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**COMMUNICATION FROM THE COMMISSION**

**Common principles on national fiscal correction mechanisms**

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#### Background

The Treaty on the functioning of the European Union requires that Member States regard their economic policies as a matter of common concern and that their budgetary policies are guided by the need for sound public finances.

The global economic and financial crises have exposed weaknesses in economic and budgetary governance in the Economic and Monetary Union. Already, a new reform package – the so-called Six-Pack – has been adopted and entered into force last December. As the difficult times continue, the extent and potential consequences of the spillovers between euro area Member States' economic and budgetary situations is now clearly evident.

Based on this rationale, the Commission proposed on 23 November 2011 two further pieces of legislation aimed at strengthening the surveillance mechanisms in the euro area, in addition to a Green Paper on euro Stability Bonds. This so-called "Two-Pack" comprises two proposals:

- Regulation of the European Parliament and the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area.
- Regulation of the European Parliament and the Council on the strengthening of economic and budgetary surveillance of Member States experiencing or threatened with serious difficulties with respect to their financial stability in the euro area.

In addition, building on these elements and in view of safeguarding the stability of the euro area as a whole, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), which was signed on 2 March 2012 by twenty-five Member States, includes a fiscal compact (Title III). The aim is to enshrine these commitments into EU law within five years of its entry into force.

As part of the fiscal compact, the Contracting Parties shall introduce in their national law rules on a correction mechanism to be triggered automatically in the event of significant observed deviations from the medium-term objective or the adjustment path towards it (article 3, paragraphs 1(e) and 2).

Moreover, according to the TSCG (article 3.2), the correction mechanisms shall be put in place "on the basis of common principles to be proposed by the European Commission, concerning in particular the nature, the size, and the time-frame of the corrective action to be undertaken also in the case of exceptional circumstances, and the role and independence of the institutions responsible at national level for monitoring the observance of the rules".

As part of the implementation of the TSCG, this Communication is adopted in view of the general interest of the Union and to contribute to the proper functioning of economic and monetary union

This Communication puts forward common principles underlying the national correction mechanisms. The seven principles are to be found in the Annex. They cover the key issues to be addressed when designing the correction mechanisms, including their legal status, the consistency with the EU framework, the activation of the mechanisms, the nature of the correction in terms of size and timeline, its operational instruments, the working of possible escape clauses, and the role and independence of monitoring institutions.

.Article 3 of the TSCG also invites the Commission to propose a time-frame for rapid convergence of the Contracting Parties towards their medium-term objectives (MTO), taking into consideration country-specific sustainability risks. This timeframe will be presented by the Commission later this year. The consolidation plans presented by Member States in their latest update of the Stability or Convergence Programme would provide a natural starting point to define the pace of convergence towards MTOs. These consolidation plans would need to be reassessed against the provisions of the Stability and Growth Pact, including the adequacy of MTOs, and the principles of the exit strategy in the light of the macroeconomic outlook, notably differentiation according to fiscal vulnerability.

## **1. Legal status of the rules on the correction mechanisms and relation to the EU framework**

According to the TSCG the rules on the correction mechanisms shall take effect in national law "through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes". Thus the legal status of the correction mechanisms should be such that their provisions cannot be simply altered by the ordinary budgetary law. At the same time, as is also made clear in the TSCG and duplicated in principle (1), the correction mechanisms "shall fully respect the prerogatives of national Parliaments". These characteristics aim at ensuring that the fiscal rules effectively inform national budgetary policies, while acknowledging the fundamental parliamentary rights.

Principle (2) asserts the necessary *consistency with the EU budgetary rules* of the national correction mechanisms. The requirements of the fiscal compact are part of a broader move, already initiated with the recent reform of the Stability and Growth Pact (the "Six-Pack"), increasing the national ownership of the Union surveillance framework. Accordingly the TSCG itself refers to already existing notions of budgetary surveillance, including "the medium-term objective" and "adjustment path towards it", the "significant deviation", and the "exceptional circumstances". Principle (2) specifies that EU concepts and rules shall be relied on closely in devising the national mechanisms, although some degree of flexibility may be allowed as regards the precise national methodologies to account for country-specific features.

