COUNCIL OF THE EUROPEAN UNION

Brussels, 18 June 2014 (OR. en)

10945/1/14 REV 1 ADD 1 REV1

LIMITE

ECOFIN 674
UEM 271

COVER NOTE

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 10945/1/14 REV 1 ADD 1.

ECONOMIC AND FINANCIAL COMMITTEE

THE SECRETARIAT

Brussels, 12 June 2014
ecfin.cef.cpe(2014)1736337

IMPROVING THE ASSESSMENT OF EFFECTIVE ACTION IN THE CONTEXT OT THE EXCESSIVE DEFICIT PROCEDURE – A SPECIFICATION OF THE METHODOLOGY

(Note for the Economic and Financial Committee)

Executive summary

The 2011 reform of the Stability and Growth Pact brought along important innovations to the functioning of the Excessive Deficit Procedure (EDP). Since then, Council recommendations under Article 126(7) TFEU and notices under 126(9) TFEU include annual nominal and structural targets that, on the basis of the underlying forecast, should be consistent with a minimum annual improvement of the structural balance of at least 0.5% of GDP as a benchmark. In an effort to increase transparency, the Commission services spelled out a methodology for assessing effective action a year ago, enforcing the principle of conditional compliance, which requires that policy errors be distinguished from forecast errors in the implementation of the EDP.

In the context of the EFC-A discussions last year, it was agreed that a review of the effective action methodology should be conducted in early 2014. To this end, the Commission prepared a note to the EFC-A, which presented its assessment of the methodology together with some further improvements. This Secretariat note builds on the initial Commission note and reflects the outcome of the discussions in the EFC-A on 27 February, 17 March, 8 April and 24 April, as well as the discussion in the EFC of 24 April.

In particular, this note:

- *First, describes in detail the "EDP decision tree", which sets-out the systematic sequencing of the effective action assessment. The assessment starts by evaluating the compliance with the recommended nominal deficit targets and the uncorrected change in the structural balance. In case of non-compliance with either of these, a careful analysis of the reasons for the shortfall is undertaken based on the "top-down" and "bottom-up" approaches together with other relevant considerations, mostly of qualitative nature. If the careful analysis concludes that the Member State concerned has delivered on its policy commitments then it is considered to have taken effective action and the EDP is put in abeyance. If the policy commitments have not been delivered, the assessment will conclude on non-effective action and lead to the stepping up of the EDP. Unless the nominal deficit target has been met, in which case, the procedure would be held in abeyance.*
- *Second, this note reviews the operation of the "top-down" approach as agreed with the EFC Alternates in January 2013. The evaluation shows that the α and β corrections to the structural balance have generally improved the estimations of the fiscal effort, especially in a context where several Member States were undergoing significant structural breaks in their economies. Moreover, for Member States entering the recovery phase, these corrections will act symmetrically on the corrected structural balance. The note presents the results of the appraisal exercise and details the refinements to the β methodology as agreed.*
- *Third, this note clarifies the role of the "bottom-up" approach in the assessment of effective action and puts forward a horizontal methodology to compute the fiscal effort from this perspective. This methodology builds on the estimated budgetary impact of discretionary measures on the revenue side and takes into account both explicit and implicit measures on the expenditure side.*
- *Fourth, the note explains how the interplay of the "top-down" and "bottom-up" measures of the fiscal effort should be considered in the careful analysis, describing the potential sources of discrepancies between both metrics. When both indicators point to the same direction there is a presumption that the Member State concerned has or has not*

implemented sufficient consolidation actions to comply with the EDP recommendation. By taking together quantitative and qualitative elements, where relevant, the careful analysis will conclude whether a Member State has or has not delivered on its policy commitments.

- *Finally, focusing on the evolution of fiscal variables in a given year can lead to an asymmetry in the assessment of compliance with EDP recommendations. Therefore, it is agreed to assess effective action on the basis of the cumulative fiscal effort for a given year over the EDP lifetime. In order to facilitate this assessment, it was also agreed that the annual recommended fiscal effort be expressed in cumulative terms in future EDP recommendations.*

1. INTRODUCTION

Once a Member State is subject to an Excessive Deficit Procedure (EDP), the Commission regularly assesses whether it is acting in compliance with the EDP recommendation or notice.[1] That is, it regularly assesses whether effective action has been taken. In particular, according to Regulation 1467/97/EC, the Commission has to do so following the expiry of the deadline set by the Council for the Member State to take effective action.[2] Thereafter, the assessments take place alongside the regular monitoring of budgetary developments, based on the same methodology.[3]

The need to distinguish between fiscal consolidation actions and fiscal consolidation outcomes implies that a Member State can be found to be compliant with the EDP recommendation even if the nominal targets are not attained (consolidation outcome), provided that it is assessed to have taken sufficient measures (consolidation actions) to ensure adequate progress towards the correction of the excessive deficit situation, in the face of unexpected events with a significant impact on the public finances.[4] Accordingly, since the 2005 reform of the Stability and Growth Pact (SGP), the change in the structural balance plays a central role in the fiscal surveillance framework, approximating the extent of the consolidation actions implemented by the concerned Member State.

