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NOTE

From:	General Secretariat of the Council
To:	Working Party of Financial Counsellors
Subject:	EGR - Written Replies by the Commission services on the amending Regulation 1467/97

Delegations will find attached the written replies by the Commission services on the amending Regulation 1467/97 ("The Corrective arm").

As stated in the disclaimers, please note that (i) the note and the replies have not been adopted or endorsed by the Commission; (ii) any views expressed are preliminary views of the Commission services and may not in any circumstances be regarded as stating an official position of the Commission, and (iii) the information transmitted is intended only for the entity to which it is addressed and may contain confidential and/or privileged material.

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WRITTEN REPLIES TO MEMBER STATES' QUESTIONS ON THE PROPOSAL FOR AMENDING REGULATION (EC) NO 1467/97 ("THE CORRECTIVE ARM")

Deficit criterion: Articles 2(1) and 2(2)

1. Will the identification of an excessive deficit be based on projections or based on notified data?

The identification of an excessive deficit based on the deficit criterion remains unchanged in the Commission's legislative proposal. In line with Article 126(2), point (a), TFEU, the preparation of an Article 126(3) report will continue to be based on a planned or an actual breach of the 3% of GDP deficit reference value. For the identification of an excessive deficit based on the debt criterion, the Commission proposes to provide in Article 2(1a) and (3), point (b), of the corrective arm that an Article 126(3) report would be prepared when a Member State fails to respect the net expenditure path endorsed by the Council. This is in line with the past interpretation of Article 126(2), point (b), TFEU, according to which it only applies to outturn data.

2. What is the meaning of the severe economic downturn at country-level referred to in Article 2(2)?

The proposed Article 2(2) states that an excess over the 3% of GDP reference value that results from a severe economic downturn in a Member State could be considered as exceptional in the sense of Article 126(2), point (a), TFEU where the Council establishes the existence of exceptional circumstances in accordance with Article 25 of the proposed preventive arm Regulation. Article 2(2) is therefore a specific case of the general reference to exceptional circumstances outside the control of the government with a major impact on the public finances of the Member State concerned referred to in the proposed Article 2(1).

In the current Regulation on the corrective arm, an excess resulting from a severe economic downturn at Member State level is considered exceptional in case of negative real GDP growth or an accumulated loss of output during a protracted period of very low real GDP growth relative to its potential. In the proposed article 2(2), the Commission proposes to directly link this exceptional circumstance to the activation of the country-specific escape clause under the proposed preventive arm Regulation. It thus links the exceptional breach of the 3% of GDP reference value to the exceptional circumstances that allow for a deviation from the net expenditure path. This will ensure a consistent interpretation of exceptional circumstances between the preventive and corrective arms.

Debt criterion: Article 2(1a)

3. How is the debt criterion operationalised?

A Member State complies with the debt criterion of Article 126(2) TFEU if its debt ratio is below 60% of GDP or "sufficiently diminishing and approaching the reference value at a satisfactory pace". The Commission proposes in Article 2(1a) of the corrective arm that the second element of this criterion shall be considered fulfilled if a Member State respects its net expenditure path, as endorsed by the Council. In this connection, it is to be noted that the Commission will assess, prior to endorsement by the Council, that the net expenditure path proposed by the Member State ensures that public debt is

put or kept on a plausibly downward path by the end of the adjustment period at the latest, or that it stays at prudent levels (Article 15 of the proposed preventive arm Regulation). In this way, the implementation of the endorsed net expenditure path should effectively put debt on a downward path towards the reference value or keep it at prudent levels.

4. What size of deviation from the net expenditure path will lead to the preparation of an Article 126(3) report or the opening of an EDP?

