. But, experience has shown that, in some countries, there is relatively little support for strict compliance with the rules. A stronger commitment on the part of those countries to ensure proper application of the European fiscal rules would in any case do much to promote the smooth operation of those rules.

In addition, the proper application of the European fiscal rules needs to be monitored and enforced. The recent application of those rules shows that the EC has exhibited flexibility and that the rules have been given a flexible interpretation. It is a good thing to make best use of the flexibility offered by the rules in order to stimulate potential growth and create jobs, but wide flexibility and too many exception clauses damage the credibility of the whole regulatory framework. It is particularly the excessive combination of flexibility and exception clauses that poses problems, as this could undermine the rule-based governance framework. Furthermore, it is sometimes difficult to determine the circumstances to which the exception clauses apply. While the EC's decision to set aside the debt criterion may be justifiable in the current situation, that can only be temporary and, as soon as inflation and activity growth begin rising again, adherence to the debt criterion must be restored as a central aim of fiscal policy in all euro area countries.

A transparent regulatory framework is therefore crucial. In particular, the rules applicable to a Member State must be clearly communicated to the policy-makers and the assessment must contain a proper explanation of the basis for the decisions. Similarly, clear communication with the national fiscal institutions is important to enable them to make recommendations that correspond to what is expected on the basis of the European fiscal framework.

The EC must also monitor compliance with the European fiscal rules and for that purpose it must take full advantage of the possibilities offered by the Six Pack. It is hard to say whether the restrictions that the EC imposes on itself in this respect are the result of a deliberate choice or whether they are partly due to the limited competence of the EC as the central authority supervising compliance with the rules. A credible fiscal framework should rely on strict application of the fiscal rules.

5.4 Reform of the budgetary framework in a broader perspective

There is a consensus that the absence of a unified fiscal policy may seriously hamper the smooth operation of monetary union. However, there is currently insufficient political will for greater centralisation of fiscal policy in Europe, which requires major steps towards political union, so that this solution may only become possible in the long term. The determination of fiscal policy is in fact a central task for any government, and it is difficult to give it up because that would imply a serious reduction in sovereignty.

In the short and medium term, it is necessary to strive for more efficient operation of the regulatory framework for

public finances. This requires a stable, robust budgetary framework that is taken seriously by the various national governments. The current Stability and Growth Pact must in any case form the basis for that. The EC needs to keep a close eye on respect for the framework, and sanctions must be imposed in the event of any breaches of the rules. It is also important to strengthen the regulatory framework in order to ensure the long-term sustainability of public finances in the light of population ageing.

Moreover, a country's public finances must not be placed in jeopardy by struggling financial institutions needing capital injections from the government, as was the case during the financial crisis; that would exacerbate the situation of public finances, leading in turn to a fall in the value of government bonds, potentially damaging the health of the banks and other financial institutions. To prevent such negative feedback effects between financial institutions and governments, it is necessary to complete the European banking union project, including the establishment of a common deposit guarantee scheme.

Ultimately, the reinforcement of the regulatory framework for public finances and its strict application could benefit the credibility of the European institutions, and that could trigger progress towards political union. At the end of the day, EMU needs to develop from a system based on fiscal policy rules and guidelines into a system based on greater sharing of sovereignty with the common institutions.

The reform of the budgetary framework must therefore be a key element in the reform of the broader European political framework, the main aim of which should be to strengthen the currency union while taking account of the challenges, interests and responsibilities common to the countries that use the euro as their currency. The report prepared by the five Presidents of the main European institutions (the European Commission, the European Council, the Eurogroup, the European Parliament and the ECB), which was published at the end of June 2015 for the purpose of completing EMU, could play a role here. The report assumes that closer coordination of economic policies is essential to the proper operation of EMU. It advocates progress on four fronts, namely the transition to a genuine economic union, a financial union – by completion of the banking union and by the launch of the capital markets union – a fiscal union and, as the cornerstone, political union. That progress is to be made in three stages and completed by 2025 at the latest. In regard to fiscal union, the authors emphasise the mutual advantages of a responsible fiscal policy and hence the importance of clear agreements on the subject. Likewise it is crucial for the sum of the national budget balances to constitute a budgetary position appropriate to the euro area as a whole. In the short term, confidence in the European budgetary framework needs to be strengthened. The report proposes the creation of an advisory European Fiscal Board, which would coordinate and complement the work of the national fiscal councils. It would formulate an opinion on the appropriate budgetary path at both national and euro area level within the framework of the Stability and Growth Pact rules. However, the EC must retain responsibility for ensuring compliance with those rules. That should improve compliance with the rules and the coordination of fiscal policy between euro area countries. In the longer term, the report foresees the creation of a fiscal stabilisation mechanism at the level of the euro area as a whole. That would be better able to deal with shocks too severe to be managed by a single country. However, before any such mechanism can be set up, it is first necessary to achieve considerable progress on economic convergence, financial integration and the coordination and centralisation of decisions on national budgets, together with greater democratic accountability for the policies adopted.

The proposals put forward by the five Presidents in their report show that there is full awareness at the highest level of the need to modify the European policy framework and to give further thought to its implementation. As regards any reforms of the budgetary framework, it is crucial to take the necessary steps to render the rules clear and transparent, but above all to ensure that the rules are applied in a consistent way.

Conclusion

Up to now, in contrast to monetary policy, the fiscal policy of the euro area countries has remained a national competence. However, it is largely determined by a European governance framework aimed at promoting fiscal discipline and avoiding undesirable budget outcomes.

The Maastricht Treaty and the Stability and Growth Pact that implements the Treaty's requirements concerning fiscal surveillance form the basis of the European budgetary framework, which comprises a preventive component aimed at avoiding the occurrence of unsustainable budget positions, and a corrective component concerning the recovery measures for Member States facing serious problems with their public finances. Various adjustments to the budgetary framework have made it more intelligent but at the same time they have also increased its complexity.

Since the start of European Monetary Union, the most important rules of the Stability and Growth Pact have often been broken. That is undeniably the result of the rather weak support for strict compliance with the rules in some countries, but it is also due in part to the very complicated rules of the budgetary framework and the lax supervision over their implementation. The wide flexibility and the numerous exception clauses are key factors here. Nevertheless, in most of the euro area countries, the strengthening of the Stability and Growth Pact rules in the period 2011-2013 seems to have helped bring about an improvement in public finances that had been derailed during the financial crisis and the resulting economic recession. All the same, many Member States – including Belgium – still need to make additional efforts in order to abide by the fiscal rules. For instance, most countries have not yet attained their medium-term objective : for most countries, that objective amounts to a structurally balanced budget or a small structural deficit. The debt ratio also remains too high in many countries, and owing to the costs of population ageing, the sustainability of public finances is not guaranteed in the long term.

In the light of that, the current Stability and Growth Pact rules need to be implemented correctly in the short and medium term. That is primarily the responsibility of the Member States, but the EC also needs to ensure greater clarity and transparency while enforcing the rules more effectively and uniformly. That could encourage the Member States to adhere strictly to the rules and would make the European budgetary framework more efficient. Making the best use of the flexibility within the existing Stability and Growth Pact rules in order to promote a growth-friendly fiscal policy can only be a good thing, but wide flexibility combined with exemption clauses threatens to undermine the rule-based governance framework, and that is absolutely to be avoided.

In the long term, it is desirable for fiscal policy to become more centralised, but that requires more macroeconomic and social convergence, and fundamental steps towards political union. The Five Presidents' Report published at the end of June contains a number of interesting proposals and in any event forms a good starting point for the reform of the budgetary framework.

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