Despite the known advantages of the structural balance as a measure of the fiscal effort, its endogenous relation with GDP may distort the estimations of governments' fiscal actions. In other words, the structural balance is frequently affected by non-policy effects. Acknowledging the latter, the methodology for the assessment of effective action already (i) corrects the structural balance from forecast errors and unexpected events (as per α, β and γ, presented to the EFC-A in January 2013), and (ii) is then considered within the context of a careful analysis.

In the context of the EFC-A discussions in early 2013, it was agreed that a review of the effective action methodology should be conducted after one year of implementation. For that matter, the Commission prepared a note for the EFC-A which presented its assessment of the methodology and proposed further improvements.[5] The original note was complemented by an additional note on transparency[6], a more detailed note on the formulation of the refinement to the beta[7] parameter and a revised "decision tree" for assessing effective action.[8] The EFC-A extensively discussed the Commission notes in its meetings on 27 February, 17 March, 8 April and 24 April and the EFC on 24 March and 24 April. A final discussion took place on the review and the proposed changes to the methodology in the EFC of 24 April. This note updates the original Commission note reflecting the outcome of the discussions, in particular concerning the revised "EDP decision tree" for assessing effective action together with a clarification on the scope and content of the careful analysis and the

---

[1] Hereinafter both referred to as "recommendation".
[2] Article 9(3) of Council Regulation (EC) 1467/97.

[3] See "*The assessment of effective action in the context of the excessive deficit procedure", Note for the Alternates of the Economic and Financial Committee.* Ref. Ares(2012)1546431 – 21/12/2012.
[4] Article 3(5) of Regulation 1467/97/EC.
[5] See Note for the EFC-A: *Improving the assessment of effective action in the context of the Excessive Deficit Procedure*.
[6] See Note for the EFC-A: *Transparency in the context of the Excessive Deficit Procedure.*
[7] See Note for the EFC-A: *The revision of the beta parameter*.
[8] Circulated to the EFC-A members on 15 April 2014.

agreed refinements to the beta parameter. This note is structured as follows: Section 2 describes the "decision tree" for assessing effective action in the excessive deficit procedure. Section 3 presents the results of the appraisal exercise of the effective action methodology and shows the agreed refinements to the β computation. Section 4 details the "bottom-up" approach methodology. In turn, Section 5 describes the "careful analysis" and finally, Section 6 proposes to assess the fiscal effort in cumulative terms to overcome asymmetry problems.

In order to increase transparency of the exercise, the Commission will supply EFC Alternates with all data needed to replicate the Commission estimates of structural effort (adjusted structural balance; bottom-up approach including data on the yields of fiscal measures as included in the Commission's assessments) as well as the calculations underlying the debt-reduction benchmark for all concerned Member States for each vintage of the Commission forecasts, starting with the spring 2014 forecast. These data would be made available on a dedicated website after the publication of the Commission forecast, with access restricted to the EFC Alternates. At a later stage consideration could be given to make this data available to the broader public.

As of autumn 2014, in order to increase further transparency, the Commission will complement the data provided on the yields of fiscal measures by a quantification of the main discretionary tax measures incorporated in the bottom-up approach of the assessment of effective action. This list will be updated with every forecast.

2. THE EDP DECISION TREE FOR ASSESSING EFFECTIVE ACTION

The "decision tree" for assessing effective action sets-out the systematic sequencing for the implementation of the methodology for assessing effective action, which plays a central role in different phases of the excessive deficit procedure (EDP).

The process, which is described in Figure 1, reads as follows:

If the Member State concerned is compliant with the nominal deficit target and the underlying improvement in the structural balance, the procedure is held in abeyance.

If the Member States fails or is at risk of failing to meet the headline deficit target or the required improvement in the structural balance, a careful analysis of the reasons of the shortfall will be undertaken.[9] The careful analysis is, therefore, a centrepiece in the assessment of effective action.

The careful analysis first builds on the two complementary fiscal effort measures provided by the "top-down" and "bottom-up" approaches. All in all, the aim of the careful analysis is to provide an adequate estimation of the extent of policy action to evaluate whether the Member State concerned has delivered on its policy commitments set in the recommendation. The weaknesses of the structural balance as a fiscal effort measure imply that, by itself, it does not always provide an adequate estimation of the extent of policy actions. Thus, the "bottom-up" approach can usefully complement it. However, it should be acknowledged that these estimates of the budgetary impact of the measures can be as unobservable as the structural balance.

The interaction between the two estimates of the fiscal effort (i.e. the corrected change in the structural balance and the "bottom-up") will result in one of the following scenarios:

(i) If the corrected change in the structural balance (ΔS^*) shows an effort equal or above what was recommended (ΔSR) and the "bottom-up" measure of fiscal effort is also equal or above the recommended effort, then there is a presumption that the Member State concerned has delivered on its policy commitments.