All material deviations from the net expenditure path would lead to the preparation of an Article 126(3) report. Moreover, in the report itself, the size of and the reasons for the actual deviation would be assessed, along with an assessment of other relevant factors, such as the level of ambition of the net expenditure path compared to the technical trajectory. The Commission does not propose to define a threshold for the size of the deviation from the endorsed net expenditure path that would lead to the preparation of an Article 126(3) report. In the view of the Commission, such a threshold should not be included in the legislation as it would lead to an overly automatic and rigid framework for fiscal surveillance that would, in the end, not be realistic. The experience with the significant deviation procedure also showed that any pre-defined margin of tolerable deviations risks to be considered as additional leeway for fiscal policy.

5. What is the role of the control account when assessing compliance with the debt criterion?

The control account is an information and reporting tool. As per Article 21 of the proposed Regulation on the preventive arm, it will keep track of cumulative upward and downward deviations of actual net expenditures from the net expenditure path endorsed by the Council. In this sense, it will add a degree of memory that does not exist in the current framework and will strengthen the medium-term dimension of the framework. The information provided in the control account will be one relevant factor to be considered when drafting the Article 126(3) report as a measure of the annual and cumulative deviation, in line with point (b) of Article 2(3) of the proposed amended corrective arm Regulation.

Key relevant factor: Article 2(3)

6. Is there an automatic opening of an EDP in case a Member State with substantial debt challenges?

There is no automaticity in the opening of debt-based EDP. Specifically, for a Member State with debt above 60% of GDP, a deviation from the net expenditure path set by the Council will trigger an Article 126(3) report to assess if an EDP needs to be opened. The degree of a Member State's debt challenges would be considered a key relevant factor, in accordance with Article 2(3). In particular, where the Member State faces substantial debt challenges, it shall be considered a key factor leading to the opening of a debt-based EDP as a rule. The Commission shall also take into account all other relevant factors, as indicated in Article 126(3) TFEU, in so far as they significantly affect the assessment of compliance with the deficit and debt criteria by the Member State concerned. A non-exhaustive list is included in the abovementioned Article 2(3).

7. What is the frequency of the Debt Sustainability Monitor and the Fiscal Sustainability Report? Will they be merged?

The Debt Sustainability Monitor (DSM) and the Fiscal Sustainability Report (FSR) contain essentially the same kind of information, namely an overview of fiscal sustainability risks over the short, medium and long term. The differences are that the FSR closely follows the release of the Ageing Report, published every three years, with updated ageing costs and the FSR leads to Council Conclusions. In essence, the Commission services publish on a yearly basis an update of the fiscal sustainability assessment and will continue to do so. That being said, in order to avoid possible confusion, and given that there is an explicit reference to the DSM in the legislative proposal, a renaming of the reports could be considered in the future, i.e. publishing a DSM every year.

Other relevant factors: Article 2(3)

8. What is the role of the other relevant factors?

The degree of debt challenges will be considered a key relevant factor. In particular, where the Member State faces substantial debt challenges, it shall be considered a key factor leading to the opening of a debt-based EDP as a rule. The Commission will also take into account all other relevant factors as indicated in Article 126(3) TFEU, in so far as they significantly affect the assessment of compliance with the deficit and debt criteria by the Member State concerned as aggravating or mitigating factors. As under the current Regulation (Article 2(4)), when assessing compliance with the deficit criterion for a Member State with debt above 60% of GDP, the relevant factors can only be taken into account if the double overarching condition is met, i.e. the deficit remains close to the 3% of GDP reference value and its excess over the reference value is temporary.

9. What is the meaning of the relevant factors under point (a) of Article 2(3)?

The relevant factors under point (a) of Article 2(3) concern the developments in the medium-term economic position of the Member State, which is a relevant factor referred to in Article 126(3) TFEU. While the Commission tried to streamline the relevant factors in its proposal, consideration of the developments in the medium-term economic position of the Member State remains warranted.

In particular, when assessing a deviation from the net expenditure path, inflation developments compared to the assumptions underlying the net expenditure path might be relevant as a driver for deviations if the net expenditure path is formulated in nominal terms.

