



EUROPEAN COMMISSION

Brussels, 31.8.2012  
COM(2012) 476 final

**REPORT FROM THE COMMISSION TO THE COUNCIL**  
**on the exception clause (Article 10 of Annex XI to the Staff Regulations)**

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#### EXECUTIVE SUMMARY

In this report the Commission presents the third assessment (since 2011) on the conditions of the exception clause. The Commission recalls the principles underlying the method and the legal interpretation of the exception clause based on the judgment of the Court of Justice in Case C-40/10. Afterwards, the Commission assesses the economic and social situation of the Union from 1 July 2011 until mid-May 2012, when the 2012 Spring European Economic Forecast was issued.

In the judgment rendered on 24 November 2010 in Case C-40/10, the Court of Justice stressed that the exception clause enables account to be taken of the consequences of a deterioration in the economic and social situation which is both serious and sudden where, under the 'normal method', the remuneration of officials would not be adjusted quickly enough. The Court clarified that the procedure laid down in Article 10 of Annex XI to the Staff Regulations constitutes the only means of taking account of an economic crisis in the adjustment of remuneration and therefore of disapplying the criteria laid down in Article 3(2) of that Annex.

The method thoroughly measures, through the principle of parallelism, the relevant economic and social situation within the Union, as reflected in decisions of Member States on the salaries of national civil servants. The legislator carefully chose the criteria to be taken into account for the adjustment of remuneration and pensions; these criteria can be applied during both an upswing and a downturn in the economy.

The exception clause is not an economic cycle clause: it is therefore to be used only when there are extreme developments in the EU and only if the method is not able to measure them. It is not to be used whenever the EU is in the downward phase of the economic cycle.

The Commission has used 15 indicators to assess whether it is necessary to use the exception clause in 2012. The last forecasts of DG ECFIN show that the EU economy is likely to stagnate in 2012 (0.1 GDP growth) and the economic growth will gain momentum in 2013 (1.3% GDP growth). Salaries in the total economy are expected to increase by 2.1% in 2012 and 2013. National officials and EU staff are expected to lose purchasing power in 2012. Until the end of May, none of the Member States had forecast a salary cut in the second half of 2012. The Commission has also addressed the Council's request to examine the number of the Member States in an ongoing excessive deficit procedure and assessed the link of this indicator to government deficit and public debt.

The report concludes that there has been no sudden and serious deterioration in the economic and social situation within the Union which could not be reflected under the normal application of the method during the reference period of 1 July 2011 to mid-May 2012, and that it is not justified to submit a proposal under Article 10 of Annex XI to the Staff Regulations.

The Commission recalls that, in reply to the difficult general economic context, it has already submitted a draft proposal to the European Parliament and the Council which would lead to significant savings in the next years and to even higher savings in the long term. The proposal includes a new and revised method as well as amendments to the mechanism of the exception clause.

## 1. INTRODUCTION

In March 2012, the Council issued the following request to the Commission<sup>1</sup>:

### *'THE COUNCIL*

*RECALLS that the interpretation of the exception clause of Article 10 of Annex XI of the Staff Regulations as regards the adjustment of remunerations and pensions of officials and other servants with effect from 1st July 2011 is currently the subject of proceedings before the European Court of Justice.*

*NOTES that the economic and social situation within the EU continues to give rise to concern.*

*REQUESTS therefore the Commission, in conformity with Article 241 TFEU, to monitor closely the evolution of the economic and social situation as well to present, on the basis of Article 10 of Annex XI of the Staff Regulations, a report assessing whether, in the light of objective data supplied by the Commission, there is a serious and sudden deterioration in the economic and social situation within the EU and to submit appropriate proposals whenever that is case, but in any case in time for the European Parliament and the Council to examine and adopt them before the end of 2012.*

*REQUESTS the Commission, in addition to the data used in its 2011 report to take into account, inter alia, the number of Member States with an ongoing excessive deficit procedure.'*

Under Article 241 TFEU, the Council, acting by simple majority, may request the Commission to undertake any studies the Council considers desirable for the attainment of the common objectives, and to submit to it any appropriate proposals. If the Commission does not submit a proposal, it must inform the Council of the reasons.

This report addresses the request of the Council and complies with Article 241 TFEU. Moreover, in 2011 the Commission committed to examine once again the application of the exception clause in 2012. This is the third assessment of the conditions laid down in the exception clause. The two previous assessments were presented on 13 July 2011 (COM (2011) 440) and on 13 December 2011 (COM (2011) 829).

This assessment covers the period starting from the effective date of the last annual adjustment of remuneration and pensions (1 July 2011) until the moment when the

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<sup>1</sup> Council Document 7421/12 of 12 March 2012.

latest data were made available for the purposes of this report (mid-May 2012). Moreover, it provides an outlook of the economic and social situation in 2012 and 2013 based on forecasts. In its request, the Council specifically asked the Commission to take into account the number of Member States with an ongoing excessive deficit procedure. The Commission addresses this particular request in the light of its general assessment on public finances.

## 2. LEGAL BASIS

*Under Article 65 of the Staff Regulations, ‘... [t]he Council shall each year review the remuneration of the officials and other servants of the Union. This review shall take place in September in the light of a joint report by the Commission based on a joint index prepared by the Statistical Office of the European Union in agreement with the national statistical offices of the Member States; the index shall reflect the situation as at 1 July in each of the countries of the Union.*

*During this review the Council shall consider whether, as part of economic and social policy of the Union, remuneration should be adjusted. Particular account shall be taken of any increases in salaries in the public service and the needs of recruitment.’*

Pursuant to Article 65a of the Staff Regulations, the rules for implementing Articles 64 and 65 are set out in Annex XI.