(ii) Conversely, when both the "top-down" (ΔS^*) and the "bottom-up" measure of fiscal effort are below the recommended effort, there is a presumption of non-delivery on its policy commitments.

(iii) In the intermediate cases, when both metrics send conflicting messages, there is no presumption.

In all cases, the careful analysis needs to be complemented by a qualified economic judgement of the outcome of both algorithms in order to conclude whether the Member State has delivered or not on its policy commitments. In other words, the careful analysis evaluates whether the Member State concerned has put in place enough actions to comply with the EDP recommendation. Any conclusion needs to take into consideration the quantitative information from the 'top-down' and

[9] The Code of Conduct states in this respect that: *'In case the observed budget balance proves to be lower than recommended or if the improvement of the cyclically adjusted balance net of one off and other temporary measures falls significantly short of the adjustment underlying the target, a careful analysis of the reasons of the shortfall will be made'.*

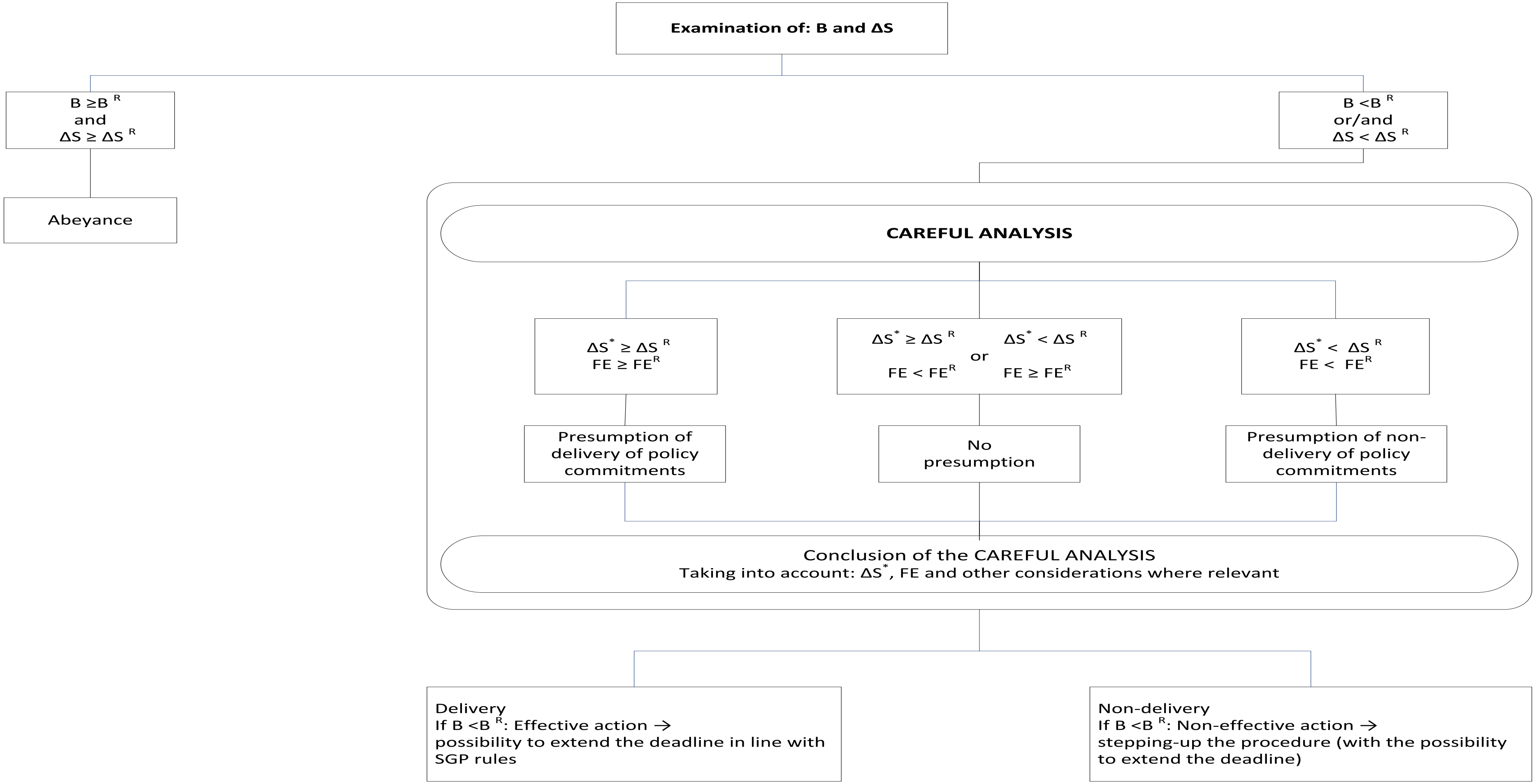
'bottom-up' measures of fiscal effort together with other considerations mostly of qualitative nature that do not emerge from the formulae.