Cyclical developments might also be relevant, for instance when assessing temporary breaches of the 3% of GDP deficit reference value. Indeed, a Member State might exceed the 3% of GDP threshold due to an adverse cyclical impact on the deficit even when adhering to the endorsed net expenditure path. At the same time, by design, cyclical developments do not have a direct impact on a Member State's net expenditure and its adherence to the endorsed path, as the indicator allows for the operation of automatic stabilisers along the cycle: the indicator does not include non-discretionary revenue fluctuations and cyclical unemployment expenditure.

In contrast, the Commission's proposal no longer refers to potential growth because in principle it would not have an impact on compliance with the net expenditure path (see response to question 7 over the preventive arm). Revisions to potential growth would rather only have an impact on the new expenditure path in the subsequent medium-term fiscal-structural plan, based on an update of the Commission's debt sustainability analysis.

10. Why does the Commission propose to compare the net expenditure with the technical trajectory as a relevant factor?

Where relevant, when assessing the size of a deviation from the endorsed net expenditure path, considering the deviation from the technical trajectory allows to take into account the ambition of the net expenditure path of the endorsed plan. This also avoids disincentives leading to a Member State not putting forward a net expenditure path more ambitious than the technical trajectory in order to minimise the risk of a deviation.

11. What is meant by “particular consideration shall be given to financial contributions to fostering international solidarity and achieving the policy goals of the Union” in Article 2(3), last subparagraph?

Regarding the consideration of financial contributions to fostering international solidarity and achieving the policy goals of the Union amongst the relevant factors, there is no change compared to the current legislation. It is up to the Member State to put forward the factors it considers relevant in order for the Commission and Council to comprehensively assess compliance with the deficit and debt criteria. Therefore, it is not warranted for the Commission and the Council to further specify what should be included under such factors.

Reforms and investment underpinning an extension

12. Would an EDP be opened if a Member State does not implement reforms or investments that underpin a more gradual adjustment path?

The main purpose of the corrective arm is to ensure the prompt correction of excessive deficits. According to Article 2(3) of the proposal, at the point of preparing a 126(3) report for a Member State due to the breach of the 3% of GDP deficit reference value (deficit criterion) or a deviation from the endorsed net expenditure path (debt criterion), the Commission would carefully analyse all relevant factors. These relevant factors could include the implementation of reforms and investment, as proposed under point (d) of Article 2(3).

In addition, a new enforcement tool under the preventive arm would lead to a revision of the adjustment path in a more restrictive sense in case of non-implementation of the reforms and investment underpinning a more gradual adjustment path. Concretely, according to Article 19 of the proposal on the preventive arm, where a Member State has been granted an extension of its adjustment period but fails to satisfactorily comply with its set of reform and investment commitments underpinning the extension, the Council may, on a recommendation from the Commission, recommend a revised net expenditure path with a shorter adjustment period. For Member States with debt above 60% of GDP, this could in turn entail the opening of an EDP if the Member State deviates from the shorter (and in principle more-demanding) revised net expenditure path.

13. Is it possible to have a more gradual corrective net expenditure path underpinned by reforms and investment?

In accordance with the proposed Article 3(4), the corrective net expenditure path under the EDP should bring and/or maintain the deficit durably below the reference value of 3% of GDP within the deadline established by the Council (with a minimum annual adjustment of at least 0.5% of GDP as a benchmark) and put the projected debt ratio on a plausibly downward path or keep it at a prudent

level. In accordance with Article 2(6) of the proposed Regulation, the Council shall take into account the relevant factors, which include the implementation of reforms and investment, in the procedural steps under the EDP, in particular in establishing a deadline for the correction of the excessive deficit. This provision is unchanged from the current regulation. (See also reply to question 19.)