Article 3(1) and (2) of Annex XI to the Staff Regulations states:

*1. Under Article 65(3) of the Staff Regulations, the Council, acting on a Commission proposal and on the basis of the criteria set out in Section 1 of this Annex, shall take a decision before the end of each year adjusting remuneration and pensions, with effect from 1 July.*

*2. The amount of the adjustment shall be obtained by multiplying the Brussels International Index by the specific indicator. The adjustment shall be in net terms as a uniform across-the-board percentage.*

Article 10 of Annex XI to the Staff Regulations (the exception clause) stipulates:

*If there is a serious and sudden deterioration in the economic and social situation within the Union, assessed in the light of objective data supplied for this purpose by the Commission, the latter shall submit appropriate proposals on which the European Parliament and the Council shall decide in accordance with Article 336 of the Treaty on the Functioning of the European Union.*

The relationship between Article 3 of Annex XI and the exception clause was analysed by the Court of Justice in its judgment in Case C-40/10 Commission / Council. The Court pointed out that the exception clause ‘... makes it possible, in an extraordinary situation, to disregard on an ad hoc basis the method laid down in Article 3 of Annex XI to the Staff Regulations, without amending it or repealing it for the following years’ (paragraph 74, underlining added).

In addition, the Court explained that ‘... *as the Commission considered in its report of 27 June 1994 on the applicability of the exception clause (SEC(94) 1027 final, point II.3, pp. 5 and 6), that clause enables account to be taken of the consequences of a deterioration in the economic and social situation which is both serious and sudden where, under the ‘normal method’, the remuneration of officials would not be adjusted quickly enough*’ (paragraph 75, underlining added).

The Court of Justice made clear that: ‘... *the procedure laid down in Article 10 [of Annex XI to the Staff Regulations] constitutes the only means of taking account of an economic crisis in the adjustment of remuneration and therefore of disapplying the criteria laid down in Article 3(2) of that annex*’ (paragraph 77, underlining added).

*That finding cannot be invalidated by the fact that the application of Article 10 of Annex XI to the Staff Regulations is dependent on a proposal from the Commission. It is clear inter alia from Article 17(2) TEU that that situation is consistent with the institutional balance envisaged by the Treaties which, in principle, grant the Commission, in respect of legislative procedures, the sole power to initiate proposals*’ (paragraph 78).

### **3. OBJECTIVES AND UNDERLYING PRINCIPLES OF THE METHOD**

The Commission considers it appropriate to recapitulate the objectives and principles underlying the method for salary and pension adjustments.

It is worth mentioning that the scope and application of the exception clause is currently subject to the judicial review in Case C-66/12 pending before the Court of Justice.

The provisions of the current method for adjusting remuneration and pensions apply from 1 July 2004 until 31 December 2012 and are laid down in Articles 64, 65 and 65a of and Annex XI to the Staff Regulations.

The main objectives of the method are:

- automatic salary adjustment in order to avoid that the work of all Union Institutions and agencies is disrupted by annual negotiations and possibly strikes;
- transparent, efficient, relatively straightforward rules to determine salary adjustments for officials and other servants of all EU Institutions based on political decisions taken by Member States for national civil servants.

In order to ensure that the method functions properly, the following principles have been laid down:

- equality of purchasing power among EU civil servants in different duty stations;
- parallelism with national officials in terms of changes in purchasing power.

Two aspects of the method should be examined more closely:

- the principle of parallelism;

- the time-lag.

### **3.1. The principle of parallelism**

In accordance with Article 1(4) of Annex XI, the (global) specific indicator is calculated to reflect the average change in the net remuneration of national officials in central government in real terms, i.e. after taking account of inflation in the country where they work. Then, as laid down in Article 3(2) of Annex XI, consumer price inflation in Brussels, which is the reference location where most EU officials work, is measured by the Brussels International Index (BII). Finally, the BII is multiplied by the global specific indicator to calculate the nominal annual adjustment to the basic salaries of EU officials, which may be either positive or negative.

Therefore, the change in the purchasing power of EU officials is fully determined by the global specific indicator, which ensures equivalence with developments in the purchasing power of national officials. This is the principle of parallelism.

### **3.2. The time-lag inherent in the method**

In line with Articles 1(2) and (4) of Annex XI to the Staff Regulations, the Brussels International Index is to take into account the changes in consumer prices between June of the previous year and June of the current year, and Eurostat is to calculate specific indicators reflecting changes in the real remuneration of civil servants in central government, for the countries in the sample, between 1 July of the previous year and 1 July of the current year. Under Article 3(1) of Annex XI to the Staff Regulations, the Council, acting on a Commission proposal, has to take a decision before the end of each year adjusting remuneration and pensions, with effect from 1 July. Therefore, the annual adjustment applies with a maximum delay of one year. There is then a further delay of up to six months until adoption of the salary adjustment regulation, required before 31 December, which is applied retrospectively.

The legislator considered that the method could function with this time-lag, and EU officials and other staff would be able to bear the impact of yearly inflation. That is why Article 65 lays down only one annual deadline for the adjustment of remuneration. There is, however, the possibility to make an intermediate adjustment of remuneration, provided for in Articles 4-8 of Annex XI to the Staff Regulations, if there is a substantial change in the cost of living between June and December.

## **4. EXCEPTION CLAUSE**

The legislator adopted an exception clause as an integral part of the Method. This clause sets a number of triggering preconditions that have to be met before any action is taken:

- the deterioration has to be both serious and sudden, it must affect the economic and social situation at Union level, and it must be assessed in the light of objective data provided by the Commission;

- the deterioration has to be such that the method would not be able to take it properly into account due to its exceptional nature in terms of timing and magnitude.