If the careful analysis concludes that the Member State concerned has delivered on its policy commitments, the assessment will conclude that effective action has been taken, with a possibility to extend the deadline, even if the headline deficit target has not been met.

If the careful analysis concludes that policy commitments have not been delivered and that the headline deficit target is not met, the assessment will conclude on non-effective action and the procedure should be stepped up including by setting a new correction deadline as appropriate.

It must be emphasized that if the intermediate nominal deficit target has been met, the procedure will not be stepped up even if the policy commitments have not been delivered. However, it should be stressed that where the absence of stepping-up of the procedure is taken based on in -year data, should the (notified) ex-post data show that the intermediate budgetary balance has eventually not been met, the EDP can still be stepped up.

Figure 1. The EDP decision tree 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

3. THE "TOP-DOWN" APPROACH

3.1. The "top down" methodology for assessing effective action was supported by the EFC in January 2013 with a review-clause in a year's time.

The Commission proposed a methodological framework for assessing effective action in January 2013 based on the "top down" approach.[10] This compares the actual change in the structural balance (ΔS) to the recommended change in the structural balance, adjusting the former for forecast errors that are assumed to be outside the control of the government. The change in the structural balance is corrected for three effects:

- The effect of revision of potential output growth compared to the forecasts underlying the Council recommendations (α):

$$\alpha_t = \frac{G^S_{t-1}}{GDP^{potential}_{t-1}}\left(y^{potential}_t - y^{potential\,rec}_t\right)$$

  where $\frac{G^S_{t-1}}{GDP^{potential}_{t-1}}$ is the expenditure to GDP ratio net of cyclical factors in year *t* -1 – that is the year in which the Council recommendation was issued, and $y^{potential}_t$ is potential GDP growth in year *t*. All variables refer to outturn or current forecast figures, except where the superscript *rec* denotes the value given at the time of the recommendation.[11]

- The effect of revision in revenue windfalls/shortfalls relative to the forecasts underlying the Council recommendations (β):

$$\beta_t = \frac{\overbrace{\left(\Delta R_t - DM_t - g^r_t R_{t-1}\right) - \left(\Delta R^{rec}_t - DM^{rec}_t - g^{r\,rec}_t R^{rec}_{t-1}\right)}^{\text{Revenue gap}}}{GDP^{potential}_t\left(GDP^{nom}_t \big/ GDP^{real}_t\right)}$$

  where R_t, DM_t, and g^r_t respectively stand for the level of government revenues, the level of discretionary revenues measures and the mechanical annual growth in revenue. $GDP^{potential}_t$ stands for the potential output and $GDP^{nom}_t \big/ GDP^{real}_t$ is the ratio of GDP at current prices over the GDP at constant prices (this ratio being the price deflator of the GDP). $GDP^{potential}_t\left(GDP^{nom}_t \big/ GDP^{real}_t\right)$ can then be interpreted as a nominal potential output.

---

[10] See Note for the EFC-A: *The assessment of the effective action in the context of the Excessive Deficit Procedure*, and Note for the EFC-A: *The assessment of the effective action in the context of the Excessive Deficit Procedure – A follow-up of the 8th January discussion* of *25.1.2013*.

[11] A detailed explanation is provided in the notes referenced in footnote 5.

The mechanical annual revenue growth is defined as $g_t^r = \eta^R \ y_t^{nom}$, where y_t^{nom} and ε^* stand for GDP growth at current values and the revenue elasticity embedded in the computation of the cyclical component of the headline balance.

- In exceptional cases, the impact of other unexpected events such as natural disasters (γ).[12]

This, then, gives the adjusted change in the structural balance: $\Delta S^* = \Delta S - (\alpha+\beta+\gamma)$, which is compared to the fiscal effort required in the recommendation.

The methodology has been implemented in the assessments of effective action made since November 2012. The application of the α and β corrections have played an important contribution in correcting for the forecast errors made at the time of the recommendations, particularly given the difficult economic circumstances that continued to prevail in many countries in 2013. In the absence of the α and β corrections, forecast errors would have contributed to reducing the perceived effort stemming from the observation of the structural balance. With the return to growth expected in 2014, the α and β corrections should start to operate in the opposite direction in an increasing number of cases due to the symmetry in their operation.

3.2. *Refining the methodology*

The implementation of the adjustment methodology has allowed the subtleties of its operation to be better understood. As a result of the experience gained, it was decided not to change the way in which potential output revisions are taken into account (i.e. the α correction). This section does, however, present the agreed two refinements to the methodology for calculating the β component so as to improve the consistency with respect to the theoretical expression of the change in structural balance. First, the revenue gap is divided by actual – and not potential – GDP. Second, the mechanical growth in revenue g_t^r is also revised. The detailed computations underpinning these proposals are shown in Annex 1.

As shown in the annex, taking the theoretical expression of the change in structural balance as the starting point for the derivation of the β component, the "natural" denominator associated to the windfall/shortfall that comes out from the calculation is not the potential output but the actual (nominal) output.