Escape clauses

14. What is the definition of “severe economic downturn” and “exceptional circumstances”?

The reformed system would incorporate robust escape clauses to address exceptional situations when the endorsed fiscal adjustment path cannot realistically be adhered to. In particular:

- A general escape clause could be activated to deal with a severe economic downturn in the euro area or EU as a whole; and
- An exceptional circumstances clause would allow a Member State to deviate from its net expenditure path in the case of exceptional circumstances outside the control of the government with a major impact on public finances.

Defining the concepts of “severe economic downturn” and “exceptional circumstances” in a very precise or narrow manner would defeat the very purpose of these provisions, which should deal with situations that are truly exceptional but cannot always be foreseen. As per Articles 24 and 25 of the proposed preventive arm regulation, the Council would have to decide to activate or prolong the application of the general and country-specific escape clauses and set related time limits based on a recommendation from the Commission.

15. What is the role of the different references to severe economic downturns and exceptional circumstances in the corrective arm?

The different references to severe economic downturns or exceptional circumstances outside the control of the government refer to different steps in the EDP. In order to ensure a consistent application, the occurrence of a severe economic downturn or exceptional circumstances is defined, where possible, through cross-references to the proposed preventive arm Regulation, respectively its Article 24 and 25.

- Article 2(1) defines the concept in Article 126(2), point (a), TFEU of an exceptional excess over the 3% of GDP deficit reference value. An excess is defined as exceptional if the excess occurs during the activation of the general escape clause or the country-specific escape clause of the proposed preventive arm Regulation. Article 2(2) refers to an exceptional excess that follows a severe economic downturn in an individual Member State, leading to the triggering of the country-specific escape clause (see above, response to question 2).
- Article 2(3) point (b) refers to the activation of the general escape clause or the country-specific escape clause as a relevant factor when assessing compliance with the deficit criterion (breach of the 3% of GDP reference value) and/or debt criterion (respect of the net expenditure path).
- Article 2(5) introduces the possibility of not concluding on the existence of an excessive deficit in case of activation of the general escape clause. This would be mostly relevant for the assessment of compliance with the deficit criterion where the double overarching condition would prevent the consideration of a severe economic downturn as a relevant factor.

- Articles 3(6) and 5(2) allow the Council to adopt a revised recommendation (under Article 126(7) TFEU) or notice (under Article 126(9) TFEU) following the activation of the general escape clause under the preventive arm. The revised recommendation or revised notice may, in particular, extend the deadline for the correction of the excessive deficit by one year as a rule.
- Articles 3(6) and 5(2) also allow the Council to adopt a revised recommendation or notice following exceptional circumstances outside the control of the government with a major impact on the public finances of the Member State concerned. A cross-reference to Article 25 of the proposed preventive arm Regulation is not possible in this particular case, as the Member State would no longer have a net expenditure path under the preventive arm from which the Council would be able to allow a deviation. The revised recommendation or revised notice may, in particular, extend the deadline for the correction of the excessive deficit by one year as a rule.

16. Why does the proposed Article 2(5) not refer to country-specific exceptional circumstances?

To draw the lessons from the response to the Covid-19 pandemic, when the process of opening EDPs was suspended in an ad hoc but necessary manner against the background of exceptionally high uncertainty (preventing the setting of a credible corrective fiscal adjustment path), the proposal for amending the corrective arm Regulation introduces the possibility of not concluding on the existence of an excessive deficit when the general escape clause is activated by the Council, in accordance with Article 24 of the proposed preventive arm, and when deviations from the net expenditure paths are thus authorised provided they do not endanger fiscal sustainability in the medium term.

In a similar vein, a breach of the 3% of GDP deficit reference value would not automatically result in the opening of an EDP when the general escape clause is activated, even if under the normal rules the relevant factors cannot be taken into account (i.e., because of the breach of the deficit reference value by Member States with debt above 60% of GDP that does not fulfil the double overarching condition of remaining close and temporary). Such a horizontal suspension of EDP openings might be warranted in a context of a wide-ranging economic crisis affecting the euro area or the EU as a whole as recognised by the Council.