The exception clause provides that, if there are objective reasons for it to be triggered, the Commission is bound to submit appropriate proposals on which the European Parliament and the Council are to decide in accordance with Article 336 TFEU. As the European Court of Justice ruled in case C-40/10 the exception clause *makes it possible, in an extraordinary situation, to disregard on an ad hoc basis the method laid down in Article 3 of Annex XI to the Staff Regulations, without amending it or repealing it for the following years*. In addition, according to its wording, Article 10 of Annex XI to the Staff Regulations *is intended to enable the institutions to react in the face of sudden events which require an ad hoc reaction rather than a comprehensive amendment of the ‘normal’ method of adjusting remuneration*.

#### **4.1. Conditions for triggering the exception clause**

The wording of the exception clause should be carefully examined since, in order to trigger the clause, all the conditions laid down in Article 10 of Annex XI to the Staff Regulations must be met.

‘*Deterioration*’ is a term used to describe a worsening of the economic and social situation. Whether a ‘*serious*’ deterioration of the economic and social situation has occurred should be determined with reference to both the magnitude and duration of the identified economic and social impacts. Whether a ‘*sudden*’ deterioration of the economic and social situation has taken place has to be considered with regard to the speed and predictability of the economic and social impacts. In this context it is particularly important to distinguish normal fluctuations of the economic cycle from those caused by external events.

The legislator empowered the Commission to determine the objective data to be used in the Commission's assessment as to whether the conditions for applying the exception clause are met. The Commission considers that this assessment should be based on a variety of objective indicators, covering both the economic and the social domains. These indicators should comply with the following set of relevant and widely accepted principles<sup>2</sup>:

- An indicator should capture the essence of the problem and have a clear and accepted normative interpretation.
- An indicator should be robust and statistically validated.
- An indicator should be timely and susceptible to revision.

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<sup>2</sup> Most of them are principles agreed for the Open Method of Coordination (OMC) on social inclusion and protection. The OMC is used by Member States to support the definition, implementation and evaluation of their social policies and to develop their mutual cooperation. A tool of governance based on common objectives and indicators, the method supplements the legislative and financial instruments of social policy. It is part of the implementation of the process of coordination of social policies, particularly in the context of the Lisbon Strategy (and now Europe 2020).

- The focus of indicators should be on the EU as a whole and not on individual Member States.
- The indicators should be mutually consistent.
- The set of indicators should be as transparent and accessible as possible to EU citizens.
- Recourse should be made to existing indicator sets wherever possible.

In accordance with these principles, the following 15 indicators are appropriate:

- Economic activity: GDP growth, domestic demand, inventories, net exports, private consumption, public consumption, total investment, and inflation (HICP) within the Union;
- Public finances: general government balance and public debt within the Union; Labour market: total employment, unemployment rate and compensation of employees within the Union;
- Sentiment indicators: Economic Sentiment Indicator and employment expectations within the Union.

In order to assess whether the criteria laid down in the exception clause are currently met, the analysis of the economic and social situation should be carried out for the period from July 2011 to mid-May 2012 (subject to the availability of relevant data or forecasts), as the 2011 annual adjustment already covered the period until 1 July 2011. This is in line with the definition of a ‘sudden’ deterioration, referred to in Article 10 of Annex XI to the Staff Regulations. However, a longer period is presented to provide a global overview where appropriate.

#### **4.2. Retaining the principle of parallelism**

The method thoroughly measures, through the principle of parallelism, the relevant economic and social situation within the Union, as reflected in decisions of Member States on the salaries of national civil servants. The legislator carefully chose the criteria to be taken into account for the adjustment of remuneration and pensions; these criteria can be applied during both an upswing and a downturn in the economy.

The method for adjusting remuneration and pensions has been in force for almost forty years. During this long period of time, the EU economy has experienced periods of rapid growth as well as periods of economic downturn.

The principle of parallelism with national officials in terms of changes in purchasing power, which has been enshrined in the Staff Regulations since 1962, has to be maintained also at a time of economic downturn in the European Union. This is fully in line with Article 65, which states that particular account is to be taken of any increases in salaries of the public service during the annual review.

However, if there is a sudden and serious deterioration that the method would not be able to take properly into account, due to its exceptional nature in terms of either timing or magnitude, the exception clause should be used.



A different interpretation would lead to incoherent results: despite the method's ability to capture properly economic and social developments within the EU through their effect on salaries of national civil servants, the legislator would have to adopt exceptional measures with respect to the annual adjustment of EU civil servants' remuneration and pensions. Such an interpretation would fall outside the economic and social policy of the European Union, as referred to in Article 65 of the Staff Regulations.

The same applies to the time-lag inherent in the method. The reference period, by definition, entails a maximum delay of one year in salary adjustments (although the delay in practice is likely to be smaller). While the legislator considered that the method should work with this time-lag, the exception clause clearly makes it possible to decrease it, if Member States were to take extreme measures to adjust the salaries of national officials, which should be applied to EU civil servants without waiting for the following annual adjustment exercise.

Therefore, the appropriate proposals, where necessary, should be such as to reflect the exceptional developments that have not been properly captured by the method. These proposals should not go beyond the implementing rules laid down in Annex XI to the Staff Regulations: there is no objective reason to apply criteria other than the change in purchasing power in the Member States' civil services, because that would undermine the effects of the method and would impose additional measures on EU staff which had not been applied to staff in the Member States.

Lastly, the exception clause is not an economic cycle clause. As explained above, the legislator carefully chose the economic and social criteria to be taken into account for salary and pension adjustments; these criteria can be applied at a time of economic growth as well as at a time of economic downturn. The method can be applied equally when salaries in Member States increase or decrease, and the gain or loss in the purchasing power of national civil servants will be directly reflected in the salaries and pensions of EU civil servants. Hence, the exception clause is to be used when there are extreme developments in the EU and only if the method is not able to measure them. It is not to be used whenever the EU is in the downward phase of the economic cycle.