The windfall/shortfall is computed by comparing *the actual variation in revenue* with the *projected revenue*. The projected revenue is the sum of i) the estimated policy change, i.e. the discretionary tax measures, and ii) the expected change in revenue induced mechanically by the economic growth. The latter is estimated by multiplying the previous year's revenue with the mechanical growth in revenue g_t^r .

Yet, the mechanical growth in revenue g_t^r that was computed did not completely capture the automatic response of the revenue to a change in nominal GDP. Until now, g_t^r was estimated by multiplying nominal GDP growth with the elasticity of revenue to the output gap, a technical

[12] However, it should be borne in mind that in case the response to these unexpected events is a one-off measure, it would already be netted out the computation of the structural balance.

coefficient measuring the reaction of revenues to the change in cyclical conditions and denoted η^R. This elasticity is an approximation to the impact of nominal growth on revenues, as the change in the output gap explains in practice between one quarter and three quarters of the economic growth, depending of the country and the time period considered. However, as the remaining components that explain nominal growth may (and indeed are likely to) have a different impact on revenues, using the elasticity of revenues to the output gap on nominal growth is an approximation.

An analytical decomposition of the theoretical expression of the change in structural balance shows that the following formula is more appropriate in order to fully capture the automatic response of the revenue to a change in nominal GDP:

$$g_{t\,new}^{r} = y_t^{nom} + (\eta^R - 1).\Delta OG_t$$

y_t^{nom} and ΔOG_t respectively stand for nominal GDP growth and the variation of the output gap expressed in real terms.

Therefore, the following refined formula to compute the β component will be used:

$$\beta_t^{new} = \frac{\left(\Delta R_t - DM_t - g_{t\,new}^{r}.R_{t-1}\right) - \left(\Delta R_t^{rec} - DM_t^{rec} - g_{t\,new}^{r\,rec}.R_{t-1}^{rec}\right)}{GDP_t^{nom}}$$

4. THE "BOTTOM-UP" APPROACH: METHODOLOGY

Traditionally the fiscal effort has been measured using the so-called "top-down" approach, by computing the change in the structural balance. Accordingly, this approach has also been so far the centrepiece in the effective action assessment as described above. However, the "top-down" approach, by itself, does not always provide an adequate estimation of the extent of consolidation actions. In particular, it does not provide a metric for "whether expenditure targets have been met and the planned discretionary measures on the revenue side have been implemented" as indicated in the Code of Conduct for the careful analysis.

The "bottom-up" approach aims at providing a direct estimation of the budgetary impact of the fiscal measures implemented by the government and, as such, serves as a complementary indicator of the fiscal effort. This approach though has its own weaknesses, mainly related to the difficulty in defining the impact of the measures and the benchmark of "unchanged policies" against which the government actions will be assessed. This section describes the agreed methodology for quantifying the fiscal effort from a "bottom-up" approach.

4.1. The methodology.

The "bottom-up" assessment of effective action aims at identifying the budgetary impact of the new fiscal measures implemented since the EDP recommendation was issued or since compliance with the EDP recommendation was last assessed: either of them, as appropriate in each case, is the cut-off date. While all measures implemented before that moment are already part of the baseline scenario and should not be included in the bottom-up analysis, all measures adopted afterward should be included in the assessment.

The different nature of public expenditures and revenues requires a separate treatment. While the total amount of revenues largely depends on exogenous factors, beyond the direct control of the government (e.g. changes in the tax bases – disposable income, overall consumption, production, etc. – or tax compliance), expenditures can be considered largely under the direct control of the government, except for a limited number of exogenously driven expenditure changes.[13] As such, with few exceptions, nominal changes in public expenditure can be broadly considered as resulting from autonomous decisions by the government. This fundamental difference has obvious implications for the way the developments on both sides of the budget balance are to be treated in the context of the "bottom-up" approach to the assessment of effective action.

Expenditure trends are influenced by active or explicit governmental decisions as well as by indirect ones, as governments can influence expenditures either through their action or their inaction. In this sense, estimating the fiscal effort on the expenditure side by adding up actions which are officially implemented or announced as expenditure measures, as done on the revenue side, will only capture part of the governments' decisions that determine expenditure: the explicit expenditure-related ones. The remaining share of the governments' choices, including not acting, which also affects expenditure outcomes, would be unduly left aside. Furthermore, a pure "bottom-up" approach to the expenditure side would in practice be subject to important information asymmetries between the Commission and the national authorities, which could raise cross-country comparability problems.

---

[13] These are changes in unemployment benefits due to a change in the number of unemployed, changes in interest expenditure related to fluctuations in interest and exchange rates and the share of public investment matched by EU funds.