Regarding country-specific exceptional circumstances with a major impact on the public finances of the Member State concerned, they may result only in a temporary and limited breach of the 3% of GDP deficit reference value, allowing those circumstances to be considered as a mitigating relevant factor in the assessment of compliance with the deficit criterion made in the 126(3) report. Country-specific exceptional circumstances would also be taken into account as a relevant factor when assessing compliance with the debt criterion following a deviation from the net expenditure path.

17. Why are the conditions in Article 3(6) and Article 5(2) (effective action OR exceptional circumstances) for issuing a revised EDP recommendation or notice no longer cumulative?

When there are exceptional circumstances outside the control of the government with a major impact on public finances, it would likely become unfeasible to stick to the corrective net expenditure path, and therefore the Council should be able to adopt a revised recommendation or notice and, if needed, extend the EDP deadline even in the absence of effective action. Conversely, if the corrective net expenditure path is followed, thus showing effective action, but the deficit is not brought below 3% of GDP due to cyclical conditions, the Council should have the possibility to extend the deadline for correction, even in the absence of exceptional circumstances outside the control of the government. In both cases, the Council is not obliged to extend the deadline, as the proposed Article 3(6) and Article

5(2) only provides the possibility for a revised recommendation or notice with a revised deadline and revised corrective path.

Corrective net expenditure path: Article 3(4) and 5(1)

18. What would be the indicator for the 0.5% of GDP benchmark adjustment of the corrective net expenditure path?

In the current Regulation, the benchmark adjustment of at least 0.5% of GDP is defined in structural balance terms. In the Commission's proposal, the indicator used is not defined, but given the reference to (fiscal) adjustment it should capture the fiscal effort by the Member State, rather than developments in the headline balance.

In the context of the reform, the metric used can either be the change in the structural primary balance or the developments of net primary expenditure (which are equivalent ex ante). Using net expenditure would ensure full consistency with the single operational indicator that is proposed to be used for the formulation of the corrective net expenditure path and the monitoring of its implementation. Whilst the technical trajectories in the simulations shared with Member States were calibrated on the structural primary balance, as has traditionally been the case in the Commission's debt sustainability analysis, the trajectory could be calibrated on net expenditure in the future.

19. How will the corrective net expenditure path be set? How many years would be covered? Will there be an updated Commission technical trajectory and a dialogue?

It is at the discretion of the Council, based on a recommendation from the Commission, to set a deadline for the correction of the excessive deficit and a corrective net expenditure path that complies with the provisions of the proposed Article 3(4).

In particular, the corrective net expenditure path should be consistent with the criteria for setting the technical trajectory, as defined in Annex I of the proposed preventive arm Regulation. The path would have to ensure that by the end of the adjustment period, at the latest, the 10-year debt trajectory is on a plausibly downward path, or stays at prudent levels, and the deficit is brought below the 3% of GDP reference value and maintained below it over the same 10-year period. The path would also need to be consistent with a minimum annual adjustment of at least 0.5% of GDP as a benchmark for the years when the deficit is expected to be above 3% of GDP. The adjustment effort should not be postponed towards the final years of the adjustment period. Concretely, the corrective net expenditure path shall ensure that the average annual fiscal adjustment effort in the first three years is at least as high as the average annual effort of the total adjustment effort. When debt is above 60% of GDP, the public debt ratio at the end should be below the public debt ratio before the start of the adjustment period. Lastly, national net expenditure growth should remain below medium-term output growth, on average.

As noted in recital 16 of the amending Regulation, such corrective net expenditure path could in principle be the net expenditure path of the plan endorsed by the Council under the preventive arm, while taking into account the need to correct the deviation from that path, unless that path is no longer feasible due to objective circumstances. The proposed regulation does not provide for a technical dialogue on the corrective net expenditure path, given that under the corrective arm the path would be proposed by the Commission and no longer by the Member State.

