

CONTENTS

Summary	1
Part I: Current developments and prospects	9
Summary	11
1. Current developments and prospects	15
1.1. A slow and uncertain recovery	15
1.2. The budgetary legacy of the crisis	15
1.3. Short-term developments and prospects for the budgetary position	23
1.4. Short-term developments and prospects for public debt	25
1.5. Government revenue and expenditure	27
2. Implementation of the Stability and Growth Pact	31
2.1. Introduction	31
2.2. The excessive deficit procedure	32
3. Stability and convergence programmes set out the consolidation plans over the medium term	37
3.1. Macroeconomic scenarios	37
3.2. Deficit developments in 2012	38
3.3. Fiscal consolidation	40
3.4. Debt implications	43
3.5. Long-term fiscal sustainability	46
Part II: Evolving budgetary surveillance	63
Summary	63
1. Introduction	67
2. Reform of the preventive arm of the SGP	69
2.1. The Preventive Arm of the Pact	69
2.2. The reform of the preventive arm	71
3. Reform of the corrective arm of the SGP	89
3.1. The Corrective Arm of the Pact	89
3.2. The reform of the corrective arm	91
3.3. The operationalisation of the debt criterion	93
4. National fiscal frameworks	101
4.1. Introduction	101
4.2. National systems of public accounting and statistics	101
Part III: Fiscal governance and sovereign spreads	109
1. Fiscal governance and sovereign spreads	111
1.1. Introduction	111
1.2. Fiscal governance and sovereign risk: review of empirical evidence	112
1.3. Fiscal governance and sovereign risk: descriptive analysis	114
1.4. Effects of rules-based fiscal governance on sovereign spreads: econometric analysis	123
1.5. Conclusion	127

Part IV:	Debt sustainability in the EU	129
	Summary	131
	1. Introduction	135
	1.1. The traditional commission approach	136
	1.2. Some new possible indicators for sustainability analysis	138
	2. Potential impact of balance situation of the banks on public finance	141
	2.1. Introduction	141
	2.2. Methodology and data issues	143
	2.3. Results and sustainability assessment	148
	2.4. Conclusions	150
	3. Fiscal Stress Analysis	153
	3.1. Fiscal crisis risk models in sustainability assessment frameworks and early warning systems	153
	3.2. The "signals approach": description of the methodology	153
	3.3. A composite indicator of fiscal crisis vulnerability	156
	3.4. Data and preliminary results	156
	3.5. Conclusions	162
	4. Fiscal reaction functions and debt thresholds for the EU	167
	4.1. Introduction	167
	4.2. Estimating a fiscal reaction function for the EU: some technical aspects	167
	4.3. Predictions of primary balance in 2011 and 2012 based on the FRF	170
	4.4. Thresholds for sustainable debt	172
	4.5. conclusions	176
	5. A model-based approach to fiscal sustainability	177
	5.1. Analysing fiscal limits with the QUEST model	178
	5.2. Fiscal limits in sustainability analysis	183
	5.3. Conclusion	185
Part V:	Resources	187
	1. Abbreviations and symbols used	188
	2. Glossary	193
	3. References	201
	4. Useful Internet Links	209

LIST OF TABLES

I.1.1.	Budget balances in EU Member States	24
I.1.2.	Euro area - The General government budget balance	25
I.1.3.	Composition of changes in the government debt ratio in EU Member States	26
I.1.4.	Euro Area – Government revenue and expenditures	27
I.1.5.	Government revenue and expenditure	28
I.2.1.	Overview of EDP procedure: euro area Member States	34
I.2.2.	Overview of EDP procedure: Greece	35
I.2.3.	Overview of EDP procedure: non-euro area Member States	36
I.3.1.	Actual versus planned fiscal adjustment for EU 27	42

I.3.2.	Overview of the most fiscal-policy relevant Council recommendations of 12 July 2011 – summary and policy invitations	50
II.4.1.	Instruments for the improvement of budgetary frameworks in the EU	102
III.1.1.	Tasks of independent fiscal institutions in EU Member States	118
III.1.2.	Credit ratings of Moody's of EU Member States grouped by their strength of rules-based fiscal governance, mid-2009	122
III.1.3.	Econometric estimation of the impact of rules-based fiscal governance on euro area sovereign spreads	125
IV.2.1.	Description of the samples used for the SYMBOL simulations, data as of end 2009	144
IV.2.2.	Scenarios definition	147
IV.2.3.	Selected percentiles of the distribution of costs for public finances	149
IV.2.4.	Probability of becoming high-risk due to a banking crisis	150
IV.3.1.	Descriptive statistics and sources	157
IV.3.2.	Thresholds and signalling power of variables and composite indicators	160
IV.3.3.	The fiscal crisis vulnerability analysis for Greece 2007-10	163
IV.4.1.	FRF for EU27, dependent variable: primary balance - fixed effect estimator	169