## **5. THE ECONOMIC AND SOCIAL SITUATION IN THE EU**

### **5.1. The preceding period**

#### *5.1.1. Annual adjustment in 2011*

Over the period July 2010 – July 2011, five out of the eight Member States used in the sample adopted increases in nominal salaries (see Table 1). On average, this amounted to a 1.1 % increase in nominal salaries. Due to inflation (2.9 %), this resulted in a drop of the purchasing power of national officials (-1.8%). This loss of purchasing power had to be automatically applied to the salaries of EU civil servants and, with a high inflation rate in Brussels measured by the Brussels International Index (3.6 %), it resulted in a 1.7 % nominal increase in salaries for EU staff (see Table 2).

However, the Council decided not to adopt the Commission Proposal on the 2011 annual adjustment and thus breached the principle of parallelism enshrined in the Staff Regulations. This resulted in a further deterioration of the purchasing power of European officials (-3.6%) compared to national officials (-1.8%).

**Table 1: Change in net remuneration over July 2010 – July 2011, representative sample (%)**

	BE	DE	ES	FR	IT	LU	NL	UK	EU8
<b>Nominal change</b>	3,6	1,3	-0,6	2,0	-0,2	-0,8	2,0	1,3	1,1
<b>Inflation (HICP)</b>	3,4	2,4	3,0	2,3	3,0	3,8	2,5	4,2	2,9
<b>Real change</b>	0,2	-1,1	-3,5	-0,3	-3,1	-4,4	-0,5	-2,8	<b>-1,8</b>

Source: Eurostat

**Table 2: Annual adjustment in 2011 (%)**

	EU officials
<b>Annual adjustment (Nominal change)</b>	1,7
<b>BII (Brussels inflation)</b>	3,6
<b>Specific indicator (Real change)</b>	<b>-1,8</b>
<b>Annual adjustment (Council Decision)</b>	0
<b>Change in purchasing power</b>	<b>-3,6</b>

Source: Eurostat

### 5.1.2. Departure from the principle of parallelism

In order to apply the principle of parallelism laid down in the method for adjusting the remuneration of EU officials, the change in the salaries of national officials is monitored, and the average change in their purchasing power is applied to determine developments in the purchasing power of EU officials' salaries. However, the annual adjustment calculated by reference to a given 12-month period is taken into account to adjust salaries in the EU civil service during the following year. Therefore, the purchasing power of EU civil servants follows the average purchasing power of national officials within the Member States making up the representative sample, with a systematic time-lag inherent in the method.

Nevertheless, as already pointed out by the Commission in 2008<sup>3</sup>, the principle of parallelism is partially invalidated, at the potential expense of EU officials, for two reasons. Although their salaries are affected by changes in national social contributions via the specific indicator, the social contributions paid by EU officials are periodically adjusted on an independent basis. The special levy, which is an additional deduction from the remuneration of EU officials, introduces another element of double-counting. In order to make a proper comparison between the purchasing power of national and EU officials, these items should be taken into account (see Tables 3 and 4).

<sup>3</sup> Report from the Commission to the European Parliament and to the Council on Annex XI to the Staff Regulations, COM(2008) 443 final, 10.7.2008.

**Table 3: Annual percentage change in purchasing power of national and EU officials including the combined effect of increases in pension contributions and special levy**

Year	Annual % change in purchasing power of national officials	Annual % change in pension contributions and special levy	Annual % change in purchasing power of EU officials
2004	-1,2	0,3	↘
2005	0,0	0,5	-1,5
2006	0,2	0,2	-0,5
2007	0,0	0,2	0,0
2008	-1,3	0,5	-0,2
2009	2,7	0,4	-1,8
2010	-2,2	0,3	2,3
2011	-1,8	0,0	-2,5
2012	-	-	-3,6

Comment: the figures for 2011 and 2012 take into account the Council decisions not to adopt the 2011 Commission Proposals on the annual adjustment and the adjustment of the pension contribution rate. Due to these decisions, EU officials are losing 3,6% of their purchasing power in 2012.

Source: Eurostat

**Table 4: Evolution of purchasing power of national and EU officials including the combined effect of increases in pension contributions and special levy**

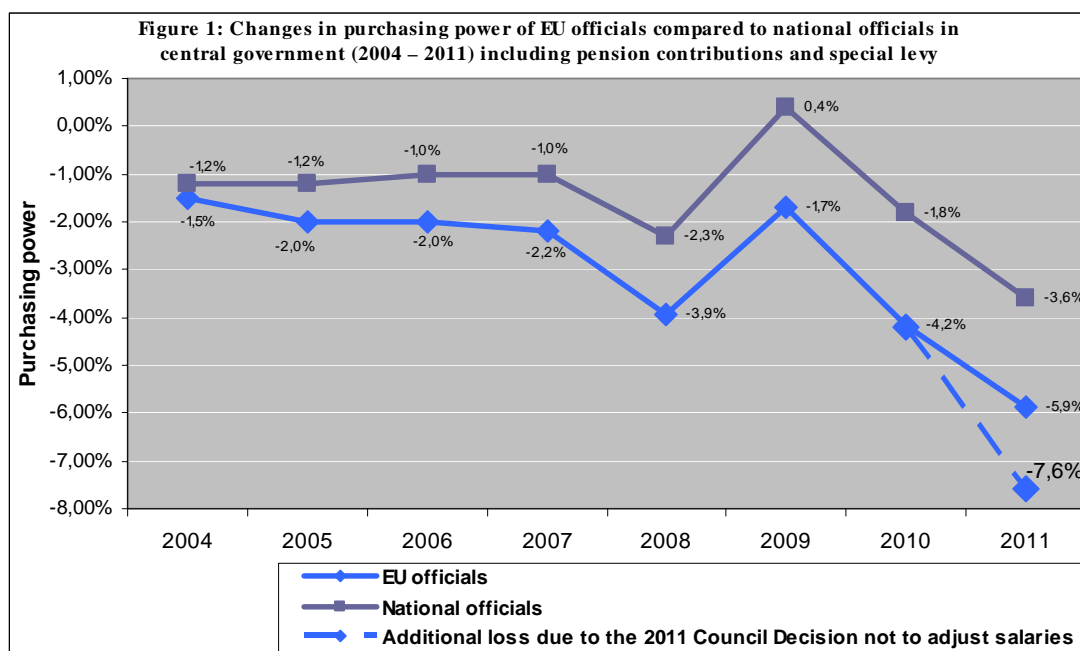
Year	Evolution of purchasing power of national officials (2003=100)	Cumulative impact of increases in pension contributions and special levy (2003=100)	Evolution of purchasing power of EU officials (2004=100)
2003	100,0	100,0	↘
2004	98,8	100,3	100,0
2005	98,8	100,8	98,5
2006	99,0	101,0	98,0
2007	99,0	101,2	98,0
2008	97,7	101,7	97,8
2009	100,3	102,1	96,1
2010	98,1	102,4	98,3
2011	96,4	102,4	95,8
2012	-	-	92,4

