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# The EU's economic governance explained

An explanation of the EU's economic governance

This text is a translation of the web-page of the EU that explains the system of the EU's Economic Governance

The recent economic and financial crisis revealed weaknesses in the EU's economic governance. The EU responded by taking a wide range of measures to strengthen its governance and to facilitate a return to sustainable economic growth, job creation, financial stability and sound public finances. Central pillars of these efforts are: the legislative packages to strengthen the Stability and Growth Pact known as the "[Six Pack](#)" and "[Two Pack](#)", and the [Treaty on Stability, Coordination and Governance in the Economic and Monetary Union](#). All EU Member States except the Czech Republic and Croatia have now signed this Treaty. The "Six Pack" strengthened the Stability and Growth Pact and also introduced a new macroeconomic surveillance tool: the [macroeconomic imbalance procedure](#). The "Two Pack" requests that euro area Member States present Draft Budgetary Plans for the following year in mid-October. This ensures that fiscal policy is discussed early in the budgetary process and that Commission's guidance can be taken into account before national budgets are adopted.

The rules are applied in the context of the European Semester, an annual cycle of coordination and surveillance of the EU's economic policies. Compared to the previous set up this integrated system ensures that there are clearer rules, better follow-up and improved implementation by Member States of the commonly agreed policies throughout the year. It also allows for regular monitoring, and the possibility of swifter response ahead or in case of problems. This helps Member States deliver their reform and budgetary commitments, while making the Economic and Monetary Union more robust. By allowing more time for dialogue, the revamped European Semester, initiated in 2015 and applied subsequently, allows for greater involvement of the European Parliament and national legislatures, as well as social partners and stakeholders at all levels.

## Coordination throughout the year: the European Semester

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Before the crisis, economic and budgetary policy planning took place essentially at the national level, with only a limited coordinated overview at EU level of the national efforts. Member States hardly needed to discuss a collective strategy for the EU economy, or indeed the euro area, as a whole.

### **Coordination and guidance.**

The European Semester, introduced in 2010, ensures that Member States discuss their economic and budgetary plans with their EU partners at specific times in the first part of the year, so that national action could be accordingly taken in the second part of the year, notably with the adoption of the budgets for the subsequent year. This early interaction allows them to comment on each other's plans and monitor progress collectively. It also allows them to take better account of common challenges. Each year in spring, the Commission analyses in detail the EU Member States' plans for macroeconomic, budgetary and structural reforms and issues recommendations for the next 12-18 months to be adopted by the Council. Since 2016, the recommendations to Member States reflect to a large extent the annual recommendations for the euro area which are adopted through a similar process at the beginning of the year. The Commission also monitors Member States' efforts in working towards "Europe 2020", the EU's targets for its long-term growth strategy in the fields of employment, education, innovation, climate and the fight against poverty.

### **A clear timeline**

The European Semester cycle starts in November with the publication of the Commission's Annual Sustainable Growth Strategy (ASGS), the Alert Mechanism Report (AMR), the draft Joint Employment Report and recommendations for the euro area, accompanied by a Staff Working Document. The Annual Sustainable Growth Strategy sets out general economic and social priorities for the EU and provides Member States with generic policy guidance for the following year. The Alert Mechanism Report is the starting point of the annual macroeconomic imbalance procedure (MIP). The MIP aims to identify potential risks early on, prevent the emergence of harmful macroeconomic imbalances and correct the imbalances already in place in the economies of Member States, the EU, or the euro area. The recommendations for the euro area address key issues for the functioning of the euro area and provide orientation on concrete actions for their implementation, which are reflected in the country-specific specific recommendations where appropriate. The euro area recommendations are published alongside the ASGS to allow for better integration of the euro area and national dimensions of EU economic governance and therefore strengthen the surveillance process. The euro area recommendations are accompanied by a Staff Working Document, the Report on the Euro Area. The draft Joint Employment Report analyses the employment and social situation in Europe and the policy responses by Member States. Moreover, the Commission publishes its opinions on the

Draft Budgetary Plans of euro area Member States. This year – for the first time – the Commission also presented a communication on the euro area fiscal stance.

Prepared by discussions at ministerial level, EU leaders consider in March the Annual Sustainable Growth Strategy, the Alert Mechanism Report, the euro area recommendations and the draft Joint Employment Report and provide guidance on a common direction for the EU and euro area as a whole. The euro area recommendations are adopted by the Council in February.

In February, the Commission publishes a country report for each Member State analysing its economic situation and progress with implementing the Member State's reform agenda. For those Member States selected in the Alert Mechanism Report, the country report includes the findings of the so-called "in-depth review" of possible imbalances the Member State faces.

In April, Member States present their national reform programmes and their stability or convergence programmes (three-year budget plans, the former for euro area countries, the latter for other EU Member States) to the Commission. In these programmes, countries report on the specific policies they are implementing and intend to adopt in order to boost jobs and growth, prevent or correct macroeconomic imbalances, and on their concrete plans to ensure compliance with the outstanding EU's country-specific – and where applicable euro area – recommendations and fiscal rules.

