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Press Release

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Preventive arm of Stability and Growth pact: the Commission has not ensured that the regulation's main objective is met, say EU Auditors

In setting the implementation rules and through individual decisions the European Commission has extensively used discretionary powers to reduce the adjustment requirements. It thus did not give the necessary importance to reaching the main objective of the preventive arm regulation, says the European Court of Auditors. This is of particular concern in cases of several Member States with high debt ratios which might trigger market concerns about their fiscal sustainability in the next recession.

The Stability and Growth Pact (SGP) is a set of rules designed to ensure that EU Member States pursue sound public finances and coordinate their fiscal policies, given that a fiscal crisis in one Member State could cause problems for others. The SGP consists of two parts: (1) the well-known "corrective arm" or Excessive Deficit Procedure (EDP), which focuses on bringing the headline deficits below 3 % of GDP, and (2) a less well-known "preventive arm", which requires Member States to bring their structural budget balances (i.e. those excluding the effects of business cycles) into line with country-specific targets known as "Medium Term Objectives" (MTOs).

The main aim of the preventive arm regulation is that Member States should make reasonably rapid convergence towards these MTOs. Once the MTO has been reached, this would ensure two things: (1) that Member States have room for manoeuvre during recessions and (2) that debt ratios in highly indebted Member States decrease toward the ceiling set in the Treaty. However, the implementation rules and precedents set by the Commission do not ensure that these objectives are met within a reasonable timeframe, even in normal economic conditions.

"*The flexibility provisions introduced by the Commission are not time-bound to the crisis period and in fact went too far in practice*", **said Neven Mates, the member of the European Court of Auditors responsible for the report**. "*As a result, in the period of recovery and expansion (2014-2018), structural balances in several highly indebted countries have either diverged from their MTOs or converged to them at a slow pace that substantial improvement ahead of the next recession is far from being assured.*"

The auditors also found that allowances for structural reforms do not correspond to the actual budget costs of these reforms, and that the Commission is instead using them as an "incentivizing instrument". This practice is not supported by the preventive arm regulation. Furthermore, the investment clause does not ensure that the public investment-to-GDP ratio is increased in the year for which such an increase is

The purpose of this press release is to convey the main messages of the European Court of Auditors' special report.
The full report is available at www.eca.europa.eu.

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approved: it requires an increase only in nominal terms. Moreover, it allows increases in non-investment spending in the years ahead. This leads to delays of several years in meeting the MTOs.

The credibility of the preventive arm has been further eroded by developments in the corrective arm, which has been implemented in such a way that its requirements can be fully met purely through cyclical recovery. As a result, Member States under EDP do not have to meet requirements on improving structural balances, as they would otherwise have to under the preventive arm.

Finally, the auditors found that the relevant country-specific recommendations adopted by the Council do not sufficiently explain the reasons for fiscal adjustments or the risks if Member States fail to meet them.

The auditors made a number of recommendations intended to tighten up the system in a coordinated manner, including:

- The Commission should address the issue of continuous deviations from the required adjustment path over several years;

- It should ensure that medium-term budget objectives are reached within a reasonable period, with stricter rules for heavily indebted Member States;

- The reform allowance should only cover direct costs related to reforms, and the allowance for unusual events should likewise only cover directly related costs. The investment allowance should not allow increases in non-investment spending in the following years;

- The adjustments required under the corrective and preventive arm should be harmonised: Adjustments required under the corrective arm should not be weaker than those required under the preventive arm.

- Country-specific recommendations should contain explicit requirements, with a clearer explanation of their rationale and the risks of not –implementing them.

- The Commission should ensure that Member States' SCPs include more information on revenue and expenditure measures.

Finally, the auditors consider that the legislation currently in place provides scope for the Commission to address all of our recommendations, given that the main objective of the regulation should take precedence over flexibility options.

Note to Editors

The Stability and Growth Pact was established in 1997 and reformed in 2005 and 2011. It is a binding agreement between all EU Member States on the implementation of the Maastricht Treaty provisions concerning the sustainability of Member State fiscal policies. The rationale for the surveillance is that one country's fiscal policies can adversely affect others, which is particularly pronounced in monetary unions.

The ECA presents its special reports to the European Parliament and Council of the EU, as well as to other interested parties such as national parliaments, industry stakeholders and representatives of civil society.

Special report 18/2018 "Is the main objective of the preventive arm of the Stability and Growth Pact delivered?" is available on the ECA website (eca.europa.eu) in 23 EU languages.