Comment: the figures for 2011 and 2012 take into account the Council decisions not to adopt the 2011 Commission Proposals on the annual adjustment and the adjustment of the pension contribution rate. Due to these decisions, EU officials are losing 3,6% of their purchasing power in 2012.

Source: Eurostat & DG HR

As a consequence, the cumulative purchasing power<sup>4</sup> of national officials fell by 3.6% over the 8 years between 2003 and 2011, while that of EU officials fell by 4.2% over the corresponding 7 years between 2004 and 2011 – and the Council Decision of December 2011 refusing to apply the method resulted in an even stronger slump of the purchasing power of European officials, i.e. a 7.6% drop altogether between 2004 and 2012 (see Figure 1).

<sup>4</sup> This is computed by compounding the year-on-year change in purchasing power from 2004 to 2011.



The principle of parallelism should be maintained through economic cycles. This stems from the assumption that Member States would take appropriate measures in respect of their national civil servants, which would have a direct impact on salaries of EU officials. Despite this principle, the remuneration of EU officials has largely diverged from the remuneration of national officials since 2004, at the expense of the EU civil service.

## 5.2. Assessment of the EU economic and social situation during the reference period

### 5.2.1. Towards slow economic growth

For the EU as a whole the recession ended in autumn 2009 and set the scene for a recovery in 2010. Overall, GDP increased by 2.0% in the EU for the whole of 2010.

In 2011, the EU yearly figure showed visible growth, mainly owing to a good start in the first quarter. Overall, GDP increased by 1.5% both in the EU for the whole of 2011. The recovery has shortly stumbled in the last quarter of 2011, with the GDP turning slightly negative.

Eurostat's flash estimate for 2012 first quarter shows stabilisation in the GDP (the GDP rate in the EU compared to the previous quarter will be 0 %) and the DG ECFIN forecast<sup>5</sup> indicates a path towards a slow growth until the end of the year in the EU.

<sup>5</sup> 2012 Spring European Economic Forecast.

**Table 5: Profiles of quarterly GDP, volume (percentage change from previous quarter)**

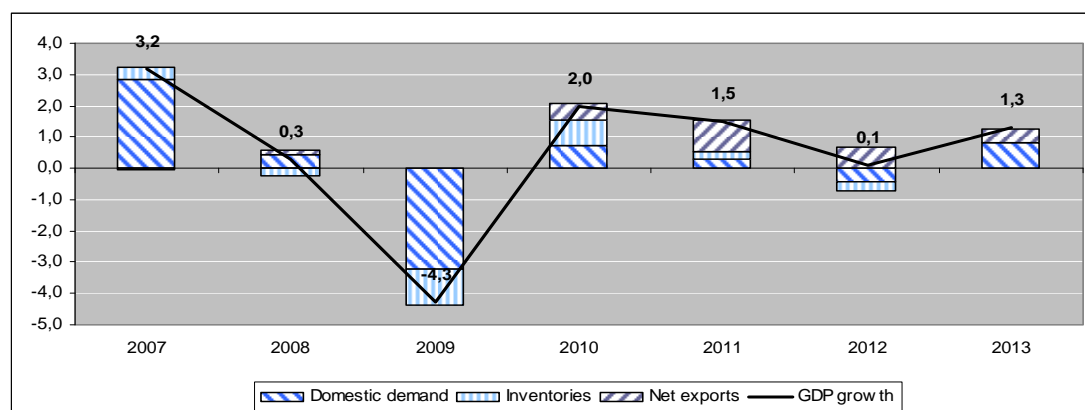
2011/1	2011/2	2011/3	2011/4	2012/1	2012/2	2012/3	2012/4
0.6	0.2	0.3	-0.3	0.0	0.0	0.2	0.2

Source: Eurostat (2011/1 – 2012/1); DG ECFIN (2012/2 – 2012/4)

The Eurostat flash estimate released on 15 May 2012 announced that that GDP grew slightly in 2012 in the EU (0.1 % growth) compared to the first quarter of 2011. Based on the assumption that the euro area will successfully handle crisis related challenges, a return of confidence over the course of 2012 is expected. With transitory shocks waning and confidence rebounding, DG.ECFIN forecasts a return to subdued economic growth for 2013, i.e. 1.3 % growth in the EU.