LIST OF GRAPHS

I.1.1.	Short-term fiscal impact of the crisis – general government debt	25
I.2.1.	Deficit and cycle in the EU	31
I.3.1.	Growth assumptions (EU)	37
I.3.2.	Growth assumptions (euro area)	37
I.3.3.	Sectoral net lending and relative unit labour cost changes (2010-2014)	38
I.3.4.	General government deficit for 2012: decomposition of the gap between the SCP projections and the COM forecasts	39
I.3.5.	Planned changes in government deficits over 2010–2014 in the SCPs	40
I.3.6.	Planned changes in structural government deficits over 2010–2014 in the SCPs and the MTOs	40
I.3.7.	Planned changes in revenue and expenditure over 2010–2014	41
I.3.8.	Average annual change in the revenue ratio planned over the 2010–2014 period versus the general government deficit in 2010	41
I.3.9.	Average annual change in the expenditure ratio planned over the 2010–2014 period versus the general government deficit in 2010	42
I.3.10.	Expenditure growth in 2012 and in 2013/2014 versus a reference medium-term growth rate of GDP	43
I.3.11.	2010-2014 planned changes in public debt	44
I.3.12.	Interest-growth differential and debt	44
I.3.13.	Comparing changes in the interest-growth rate differential (2001-2007 versus 1991-2000 and 2011-2014 versus 2001-2007)	45
I.3.14.	The level of debt in EDP closing year and the years after	46
I.3.15.	General government debt for 2012: decomposition of the gap between the SCP projections and the COM forecasts	46
I.3.16.	Medium-term projections for the EU	47
I.3.17.	Fiscal adjustment required until 2020 to reach a 60% public debt/GDP ratio by 2030 (as a percentage of GDP)	48
I.3.18.	Assessing sustainability on the basis of current and prospect S2 indicators (S2 based on 2010 and end of SCP fiscal position)	49
II.2.1.	The structural balance and the MTOs in 2007	70
II.2.2.	Planned versus final expenditure levels, 1998-2006	71
II.2.3.	Fiscal surveillance – preventive arm : stylised course of events	76

II.3.1.	General government debt as % of GDP, 2000-2007, countries over the 60% threshold	90
II.3.2.	Fiscal surveillance – corrective arm: stylised course of events (i)	91
II.3.3.	Fiscal surveillance – corrective arm: stylised course of events (ii)	92
III.1.1.	The fiscal rule index in the EU Member States, 2000, 2005, and 2009	116
III.1.2.	The fiscal rule index in 11 euro area members, 1999 to 2009	116
III.1.3.	Fiscal council index in the EU, 2010	118
III.1.4.	Sovereign spreads in the EU15, 2000-2011	120
III.1.5.	Sovereign spreads in the New EU Member States, 2000-2011	120
III.1.6.	Average sovereign spreads in euro area Members and non-euro new EU Members by strength of rules-based governance, 2000 to 2009	121
III.1.7.	Average CDS quotes on 10-year sovereign bonds of the EU Member States by strength of rules-based fiscal governance, 2008-2011	121
III.1.8.	Average sovereign spreads in euro area Members and non-euro new EU Members by coverage of activities of fiscal councils, 2000 to 2009	122
III.1.9.	Marginal effect of fiscal rule index on spreads.	124
III.1.10.	Predicted impact of a strengthening of rules-based fiscal governance on sovereign risk premia in selected euro area members	127
IV.2.1.	EU public interventions in the banking sector as of 31/10/2010	142
IV.2.2.	Probability of public finances being hit by losses deriving from banks' default	149
IV.3.1.	Number of countries in the sample experiencing a fiscal crisis, 1970-2010	158
IV.3.2.	Number of countries in the sample in default or restructuring, under IMF-supported programmes, experiencing high inflation rates or bond yield pressure, 1970-2010	159
IV.3.3.	Evolution of the fiscal crisis vulnerability index for selected economies, 1996-2010	162
IV.3.4.	The fiscal crisis vulnerability index in EU countries, 2008-10	162
IV.4.1.	Primary balance forecast vs. (point) prediction from FRF model	171
IV.4.2.	Primary balance forecast vs. min and max prediction from FRF	171
IV.4.3.	Primary balance forecast vs. predictions from FRF +/- average of three best/worst primary balance shocks	172
IV.4.4.	Debt sustainability thresholds - mean estimated primary balance 1975-2010, mean interest-growth differentials over 3 different periods - vs. current debt	173
IV.4.5.	Debt sustainability thresholds - mean estimated primary balance 1990-2008, mean interest-growth differentials over 3 different periods - vs. current debt	174
IV.4.6.	Debt sustainability ranking	175
IV.4.7.	Debt sustainability thresholds - 1. historical norm 1975-2010 2. best 3 years estimated primary balance - vs. current debt	175
IV.4.8.	Debt sustainability thresholds - 1. historical norm 1990-2008 2. best 3 years estimated primary balance - vs. current debt	176
IV.5.1.	Laffer curves for the benchmark calibration	180
IV.5.2.	Laffer curves for higher substitutability between market and home production	182
IV.5.3.	Laffer curves for higher substitutability and constant returns to scale in home production	182
IV.5.4.	The output costs of higher taxation	183
IV.5.5.	Dynamic sustainability analysis	185

LIST OF BOXES

I.1.1.	Budgetary developments and policy responses in programme countries	17
I.1.2.	The ESM, A Permanent Crisis Resolution Mechanism	21
I.1.3.	The meeting of the Euro Area Heads of State or Government of 21 July 2011: main decisions	29
II.2.1.	The relationship between the cyclically adjusted budget (CAB) and the expenditure threshold benchmark approach	74
II.2.2.	The potential benefits of an expenditure benchmark approach for fiscal performance	77
II.3.1.	A formula for the debt reduction benchmark	94
II.3.2.	Accounting for the effects of the cycle	97
II.3.3.	Accounting for the stock-flow adjustments	100
II.4.1.	Fiscal Frameworks on the move.	107
III.1.1.	The impact of rules-based fiscal governance on sovereign spreads in the presence of risk aversion: a structural model.	128
IV.2.1.	Definition of the probability that government finances are hit by losses deriving from banks defaults.	151
IV.3.1.	The methodology for the calculation of the thresholds	164
IV.3.2.	The calculation of the index of fiscal crisis vulnerability	166
IV.5.1.	The QUEST model	179