The duration of the deficit-based EDP will depend on the size of the breach and the prevailing cyclical conditions, while the path shall continue to be consistent with a minimum annual adjustment of at least 0.5% of GDP as a benchmark, as per the current Regulation.

For the debt-based EDP, the proposed Article 8 stipulates that the EDP could be abrogated if the Member State has respected the corrective path over the previous two years and is projected to continue to do so in the ongoing year, on the basis of the Commission forecast. This means that a debt-based EDP recommendation covers at least 3 years, with (early) abrogation possible as of the third year.

Role of independent fiscal institutions

20. What evidence is there for IFIs having a positive impact on plausibility of forecasts and fiscal discipline?

There is evidence, as presented for example by the OECD, IMF, the European Commission, the European Parliamentary Research Service and academia,¹ that independent fiscal institutions can play a key role in reducing the deficit bias, including by ensuring that fiscal forecasts and plans are based on realistic macroeconomic forecasts and that fiscal rules are followed. By extending their area of analysis more clearly into the budgetary field, this effect could be reinforced.

21. When assessing the relevant factors put forward by the Member State, will the Commission take the opinion of the Independent Fiscal Institutions on these factors into account?

Yes. The IFI would have an important advisory role when assessing the relevant factors put forward by the Member State. While the Commission and the Council, in line with Article 126 TFEU, have the final word on the relevance of these factors, the opinion of the IFI would inform the assessment.

¹ OECD: “Experience and empirical evidence suggest that delegating macroeconomic forecasting to an independent fiscal council can indeed reduce forecasting bias. There is some empirical evidence that independent fiscal institutions can buttress a government’s capacity to comply with a numerical rule.”

[How Can Fiscal Councils Strengthen Fiscal Performance? | OECD Journal: Economic Studies | OECD iLibrary \(oecd-ilibrary.org\)](#)

IMF: “Tentative econometric evidence suggests that the presence of a fiscal council is associated with more accurate and less optimistic fiscal forecasts, as well as greater compliance with fiscal rules.”

[Independent Fiscal Councils: Recent Trends and Performance \(imf.org\)](#)

EPRS: “...initial experience shows that .../Independent Fiscal Institutions/... can contribute to i) providing better information to both voters and politicians, thereby strengthening the democratic process; ii) identifying and warning against unsustainable trends that can potentially cause fiscal crises; and iii) reinforcing the stability of the euro area as a whole.”

[Independent fiscal institutions in the EU \(europa.eu\)](#)

The European Commission: “There is some preliminary empirical evidence that the prudence of official forecasts has improved recently.” (eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52020SC0211).

Eurasian Economic Review: “The results confirm that fiscal institutions improve the discretionary implementation of fiscal policy: policy measures are less procyclical and more concerned with the sustainability of public debt.”

[Fiscal institutions: different classifications and their effectiveness | SpringerLink](#)

Other issues

22. Why are the provisions related to the contributions to second pillar pension systems repealed?

The existing provisions require the Council and the Commission, when assessing steps under the EDP, to give due consideration to the implementation of pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar and the net cost of the publicly managed pillar.

The impact of the upfront costs of such reforms would already be taken into account when setting the net expenditure path of the plan. Therefore, there is no need to take them into account when assessing compliance with the debt criterion, following a deviation from the endorsed net expenditure path.

When assessing compliance with the deficit criterion following a breach of the 3% of GDP reference value, the impact of the upfront costs of such a pension reform could still be taken into account as a relevant factor under Article 2(3), point (b) and/or (d), for Member States with debt exceeding 60% of GDP with the double overarching condition that the deficit remains close to the reference value and the excess is temporary. The impact of such a reform could also be taken into account when setting the corrective net expenditure path.

Lastly, for the abrogation of the EDP (Article 2(7) in the current Regulation), we consider that exceptions for this particular case are not warranted and propose in all cases to only abrogate the deficit-based EDP if the deficit is brought durably below 3% of GDP .