Therefore, from a "bottom-up" perspective, the fiscal effort can be defined as follows:

$$FE_t = \underbrace{\frac{DRM_t^{assessment}}{GDP_t{}^{assessment}}}_{(1)} - \underbrace{\frac{\left(\Delta E_t{}^{assessment} - \Delta E_t{}^{baseline}\right)}{GDP_t{}^{assessment}}}_{(2)}$$

Where:

- $DRM_t^{assessment}$ is the estimated budgetary impact of the discretionary revenue measures additional to the ones already included in the no-policy change scenario[14], as estimated at the time of the assessment, net of one-offs[15] implemented in year *t* (or under the relevant subperiod of time under scrutiny).
- $\Delta E_t^{assessment}$ is the change in total nominal expenditure in year *t*, net of one-off measures, non-discretionary changes in interest payments, non-discretionary changes in unemployment benefits and public investment matched by EU funds as estimated at the time of the assessment of effective action.
- $\Delta E_t^{baseline}$ is the change in the 'no-policy change' total nominal expenditure in year *t*, as stated in the EDP recommendation, corrected for statistical revisions, net of one-off measures, non-discretionary changes in interest payments, non-discretionary changes in unemployment benefits and public investment matched by EU funds as estimated at the time the recommendation was issued.
- $GDP_t^{assesment}$ is nominal GDP in year *t* as estimated at the time of the assessment of effective action.

4.2. The revenue side.

Element (1) in the above formula represents the fiscal effort implemented on the revenue side and consists of the sum of the estimated budgetary impact of the additional discretionary revenue measures implemented in the period under scrutiny, that is as from the cut-off date.

Its full description requires the specification of the following three aspects: (i) the definition of discretionary measures with a permanent effect; (ii) how the estimated budgetary impact is computed, and finally, (iii) why is it expressed in terms of GDP in year *t* as forecast at the time of the assessment of effective action.

(i) For a government action to be considered as a discretionary revenue measure in terms of the bottom-up approach, it should fulfil the following criteria:

---

14 In the context of the bottom-up analysis, a "no-policy change scenario" can be also referred to as a "baseline scenario", as it serves as point of reference to which the current forecast is compared. It is defined in the Staff Working Document accompanying the EDP recommendation.

15 One-off measures are by definition excluded from the calculation of the structural balance, and should therefore also not be taken into account in the bottom-up analysis, which presents a complementary view on effective action. For discussion on the one-off measures, see: Public Finances in EMU 2006, Section 4. Measurement and statistical issues, European Economy 3/2006.

- autonomous interventions by the government;[16]
- enacted or credibly announced in sufficient detail;
- with a direct fiscal impact;

On the contrary, the following cases should not be considered discretionary revenue measures as a general rule:

- commitments or targets (e.g. deficit target, deficit rules) which are not underpinned by specific measures to achieve them;
- specific measures whose entry into force is conditional on reaching certain budgetary thresholds (e.g. automatic increase in a tax rate conditional on deficit breaching a deficit threshold), since those will be part of the baseline;

(ii) When estimating the budgetary impact of a discretionary revenue measure, any behavioural response or second round effects should also be factored in[17]. In this sense, it is the net impact of the discretionary revenue measure that should be added up.

(iii) Finally, the net budgetary impact of discretionary revenue measures - including second round effects - needs to be expressed in terms of an equivalent GDP. That is, one that also incorporates these second round effects so the ratio is consistent. This is GDP in year t as estimated at the time of the assessment of effective action. Otherwise, for positive multipliers, the net estimated impact of revenue increasing (decreasing) measures will be systematically underestimated (overestimated).

4.3. The expenditure side.

Element (2) in the formula compares the (almost) outturn expenditure ratio with the "no-policy change" scenario estimated at the time of the EDP recommendation at a given point in time. This comparison yields the impact of the measures – both explicit and implicit – that ended-up determining expenditure in that period. Therefore, as elaborated in Section 3.1, any expenditure slippage (or savings) as compared to the baseline scenario are taken into account in the "bottom-up" approach to the assessment of effective action along with the effect of discretionary measures.

Account should be taken of all non-discretionary expenditure items and revisions in historical data. Systematically, both $E_t^{assessment}$ and $E_t^{baseline}$ are adjusted for[18]:

(i) unemployment benefit payments related to the evolution of the number of unemployed,[19] changes in interest expenditure[20] and public investment matched by EU funds, and

---

[16] In some specific cases, a government action triggered by an event beyond the direct control of the government can be also considered as a measure, e.g. exceptional events outside the control of government (like natural disasters), some court cases, rulings by international organisations, etc. However, often those events take the form of a one-off measure, in which case they would not be relevant for the bottom-up assessment of effective action.

[17] Note however that the bottom-up estimate does not take into account broader effects, such as for instance the one that a VAT increase may have on GDP, via its impact on consumption, and then further on employment, etc. This fully concurs with the principles of estimating the budgetary effect of discretionary measures in DG ECFIN.

[18] Where relevant, other country-specific expenditure items outside the control of the government could also be taken into account. This would be done explicitly and documented.

(ii) one-offs.

Furthermore, $E_t^{baseline}$ is corrected for possible statistical revisions in the historical data including revisions in the expected (or actual) yield of measures and one-offs taken into account at the time of recommendation, which may have had an impact on the projected baseline level of expenditure.

