Box – MTO: revisions, convergence path and flexibility

MTO: revisions and convergence path

The Stability and Growth Pact (SGP) was adopted in 1997 to clarify Member States duty to avoid excessive budget deficits, as laid down in article 126 of the current Treaty on the Functioning of the European Union. It is based on «the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation». In the original wording the Member States agreed to meet the «medium-term objective of budgetary positions of close to balance or in surplus »[1] This wording is based on the notion that maintaining budgetary positions of close to balance or in surplus will allow Member States to deal with normal cyclical fluctuations while keeping the budget deficit within the 3% of GDP reference value. In other words, the SGP was based on the premise that a balanced or in surplus budget would provide sufficient fiscal leeway to counteract the normal cyclical fluctuations without incurring an excessive deficit as a result.[2]

The countries' practical commitment to this objective was limited and demonstrated that convergence towards this objective was difficult to monitor. Varied criticism built up as to the excessively simplistic nature of the SGP initial approach, which did not take sufficient account of economic cycle conditions. Therefore, under the 2005 revision and later the 2011 one, the Medium-term Objective and the respective convergence path became based on the structural balance concept.

Article 2.ºA of the current wording of Regulation (EC) nº 1466/97[3] states that each Member State shall have a differentiated Medium-term Objective (MTO) for its specific public finances that may diverge from the requirement for a budgetary position close to balance or in surplus. As is also expressed in the respective Code of Good Practice, **the MTO pursues a triple aim**:

i. **Providing a safety margin with respect to the 3% of GDP deficit limit.** That safety margin takes into account past output volatility and the budgetary sensitivity to output fluctuations which gives rise to a "minimum reference value". In the Portuguese case this value is a structural deficit of 1.1% of GDP for 2018 and 1% of GDP for 2019 (See *Vade Mecum on the Stability and Growth Pact*).
ii. **Ensuring rapid progress towards public finance sustainability.** The MTO calculation shall ensure convergence of the debt ratio on the 60% of GDP reference value taking into account the economic and budgetary impact of an ageing population. That requires taking into consideration the fiscal balance that stabilises the debt at the 60% of GDP reference value, calling for an extra effort from those countries that find themselves over the limit, as well as a pre-funding adjustment required to respond to the current value (actuarial concept) of the future increase in public expenditure relating to ageing.
iii. **Taking (i) and (ii) into account, allowing room for budgetary manoeuvre in particular taking into account the needs for public investment.**

The MTO must be set within the variation interval between -1% of GDP of the structural balance and a structural balance in a balanced position or in surplus. The lower limit is -0.5% of GDP for

States which signed the Treaty on Stability, Coordination and Governance (TSCG).[4] The Signatories to that Treaty, including Portugal, committed themselves to ensuring "a rapid convergence towards the respective medium-term objectives."

The medium-term budgetary objectives are revised every three years.[5] The revision generally takes place following publication of the European Commission's Sustainability Report which, in turn, is based on the latest update of budgetary costs relating to ageing. The MTO calculation formula, adopted under the SGP Code of Good Practice[6] represents the said aims and determines the minimum MTO value. It requires calculating the greater of three possible lower limits, namely:

$$\mathrm{MTO}^{\mathrm{min}} = \max\left\{\mathrm{MTO}^{\mathrm{VMR}}, \mathrm{MTO}^{\mathrm{ILD}}, \mathrm{MTO}_{\mathrm{Euro/TECG}}\right\}$$

Where the first term is the minimum reference value; the second, the sustainability component or rapid progress towards public finance sustainability; and the third and final term is the aforesaid general limit of -1% of GDP (-0.5% for TECG signatories). The second component which takes into account the implicit liabilities and debt (ILD) is calculated as follows:

$$\mathrm{MTO}^{\mathrm{ILD}} = \text{Balance debt-stabilizing}_{(60\%\text{of GDP})} + \alpha * \text{Ageing costs} + \text{Effort}_{\text{debt-reduction}}$$

Where: the first term is the budgetary balance that would stabilise the debt ratio at 60% of GDP [equal to output between 60% and the nominal growth forecast up to 2060 as calculated by the Ageing Working Group (AWG)]; the second term is the budgetary adjustment that would cover an agreed fraction of the present value of the increase in age-related expenditure, when α = 33%; and the third term represents a supplementary debt-reduction effort specific to countries with a gross debt ratio above 60% of GDP. This last term follows a linear function that requires a supplementary effort of 0.2% of GDP whenever debt reaches 60% of GDP and a supplementary effort of 1.4% of GDP whenever the ratio reaches 110% of GDP (this effort is equal to the outcome of the following operation: 0.024*Debt – 1.24).