In 2011 net exports were the main engine of the economic growth, while inventories and domestic demand only modestly contributed to the GDP increase. In 2012 domestic demand and inventories are expected to turn negative, but their effect would be compensated by net exports, resulting in marginal economic growth for 2012. In 2013 the domestic demand is forecast to surge and to contribute together with net exports to more considerable pick-up in the economic activity (see Figure 2)

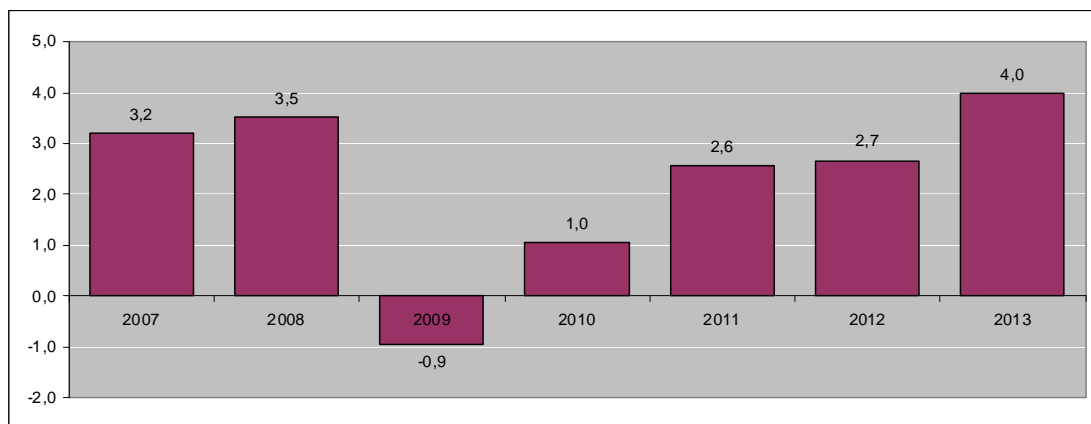
**Figure 2: GDP growth and decomposition within the EU-27 (annual % change)**



Source: Eurostat (2007-2011) and DG ECFIN (2012-2013)

The cumulative value of the GDP has been increasing since the recession that occurred in 2009. In 2011 it has reached 2.6 % (2006 is used as a basis), and is forecast to remain very close to that value in 2012. In 2013, it should make another leap forward to 4 %, due to more significant economic growth that year.

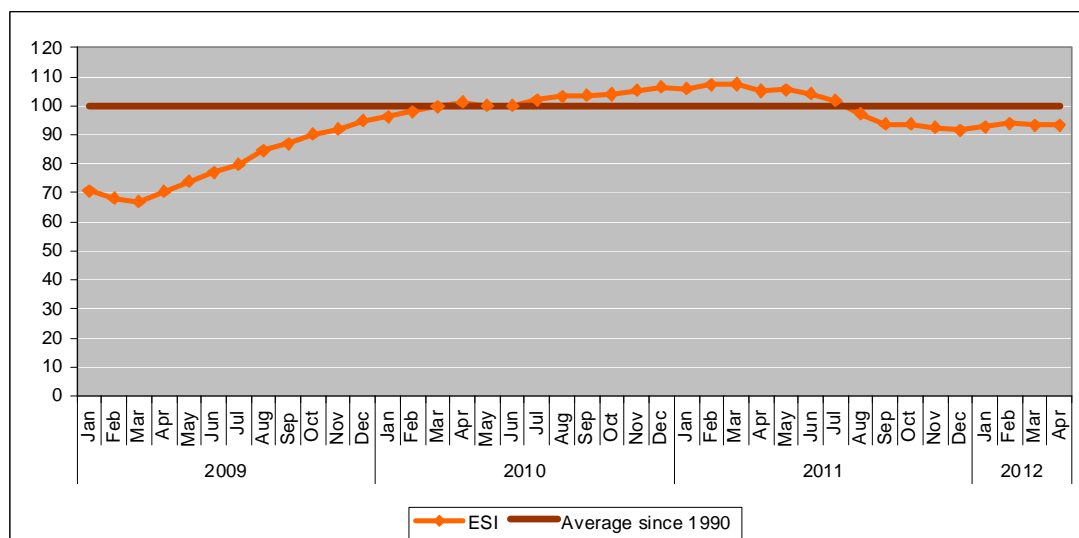
Figure 3: GDP growth within the EU-27 (cumulative % change since 2006)



Source: DG HR

The Economic Sentiment Indicator (ESI)<sup>6</sup> stabilised in the first quarter of 2012, but remained below its long-term average. The Economic Sentiment Indicator remained stable in April in the EU at 93.2. In the euro area it decreased to 92.8, thereby offsetting the gains recorded over the first quarter of 2012. The decline in the euro area was mainly driven by weakening confidence in the industry and services sectors. Confidence improved only in the retail sector. The more positive reading of the ESI in the EU reflects a strong improvement in the UK<sup>7</sup>. A visible improvement in the consumer confidence indicator in May 2012 should positively affect the Economic Sentiment Indicator in the near future.

Figure 4: Economic sentiment index within the EU-27 (Average since 1990 = 100)