The Commission then assesses the plans of the Member States and presents a series of new country-specific recommendations to each of them in May. Due to a streamlining initiated in the 2015 European Semester cycle there are now less and more focused country-specific recommendations than before. These policy recommendations are discussed between Member States in the Council. EU leaders endorse them in June before Council adopts them in July. Governments then incorporate the recommendations into their reform plans and national budgets for the following year.

Budgetary monitoring intensifies in the autumn for euro area Member States: they must submit to the Commission Draft Budgetary Plans for the following year by 15 October. The Commission then assesses the Plans against the requirements of the Stability and Growth Pact and the relevant country-specific recommendations and issues an Opinion on each of them in November, so that this guidance is taken into account when national budgets are finalised. Euro area Finance and/or Economy Ministers then discuss the Commission's assessment of the Draft Budgetary Plans in the ECOFIN Council.

Throughout the year, the Commission is in dialogue with stakeholders and Member States' authorities to closely monitor policy implementation.

### **More responsible budgeting**

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The Stability and Growth Pact was established at the same time as the single currency in order to ensure sound public finances. However, as shown during the crisis, its

enforcement did not prevent the emergence of serious fiscal imbalances in some Member States.

It was therefore reformed through the "Six Pack" (which became law in December 2011) and the "Two Pack" (which entered into force in May 2013), and reinforced by the Intergovernmental Treaty on Stability, Coordination and Governance (which entered into force in January 2013 in its 25 signatory countries). In January 2015, the Commission [issued a Communication](#) on making the best use of the flexibility within the existing rules of the Stability and Growth Pact, to strengthen the link between structural reforms, investment and fiscal responsibility in support of jobs and growth.

## Better rules

- **Headline deficit and debt limits:** the Stability and Growth Pact sets limits of 3% of GDP for deficits and 60% of GDP for debt. They remain valid. A stronger focus on debt: the new rules make the existing 60% of GDP debt limit operational. This means that Member States can be placed in the Excessive Deficit Procedure if they have debt ratios above 60% of GDP that are not being sufficiently reduced (i.e. the excess over 60% is not being reduced by at least 5% a year on average over three years).
- **A new expenditure benchmark:** under the new rules, public spending must not rise faster than medium-term potential GDP growth, unless it is matched by adequate revenue increases.
- **The importance of the underlying budgetary position:** the Stability and Growth Pact focuses more on improving public finances in structural terms (taking into account the effects of an economic downturn or one-off measures on the deficit). Member States set their own medium-term budgetary objectives. The Commission checks that the chosen medium-term budgetary objectives comply with the requirements set out in the Stability and Growth Pact. The goal is to improve the structural balance and converge towards the medium-term budgetary objective, by 0.5% of GDP a year as a benchmark. This provides a safety margin against breaching the 3% headline deficit target, with Member States, particularly those with debt levels over 60% of GDP, urged to do more in economically good times and less in bad times.
- **A fiscal pact for 25 Member States:** since January 2014, signatories to the TSCG must have legally binding, medium-term budgetary objectives enshrined in national law. They must also limit structural deficits to 0.5% of GDP (or to 1%, if their debt-to-GDP ratio is well below 60%). All Member States but the Czech Republic and Croatia have signed this Treaty.

The Treaty also says that automatic correction mechanisms should be triggered if the structural deficit limit (or the adjustment path towards it) is breached, which would require Member States to set out in national law how and when they would rectify the breach over the course of future budgets.

- **Flexibility during a crisis:** by focusing on the underlying budgetary position over the medium term, the Stability and Growth Pact can be flexible during a crisis. If growth deteriorates unexpectedly, Member States with budget deficits over 3% of GDP may receive extra time to correct those deficits, as long as the Member States have made the necessary structural effort.

- **Incentives for structural reforms and investment:** the guidance provided by the Commission in January 2015 sets out ways, within the existing rules of the Pact, to encourage effective implementation of structural reforms, promote investment, and take better account of the economic cycle in individual Member States.