In 2016 the MTO was updated according to the regular three-yearly revision. In the Portuguese case, since the previous MTO update there was an increase in the public debt ratio, which led to the minimum MTO value being revised upwards so as to ensure rapid progress towards public finance sustainability. As a result, the MTO defined by the Portuguese Government in this Stability Programme is more demanding than previous figures. Thus, the MTO went from a structural budgetary deficit of 0.5% of GDP to a structural budgetary surplus of 0.25% of GDP.

Flexibility within SGP rules

The SGP states that each Member State shall implement a minimum annual adjustment until the respective MTO is achieved. Generally, this minimum adjustment corresponds to an annual improvement in the structural balance of 0.5 p.p. of GDP, and the effort is modulated according to the economic cycle conditions, the debt ratio and the sustainability risk. Once the MTO is achieved, the quantification of the structural balance continues to be important to the monitoring of the public finance position. In this way whenever a deviation from the MTO (or compared to the respective convergence path) is deemed significant the correction mechanism is triggered.

The European Commission recently introduced the possibility of the SGP rules being interpreted in a more flexible manner as part of a strategy to boost employment and growth. Communication of 13 January 2015 provided guidelines for making the best use of the flexibility within the existing rules of the SGP, without bringing into question compliance with the said rules. That interpretative Communication was the basis for the "*Commonly agreed position on Flexibility within the Stability and Growth Pact*", which was formally endorsed by ECOFIN on 12 February 2016.

The Commission has designed a matrix that specifies the annual fiscal adjustment towards the MTO required under the preventive arm of the Pact taking into account the economic conditions and the sustainability of Member States' public finances, and which clarifies how the annual effort should be modulated. Therefore, the matrix calls for a greater fiscal effort from countries whose debt ratio is over 60% of GDP and which are experiencing more favourable economic times and calls for a smaller effort from countries with a debt ratio below 60% of GDP and experiencing less favourable economic times. The economic conditions are measured by the real GDP growth rate and the output gap.[7]

According to the path foreseen in SP/2016, Portugal should cease to fall under the preventive arm from 2017 onwards. Given the macroeconomic scenario in SP/2016, the matrix calls for an annual minimum adjustment of 0.6 p.p. of GDP, since the country has a public debt ratio of over 60% and because it is forecast that over the time frame covered by SP/2016 the output gap will be in the interval from -1.5% of GDP and 1.5% of GDP which corresponds to "normal times".

According to the commonly agreed position the European Commission may also evaluate Member States' compliance with the rules in a more flexible manner, bearing in mind their right to invoke safeguard clauses. The flexibility consists of authorising a temporary deviation from the MTO if it has been achieved previously or of granting additional time to achieve the MTO, thereby permitting a temporary deviation from the convergence path. The right to invoke the said clauses is dependent upon the following requirements:

- The Member State must be under the preventive arm of the SGP, that is to say, the Excessive Deficit Procedure must already be closed;
- A suitable safety margin is continuously preserved so that the temporary deviation from the MTO or the agreed fiscal adjustment path does not lead to an excess over the 3% of GDP reference value for the deficit. Therefore, the structural balance must never be less than the minimum reference value (which in Portugal's case is equal to 1.6 % of GDP, as mentioned earlier);
- The MTO must be reached within the four-year horizon of the Stability Programme of the year in which the clause is activated, in other words, up to *t*+4; the temporary deviation from the MTO convergence path may not last for more than three years;
- The deviation from the MTO in the year in which the clause is activated (year *t*) may not exceed 1.5% of GDP;
- The temporary deviation may not exceed 0.5% of GDP per year (except when it stems from structural reforms to the pension system that introduce a fully-funded pillar);
- The cumulative temporary deviation which may be permitted under the structural reform and investment clauses (explained below) may not exceed 0.75% of GDP;
- The implementation of the structural reform (or investment) clause is restricted to once per period of adjustment leading to the MTO. This means that a Member State may only invoke the clause a second time after the respective MTO has been met.