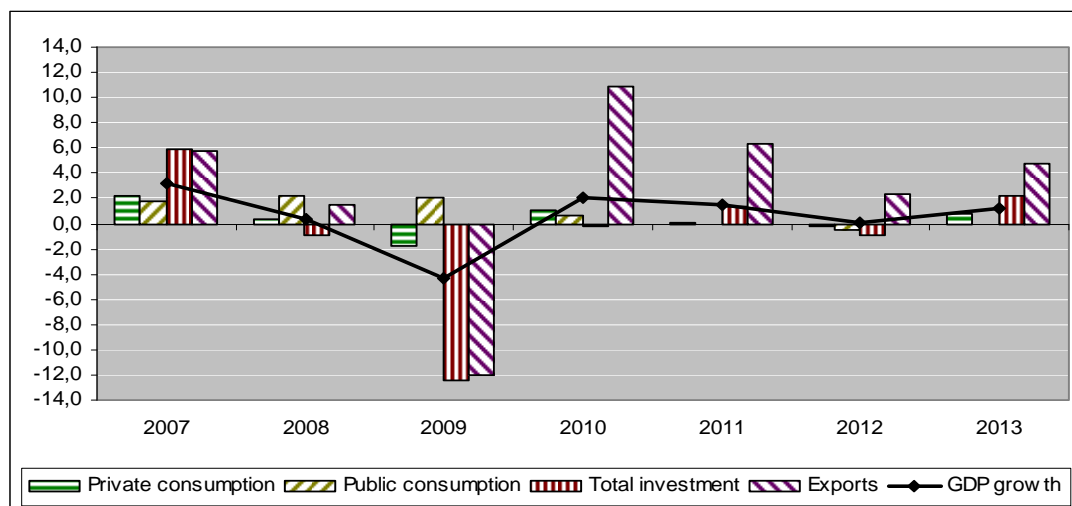


Source: DG ECFIN

<sup>6</sup> Business and consumer surveys provide monthly judgments and expectations concerning diverse facets of economic activity in the different sectors of the economy: industry, services, construction and retail trade, as well as consumers. For each of the five surveyed sectors, ‘confidence indicators’ are produced to reflect overall perceptions and expectations at the individual sector level in a one-dimensional index. In order to be able to track overall economic activity, the broader Economic Sentiment Indicator (ESI) has been calculated since 1985, as a weighted sum of these five indicators.

<sup>7</sup> Source: *Business and consumer survey results*, May 2012, DG ECFIN.

Figure 5: Main features within the EU-27 (annual % change)



Source: Eurostat (2007-2011) and DG ECFIN (2012-2013)

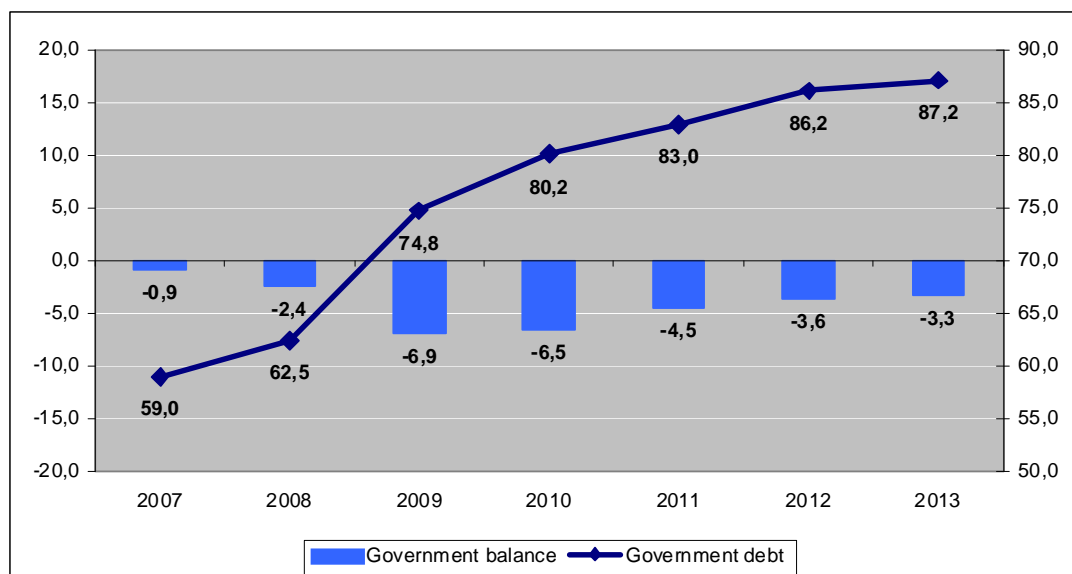
### 5.2.2. Public finances start to adjust

Public finance developments in the euro area and the EU continue to be characterised by the fiscal exit strategy put in place after the 2008-09 recession. In line with the Council conclusions first issued in 2009 and subsequently reiterated in 2011 and in early 2012, the key objective of the fiscal exit strategy is to bring public finances back to a sustainable path within the context of the EU fiscal rules. Fiscal consolidation efforts, which started in 2010, intensified in 2011 and led to a significant improvement in public finance conditions in both the euro area and in the EU. The economic cycle, which was still supportive in the first half of 2011, also contributed positively to this improvement.

The aggregate general government deficit in the euro area is expected to decline to 3.2% of GDP in 2012, about 1 percentage point of GDP lower than in 2011. Taking into account only adopted budgets and other measures sufficiently specified by Member States by the cut-off date, the overall budget deficit is set to decrease further to 2.9% of GDP in 2013. A similar profile is expected in the EU, where the aggregate deficit is expected to reach 3.6% and 3.3% of GDP in 2012 and 2013 respectively.

Government debt-to-GDP ratios are expected to continue to increase over the forecast horizon in both the euro area and in the EU, albeit at a slowing pace compared with the 2008-10 period. Even though current deficits are being reduced, increasing interest payments, combined with somewhat lower nominal GDP growth, are assumed to increase debt ratios very moderately. On the whole, in the euro area gross public debt is projected to reach 92.5 % of GDP in 2013, while in the EU it is expected to slightly exceed 87% of GDP (see Figure 6).

Figure 6: General government balance and public debt within the EU-27, in % of GDP (2007 – 2013)



Source: Eurostat (2007-2011) and DG ECFIN (2012-2013)

### Box: Number of Member States in an ongoing excessive deficit procedure (EDP)

The Council requested the Commission, in addition to the data used in its 2011 Report, to take into account the number of Member States with an ongoing Excessive Deficit Procedure (EDP). This indicator derives from the general government balance, which is assessed above. In the Commission's view, the general government balance better captures the essence of the problem. The number of Member States in the ongoing EDP does not show the magnitude of the deficit, but merely indicates the number of the Member States where it is above the threshold of 3%. It should be noted that reasons for being in the EDP are structurally different for each Member State.