## Better enforcement of the rules

- **Better prevention:** The Commission and the Council assess whether Member States meet their medium-term budgetary objectives, as set out in their Stability or Convergence Programmes presented each April. The assessments feed into the Commission's Country-Specific Recommendations each spring. This comes on top of the opinions on the draft budgetary plans delivered annually to euro area Member States in autumn (see below).
- **Early warning:** in addition to the Country-Specific Recommendations and dedicated fiscal recommendations, if there is a significant deviation from the medium-term objective or the adjustment path towards it, the Commission addresses a warning to the Member State, to be endorsed by the Council. This warning can be made public. The situation is then monitored throughout the year, and if it is not rectified, the Commission can propose an interest-bearing deposit of 0.2% of GDP (euro area only), which must be approved by the Council. This can be returned to the Member State if it corrects the deviation.
- **Excessive Deficit Procedure (EDP):** if Member States breach either the deficit or debt criteria, they are placed in an Excessive Deficit Procedure, where they are subject to additional monitoring (usually every three or six months) and are set a deadline for correcting their excessive deficit. The Commission monitors compliance throughout the year, based on regular economic forecasts and on Eurostat data. The Commission can request more information or recommend further action from those at risk of missing their deficit deadlines.
- **Swifter sanctions:** for euro area Member States in the Excessive Deficit Procedure, financial penalties kick in earlier and can be gradually stepped up. Failure to reduce the deficit adequately can result in fines of 0.2% of GDP. Fines can rise to a maximum of 0.5% if statistical fraud is detected. Penalties can include a suspension of EU regional funding, even for non-euro area countries. In parallel, the 25 Member States that signed the TSCG can be fined 0.1% of GDP for failing to properly integrate its provisions into national law.
- **Transparency and automaticity:** the adoption of the annual Country-Specific Recommendations follows a "comply-or-explain" principle, whereby Member States must justify changes to the original proposals from the Commission. Moreover, decisions on most sanctions under the Excessive Deficit Procedure are now taken by reverse qualified majority voting (RQMV), which means that fines are deemed to be approved by the Council unless a qualified majority of Member States overturns them. This was not possible before the "Six Pack" entered into force. In addition, the 25 Member States that have signed the Fiscal Compact have agreed to replicate the RQMV mechanism even earlier in the process, for example, when deciding whether to place a Member State in the Excessive Deficit Procedure.

## Stepped-up surveillance in the euro area

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The crisis has shown that difficulties in one euro area Member State can have contagion effects in others. Therefore, extra surveillance is warranted to contain problems before they spread.

The "Two Pack" introduced an additional cycle of monitoring for the euro area, as well as tighter surveillance of those facing more serious difficulties.

**Draft Budgetary Plans:** euro area Member States (except for those Member States under macroeconomic adjustment programmes) must present their Draft Budgetary Plans for the following year by 15 October. The Commission then issues an Opinion on these DBPs.

**Economic Partnership Programmes:** euro area Member States must present such programmes when entering the EDP or receiving a new EDP deadline. These Economic Partnership Programmes contain detailed fiscal and structural reforms (for example, on pension systems, taxation or public healthcare) that will correct Member States' deficits in a lasting way.

**Enhanced surveillance:** Member States experiencing financial difficulties or under precautionary assistance programmes from the European Stability Mechanism are put under "enhanced surveillance", which means they are subject to regular review missions by the Commission and must provide additional data, for example, on their financial sectors.

**Financial assistance programmes:** Member States experiencing or threatened with serious difficulties in respect to their financial stability, which could have significant adverse effects on the rest of the euro area, can be asked to prepare full macroeconomic adjustment programmes. This decision is taken by the Council, acting by a qualified majority, on a proposal from the Commission. These programmes are subject to quarterly review missions and strict conditionality in exchange for any financial assistance.

**Post-programme surveillance:** Member States will undergo post-programme surveillance as long as 75% of any financial assistance drawn remains outstanding.

## Macroeconomic imbalance procedure

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Drawing on the experience of the crisis, the "Six Pack" reforms introduced the [Macroeconomic Imbalance Procedure](#) (MIP) with the aim of monitoring and preventing economic developments that could jeopardise macroeconomic stability (linked, for instance, to current account imbalances, real estate bubbles, banking crises) and fostering adjustment by means of appropriate policies. The MIP is applied in the framework of the European Semester and developed through a number of main stages:

- **Alert Mechanism Report:** Member States are screened for potential imbalances on the basis of a scoreboard of main variables, as well as auxiliary indicators and other information, to measure economic developments over time. Each November, the Commission publishes its Alert Mechanism Report. The report identifies Member States that require further analysis (an in-depth review).
- **In-depth reviews:** the Commission undertakes an in-depth review of those Member States identified in the AMR that are potentially at risk of imbalances. The in-depth review (IDR) verifies the existence of imbalances and their severity (the identification of excessive imbalances requiring enhanced surveillance). IDRs are published in the spring and are part of the European Semester Country Reports.
- **Recommendations.** For countries identified with imbalances, the Commission may propose recommendations to address these imbalances as part of the package of country-specific recommendations issued in May.
- **Monitoring.** The policies aimed at addressing by countries under MIP surveillance are monitored through a system of specific monitoring comprising missions and reports. The
- **Follow up to the identification of excessive imbalances.** Countries identified with excessive imbalances receive MIP-related recommendations commensurate with challenges, and close monitoring of action taken. If the Commission concludes that excessive imbalances exist in a Member State, it may also launch the Excessive Imbalance Procedure (EIP), implying the delivery and adoption of a corrective action plan within deadlines. The Commission monitors throughout the year whether the policies in the plan are being implemented. The repeated lack of compliance with the requirements of the EIP could lead to sanctions (amounting to 0.1% of GDP, applying to euro-area countries only).