Finally, the amount of measures on the expenditure side is expressed in terms of GDP at the time of the assessment, ensuring consistency between the revenue and expenditure components of the indicator, as opposed to the alternative of GDP as estimated at the time of the recommendation. In any case, the amount of the difference between the estimate of the GDP at the time of the recommendation and at the time of the assessment should be minimal. Simulations for increasing differences in the alternative denominators (nominal GDP at the time of the assessment *minus* nominal GDP at the time of the recommendation) show that, as a rule-of-thumb, every 5% difference between the two denominators yields between 0.01 and 0.05 of a percentage point difference in the estimated effort on the expenditure side, depending on the Member State. That is, for some Member States, only if GDP at the time of the assessment turns out to be more than 10% different to what was envisaged at the time of the recommendation, would the denominator effect have a significant impact (around a decimal point) on the estimation of the effort. For other Member States, the difference between both GDPs would need to be much larger for it to have a noticeable impact on the estimation of the effort. Taking into account that the EU-average Commission's forecast error in real GDP growth and inflation is around 1 and 0.8 p.p. respectively,[21] it seems extremely unlikely that the difference in the GDP estimation at the time of the recommendation and at the time of the assessment would be such as to actually matter for the computation of the expenditure effort.

---

19 These are gauged by applying a constant benefit ratio to the number of unemployed people. The constant benefit ratio is obtained as the ratio between total unemployment expenditure using the most recent COFOG data available and the number of unemployed people that year.

20 Except changes due to measures directly affecting the level of the debt.

21 See "*The accuracy of the European Commission's forecasts re-examined*". http://ec.europa.eu/economy_finance/publications/economic_paper/2012/pdf/ecp476_en.pdf

5. THE CAREFUL ANALYSIS

As per the "decision tree" described in section 2, a careful analysis is warranted when the Member State concerned fails or it is at risk of failing to meet the headline deficit target or the required improvement in the structural balance. In order to determine the reasons of the shortfall and ultimately whether the country has delivered on the policy commitments laid down in the recommendation, the careful analysis first and foremost builds on the outcome from the "top-down" and "bottom-up" measures of fiscal effort. Then, the careful analysis should, as indicated in the Code of Conduct, provide a qualified economic judgement of the outcome of both algorithms that will allow determining whether a Member State has put in place enough actions to comply with the EDP recommendation. It is, therefore, the final step in the assessment of effective action that aims at capturing any relevant factor that does not emerge from the formulae and at bringing together both indicators of fiscal effort.

When both the corrected change in the structural balance and the "bottom-up" measure of fiscal effort point in the same direction, the careful analysis would look into other considerations mainly to address possible measurement errors, especially in case the estimated effort only marginally exceeds (falls short of) the recommended one.

Conversely, in the other two cases – where the indicators send conflicting messages – the careful analysis aims at disentangling the possible sources of the difference, in order to conclude which of the two is providing the most accurate picture of the fiscal consolidation actions implemented by the concerned Member State.

In this sense, differences may stem from, among other reasons:

(i) Unexpected dynamics in certain expenditure items. Generally, fiscal authorities can reasonably not be held accountable for the dynamics of certain expenditure categories: while any expenditure trend that is predictable should be considered and internalized by governments when deciding their fiscal policy mix, unexpected dynamics can be potentially excluded from the general framework. This would be the case, for instance, of increases in health expenditure related to unexpected health events affecting a large size of the population. This kind of unexpected events is already captured in the "top-down" approach via the γ correction. However, in the "bottom-up" general framework this will be considered as an expenditure slippage, given that the formula systematically corrects for some exogenous expenditure items[22] but not for other more specific ones. Thus, the careful analysis will allow the reconciliation of the two indicators where the difference stems from some specific non-discretionary expenditure developments that are asymmetrically accounted for in both indicators.

(ii) Inflation developments. The careful analysis will also allow the identification of whether inflation developments may be driving the "bottom-up" and "top-down" estimates apart. In fact, the "bottom-up" estimate of fiscal effort on the expenditure side considers expenditures in nominal terms, whereas the "top-down" estimate is computed in real terms. For a given real expenditure level, unexpected inflation developments will be corrected for in the "top-down" approach through

[22] Namely the share of interest expenditure and unemployment benefits that can be considered outside the control of the government. The share of public investment matched by EU funds should not be considered as a negative fiscal effort given that this expenditure is being compensated on by dedicated funds.

the cyclical adjustment, whereas they will be considered as an expenditure slippage in the "bottom-up" estimate. This should be reconciled in the qualitative assessment of the results.

(iii) Adjustments to the "bottom-up" measure of the fiscal effort on the expenditure side. The "bottom-up" estimate of fiscal effort on expenditure side explicitly excludes the changes in interest expenditure and public investment matched by EU funds,[23] which are not excluded from the computation of the structural balance and should therefore be considered in the careful analysis.