## **2. The substance of correction mechanisms: activation, nature of the correction, operational instruments, escape clauses**

As established by principle (3), the *activation of the correction mechanisms* should occur in well-defined circumstances characterising a significant deviation from the MTO, or the adjustment path towards it. This entails the existence of provisions determining beforehand the criteria for assessing the occurrence of a significant deviation. Principle (3) also acknowledges that subject to these conditions, a variety of mechanisms and criteria can be used by Contracting Parties. In particular, trigger points may rely on either EU-level criteria,

country-specific criteria, or both. EU-level decisions establishing the occurrence of a significant deviation would be a natural trigger for corrections mechanisms. At the same time, country-specific criteria, to the extent that they embody the concept of a significant deviation, may act as relevant triggers with the possible additional benefit of occurring earlier in time.

The *nature of the correction* in terms of size and timeframe is the object of principle (4). The proposed principle provides concrete operational guidance while avoiding an overly rigid approach.

Accordingly principle (4) comprises five sub-principles:

- First, it is asked that pre-determined rules frame the size and timeline of the correction, thereby limiting, though not entirely ruling out, the scope for discretion in devising the response to a significant budgetary deviation.
- Second, larger deviations should lead to larger corrections, in line with a common-sense norm of proportionality.
- Third, the reference point for determining the correction would be adherence with the MTO and the adjustment path towards it, thereby echoing the spirit of the fiscal compact, which at its core is about respecting the MTO and the adjustment path towards it. Specifically, when on its adjustment path, a Member State that deviates would thus generally be expected to keep unchanged the timeline for returning to the MTO. When initially at the MTO and deviating therefrom, a Member State would be expected to restore the MTO as fast as reasonable, which generally would mean either the year immediately following the occurrence of the deviation or the subsequent year. Acting as a reference scenario does not however entirely precludes room for flexibility depending on the precise circumstances.
- Fourth, the correction mechanisms should be instrumental in providing critical elements of stability in the budgetary framework, so as to prevent the "moving-target syndrome" typically associated in response to budgetary slippages. To that aim the correction mechanisms should ensure adherence to key fiscal targets as set before the occurrence of the significant deviation.
- Fifth, at the onset of the correction a corrective plan would need to be adopted and would be binding on the subsequent budgets covering the period of the correction, thereby strengthening the credibility of the mechanisms.

The *operational working* of the correction mechanisms is also an important aspect of the design of correction mechanisms. Principle (5) acknowledges the key role that rules over public expenditure and discretionary revenue measures can play in this respect, bearing in mind that these aggregates are a more immediate reflection of the discretionary decisions of fiscal authorities than eventual fiscal outcomes or cyclically-adjusted balances. Another crucial element for Member States to consider in designing their systems pertains to the coordination across some or all of the sub-levels of general governments in response to a significant budgetary deviation, thereby strengthening the credibility of their mechanisms. These coordination mechanisms would not necessarily entail a predetermined distribution of the correction between the central government and the subnational elements. But there must be strong safeguards that the achievement of the general government budgetary targets, for

which the central government is responsible vis-à-vis the EU level, is not put at risk by the behaviour of sub-sectors.

The notion that budgetary rules should be able to react to particularly adverse circumstances has long been acknowledged in the EU surveillance framework and is also recognised by the TSCG. Principle (6) requests that possible *escape clauses* rely closely on EU agreed notions, so as to promote consistency and prevent overly permissive definitions of exceptional circumstances. It is also demanded that the possible suspension of the correction mechanism offered by an escape clause be granted over a defined horizon, and that a minimum pace of adjustment follows the exit from the escape clause, in line with both the requirement of the Stability and Growth Pact as a minimum. Again, a corrective plan that would be binding on future budgets would be expected at the exit of the escape clause.

### **3. Role and independence of monitoring institutions**

While the responsibility for ensuring compliance with the correction mechanisms primarily lies with fiscal authorities, national *monitoring institutions* would be a key ingredient in fostering credibility and transparency, as acknowledged in the last of the proposed principles (principle (7)). These bodies would be expected to evaluate the working of the correction mechanisms in conformity with national rules at the various stages of activation and implementation of the correction, including also the possible recourse to escape clauses.

A "comply or explain" principle – whereby the advice of these monitoring institutions would either be followed, or the concerned Member States would explain why it departs from it – would ensure that the assessments are not just ignored, without infringing on the policymaking responsibilities of fiscal authorities.