Whenever a Member State fulfils these requirements it may invoke the following safeguard clauses:

i) Structural reforms

Pursuant to the current rules of the Pact, Member States covered by the preventive arm of the SGP which implement important structural reforms are allowed to temporarily depart from the MTO convergence path, due to the short-term costs of introducing the reforms. However, that deviation is only allowed under the following conditions (in addition to those referred to above): the reforms in question must have a major positive impact (such as a reform of the pension system), must be fully implemented, and must have long-term positive budgetary effects, namely by strengthening the sustainability of public finances through an increase in revenue or potential output, or a decrease in expenditure. Note that in order to benefit from the structural reforms clause, the Member State has to present a comprehensive and detailed plan of the structural reforms to be implemented in the medium-term.

ii) Investment

Under the preventive arm of the Pact some investments may be deemed equivalent to major structural reforms if it is shown that they are key to achieving and implementing the said reforms. To a large extent eligible investments should benefit from Community co-financing. It should be shown that the investments have a significant net impact on potential growth and public finance sustainability. Therefore, in certain conditions, they may justify a temporary deviation of up to 0.5% of GDP compared to the MTO convergence path. Such a deviation will only be allowed under the following conditions (in addition to those referred to above): when GDP growth is negative or GDP remains well below its potential level (an output gap that is more negative than -1.5% of GDP) and national public investment cannot be replaced by expenditure co-financed by Community funds. Eligible investments are national expenditure on projects co-funded by the EU under the structural and cohesion policy, Trans-European Networks and Connecting Europe Facility, as well as national co-financing of projects also co-financed by the European Strategic Investments Fund (known as the "Juncker Plan").

Following the recent wave of migration, discussions are underway about the introduction of a new safeguard clause relating to the cost of refugee support policies. Whilst the President of the European Commission has recognised that this matter may constitute an "exceptional event", the respective decision will have to be taken on a case by case basis, and countries will have to show that their public accounts were effectively affected by the cost associated with the application of exceptional refugee support policies.

Lastly, under the preventive arm of the Pact the rules do not include detailed provisions on the possibility of the structural reforms or the investment being taken into account at the time it is assessed whether or not the Member State took effective measures regarding the correction of an excessive deficit situation. Even then, the Commission assesses a number of factors, including the outcome of structural reforms in the context of the European Semester, when considering the multiannual path for correcting an excessive deficit situation. An excess deficit versus the reference limit may be deemed exceptional if it arises due to circumstances beyond the Member State's control and has a significant impact on the public finance position or when it is the result of a serious economic recession. If the Member State has taken effective measures and carried out the structural fiscal effort recommended by the Council, it may benefit from a supplementary period in which to correct the nominal excessive deficit without facing financial penalties.

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[1] As per recital nº 2 of Council Regulation (EC) nº 1466/97 of 7 July 1997.

[2] A serious economic recession, then defined as an annual fall of at least 2% of real GDP, could justify the exceptional exceeding of the 3% of GDP limit.

[3] As amended by Regulation (EC) nº 1175/2011 of 16 November.

[4] However, when the public debt ratio is significantly below 60% of GDP and the risks to long-term sustainability of public finances are small, the MTO limit may be a structural deficit of, at most, 1.0% of GDP. The TSCG was signed in Brussels on 2 March 2012 and ratified by Portugal by way of Resolution of the Parliament no. 84/2012, approved on 13 April and published on 3 July 2012 (the legislative process may be consulted at the webpage draft resolution no. 30/XII).

[5] Outside of this regular interval, «A Member State's medium-term budgetary objective may be further revised in the event of the implementation of a structural reform with a major impact on the sustainability of public finances». See article 2-A of Regulation (EC) nº 1466/97, as amended by Council Regulation (EC) no. 1055/2005 of 27 June 2005 and by Regulation (EU) no. 1175/2011 of the European Parliament and Council of 16 November.

[6] *Guidelines on the format and content of Stability and Convergence Programmes*, 3 September 2012.

[7] The matrix can be found on page 25 of *Commonly agreed position on Flexibility in the Stability and Growth Pact.*

Note: The specific formulas and additional detail can be found in the annual publication of the European Commission, "Vade Mecum on the Stability Growth Pact &" (Edition of 2018).

Revised and updated. "Box 1 – MTO: revisions, convergence path and flexibility", initially published in the Report no. 6/2016, Analysis of the Stability Programme 2016-2020. Last update: October 2018.