All in all, the careful analysis will determine whether the Member State concerned has delivered or not on its policy commitments.

The report on action taken by the Member State concerned will be an important piece of information for conducting the careful analysis. In particular, Member States are requested to include the targets for government revenue and expenditure as well as for the discretionary measures consistent with those targets. These measures should be described in detail so as to facilitate the assessment. For non-euro area EU Member States the report on action taken is only produced once in the EDP lifetime – usually within six months of the recommendation being issued. Euro area Member States in EDP since the entry into for the 'Two-Pack' additionally shall report every six or three months the in-year budgetary execution, the budgetary impact of discretionary measures, targets for the government expenditure and revenues, and information in the measures adopted and the nature of those envisaged to achieve the targets.

[23] Unemployment benefit payments related to the evolution of the number of unemployed are cyclical, therefore they do not contribute to the difference between the "top-down" and the "bottom-up" estimate of fiscal effort.

6. THE CUMULATIVE FISCAL EFFORT FOR MULTI-ANNUAL EDPS

A Member State is found compliant with the EDP recommendation if the annual nominal target is met.[24] As a result the EDP procedure would be held in abeyance even if the required annual fiscal effort is not delivered. This can generate an asymmetry in the way compliance with the EDP recommendation is assessed, as explained below.

This poses a particular challenge for multi-annual EDPs. For example, one could consider a 2-year EDP in which a Member State complies with the nominal target without delivering the recommended annual fiscal effort in the first year, while it does not meet the nominal target but delivers the annual fiscal effort recommended for the second year. An assessment of effective action that would take place in the second year would conclude that the Member State concerned has taken effective action if it focuses only on the (second) year under consideration. Therefore, it would pave the way for an extension of the deadline for correction without imposing any sanction, in spite of the fact that the overall structural effort for both years as recommended in the EDP would not have been met, jeopardizing a durable correction of the excessive deficit. By the same token, a Member State that decides to frontload the necessary fiscal consolidation by delivering a fiscal effort above the recommended one in the first year and somewhat below in the following year, would be penalised in the assessment of effective action.

In forthcoming assessments of effective action, the Commission will examine whether the overall fiscal effort over the EDP correction period is delivered in order to balance – at least partially – the asymmetry in the assessment. This ensures that a Member State that meets its nominal target in the first year without delivering the recommended annual effort would only be found compliant with the recommendation in the second year if it delivers the cumulated fiscal effort of the first two years even if the nominal target is not met. Analogously, by looking at the cumulated fiscal effort, Member States wishing to frontload the required adjustment would not be discouraged to do so.

All in all, Member States will be better equipped to correct their excessive deficit in a lasting manner i.e. having a deficit forecast not exceeding the 3% of GDP threshold over the Commission forecast horizon. If the deficit reaches 3% of GDP at maximum in the final year of the EDP, but the durability of the correction is still not ensured, effective action will be assessed against the overall (cumulated) effort as benchmark. The α, β and γ corrections to the change in the structural balance will also be considered in cumulative terms.

Similarly, the "bottom-up" assessment will also be conducted in cumulative terms for those Member States whose EDP recommendations specifically indicate the amount of additional fiscal consolidation measures to be implemented every year (i.e. after spring 2013). For Member States that do not meet the annual nominal target nor the cumulated (uncorrected) change in the structural balance, the joint assessment of both the corrected change in the structural balance and the "bottom-

---

[24] This is consistent with the Code of Conduct, which specifies that the EDP procedure shall be abrogated when the deficit is forecast to remain below 3% of GDP in a durable manner (irrespective of whether the fiscal effort has been delivered) and the forward looking element of the debt benchmark is respected. Recursively, if the intermediary nominal targets are fulfilled, the procedure should be held in abeyance.

up" will be considered in the careful analysis together with other considerations where relevant as described in Section 2 and 5.

As a corollary to the proposed improvements in the assessment of effective action the Commission suggests that the annual recommended fiscal effort should be expressed in cumulative terms in the forthcoming EDP recommendations, as described in the example below. This change would obviously be reflected both in the required improvement of the structural balance and the necessary additional fiscal consolidation measures to achieve these targets. As mandated by the legislation, the annual targets to be expressed in terms of the cumulated change in the structural balance will be directly specified in the Article 126(7) recommendation.

Example: Fiscal consolidation targets in a multiannual EDP recommendation (% of GDP)

EDP recommendations up to December 2013

	20xx	20yy	20zz
Headline deficit	X%	Y%	Z%
Improvement in the structural balance	A%	B%	C%

Additional consolidation measures up to December 2013

	20xx	20yy	20zz
Additional consolidation measures	E%	F%	G%

EDP recommendations from December 2013

	20xx	20yy	20zz
Headline deficit	X%	Y%	Z%
Improvement in the structural balance	A%	B"%=(A+B)%	C"=(A+B+C)%

Additional consolidation measures from December 2013

	20xx	20yy	20zz
Additional consolidation measures	E%	F"%=(E+F)%	G"%=(E+F+G)%