The independence of functional autonomy of these bodies is a fundamental feature enabling them to play effectively their role in the national fiscal policy landscape. Principle (7) tables several provisions to that effect. First, to ensure ownership, the design of the monitoring institutions should be consistent with the already existing institutional setting and the country-specific administrative structure. Second, several criteria are put forward to guarantee a high degree of functional autonomy. Legal provisions should ground the statutory regime, mandate and accountability of these bodies. Strong safeguards should also be put in place regarding appointments and the adequacy of resources and access to information in relation to the mandate. These conditions are necessary to allow the monitoring institutions to effectively work and act as guardians of the transparency and credibility of the mechanisms. Particular emphasis should be placed on allowing unhindered communication with the public.

## ANNEX

### Common principles for national fiscal correction mechanisms

(1) [Legal status] The correction mechanism shall be enshrined in national law through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes. The mechanism shall fully respect the prerogatives of national Parliaments.

(2) [Consistency with EU framework] National correction mechanisms shall rely closely on the concepts and rules of the European fiscal framework. This applies in particular to the notion of a 'significant deviation' and the definition of possible escape clauses. The correction, in terms of size and timeline, shall be made consistent with possible recommendations addressed to the concerned Member State under the Stability and Growth Pact.

(3) [Activation] The activation of the correction mechanism shall occur in well-defined circumstances characterising a significant deviation from the medium-term objective (MTO) or the adjustment path towards it. The activation triggers may comprise EU-driven or country-specific criteria, to the extent that they meet the above condition. Subject to the same condition, both ex ante mechanisms that set budgetary objectives preventing the materialisation of deviations and ex post mechanisms that trigger corrections in reaction to prior deviations, may fulfil the requirements.

(4) [Nature of the correction] The size and timeline of the correction shall be framed by pre-determined rules. Larger deviations from the medium-term objective or the adjustment path towards it shall lead to larger corrections. Restoring the structural balance at or above the MTO within the planned deadline, and maintaining it there afterwards, shall provide the reference point for the correction mechanism. The correction mechanism shall ensure adherence to critical fiscal targets as set before the occurrence of the significant deviation, thereby preventing any lasting departure from overall fiscal objectives as planned before the occurrence of the significant deviation. At the onset of the correction Member States shall adopt a corrective plan that shall be binding over the budgets covered by the correction period.

(5) [Operational instruments] The correction mechanism may give a prominent operational role to rules on public expenditure and discretionary tax measures, including in activating the mechanism and implementing the correction, to the extent that these rules are consistent with attainment of the MTO and the adjustment path towards it. The design of the correction mechanism shall consider provisions as regards, in the event of activation, the coordination of fiscal adjustments across some or all sub-sectors of general government.

(6) [Escape clauses] The definition of possible escape clauses shall adhere to the notion of 'exceptional circumstances' as agreed in the Stability and Growth Pact. This would include an unusual event outside the control of the concerned Member State with a major impact on the financial position of the general government, or periods of severe economic downturn as defined in the Stability and Growth Pact, including at the level of the euro area. The suspension of the correction mechanism in the event of an escape clause shall be on a temporary basis. The correction mechanism shall foresee a minimum pace of structural adjustment once out of the escape clause, with the requirement from the Stability and Growth Pact a lower limit. When exiting the escape clause, Member States shall adopt a corrective plan that shall be binding over the budgets covered by the correction period.

(7) [Role and independence of monitoring institutions] Independent bodies or bodies with functional autonomy acting as monitoring institutions shall support the credibility and transparency of the correction mechanism. These institutions would provide public assessments over: the occurrence of circumstances warranting the activation of the correction mechanism; of whether the correction is proceeding in accordance with national rules and plans; and over the occurrence of circumstances for triggering, extending and exiting escape clauses. The concerned Member State shall be obliged to comply with, or alternatively explain publicly why they are not following the assessments of these bodies. The design of the above bodies shall take into account the already existing institutional setting and the country-specific administrative structure. National legal provisions ensuring a high degree of functional autonomy shall underpin the above bodies, including: i) a statutory regime grounded in law; ii) freedom from interference, whereby the above bodies shall not take instructions, and shall be in a capacity to communicate publicly in a timely manner; iii) nomination procedures based on experience and competence; iv) adequacy of resources and appropriate access to information to carry out the given mandate.