The Maastricht Treaty of 1992 which foresaw the creation of the EURO, organized the way multilateral fiscal surveillance is conducted within the Union. This surveillance, enforced recently by the "six-pack" and the Treaty on Stability, Coordination and Governance (TSCG) is based on the EDP. In order for EMU to function smoothly, Article 126 TFEU provides that Member States shall avoid excessive government deficits defined in the Protocol on the EDP by the reference values for the annual general government deficit (3%) and gross debt (60%) in relation to GDP at the end of the year, whereby a number of qualifications can be applied.

In the end of May 2012, there were 23 Member States with an ongoing EDP i.e. BE, BG, CZ, DK, DE, IE, EL, ES, FR, IT, CY, LV, LT, HU, MT, NL, AT, PL, PT, RO, SI, SK and UK. Seven of them have the deficit correction deadline in 2012, ten of them have the correction deadline in 2013, ES in 2013, EL in 2014, while IE and UK in 2015. Only three Member States have not met the correction deadline of 2011 (BG, HU and MT). As there are different structural reasons for launching the EDP for different Member States, the mere indication of their number does not bring strong added value, if any, to other indicators used in the present report, in particular those referring to public finances.



The objective of EDP is to improve the public finances of Member States through individual recommendations; therefore its existence may be seen as going into the direction of improved public finances. The underlying rationale of the currently reinforced economic governance framework is that sound public finances are the only way to create a healthy economic environment. Its nature is to analyse the public finances through criteria set by the legislation. This is even more important at the final stage of EPD, when the Member State complies with recommendations before the correction deadline. Therefore, the number of Member States under the EDP changes periodically as a result of actions reducing the annual general government deficit below 3% in relation to GDP. The number of Member States in this procedure can change from year to year. The increase of this number in 2009 was caused by increased public spending resulting from government interventions on financial markets. All but seven Member States (BG, CZ, EE, MT, PL, RO and SK) reported various interventions undertaken by the government in the context of the financial crisis since 2007. Therefore, the indicator of the number of Member States with ongoing EDP is not conclusive. In this context, the indicators reflecting the level and change of the government deficit and gross debt in Member States are more relevant.

All in all, the government finances have been adjusting. The government deficit rate has significantly improved since 2008 and is expected to go down to 3.3 % in 2013, while the debt ratio will increase very moderately to 87% of GDP in 2013.

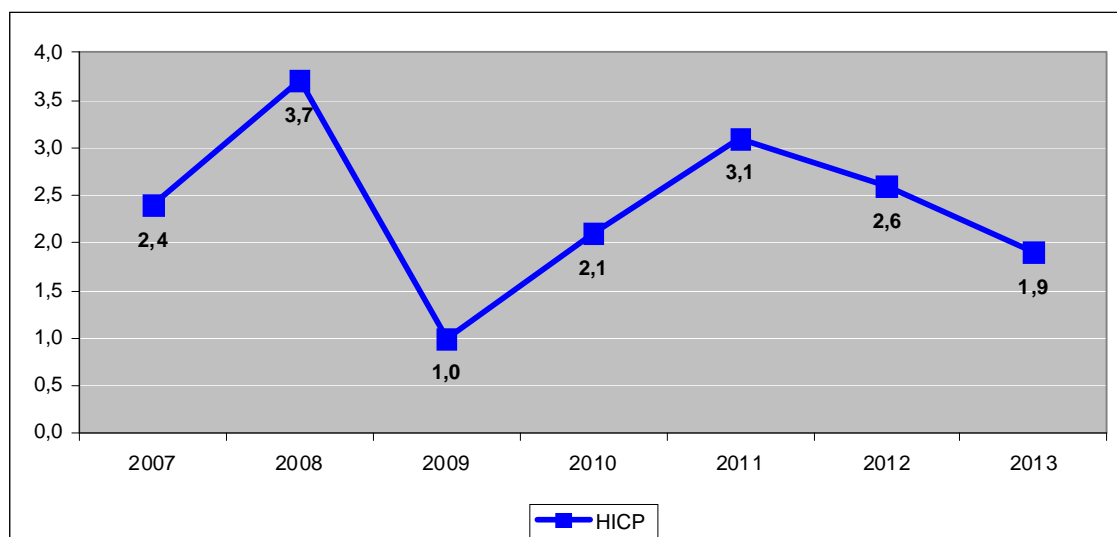
### 5.2.3. *Inflation is expected to abate gradually*

Consumer prices in 2011 were mainly driven by the pass-through of rising global commodity prices and, in some Member States, by increases in indirect taxes and administered prices. HICP inflation temporarily exceeded 3% in 2011, but began to recede in the light of a weakening economic environment. The easing in commodity prices as indicated by commodities futures toward the end of this year and relative weak economic activity should lower consumer-price inflation further. A faster decline in inflation rates is precluded by fiscal measures adopted in several Member States, most notably increases in indirect taxes and administered prices. The return of subdued growth in late 2012 and 2013 is not expected to contribute to price pressures, in particular since output gaps are expected to narrow very slowly in the EU and the euro area.

The easing in commodity prices towards the end of this year, in line with the futures-based assumptions, and relatively weak economic activity, should lower consumer-price inflation. Further on, headline inflation is expected to decline, owing to the fall in energy inflation, reflecting base effects related to oil price hikes in early 2011.

The return to subdued economic growth in late 2012 and 2013 is not expected to add any substantial inflationary pressure, in particular since output gaps are only closing very slowly in the EU and the euro area. HICP headline inflation is expected to stay close to 2% in 2013 (1.9% in the EU, 1.8% in the euro area) and thus to be in line with inflation expectations. In 2013, core inflation, despite some distortion from increases in indirect taxes and administered prices, will move in parallel (see Figure 7).

**Figure 7: Harmonised index of consumer prices within the EU-27 (annual % change)**



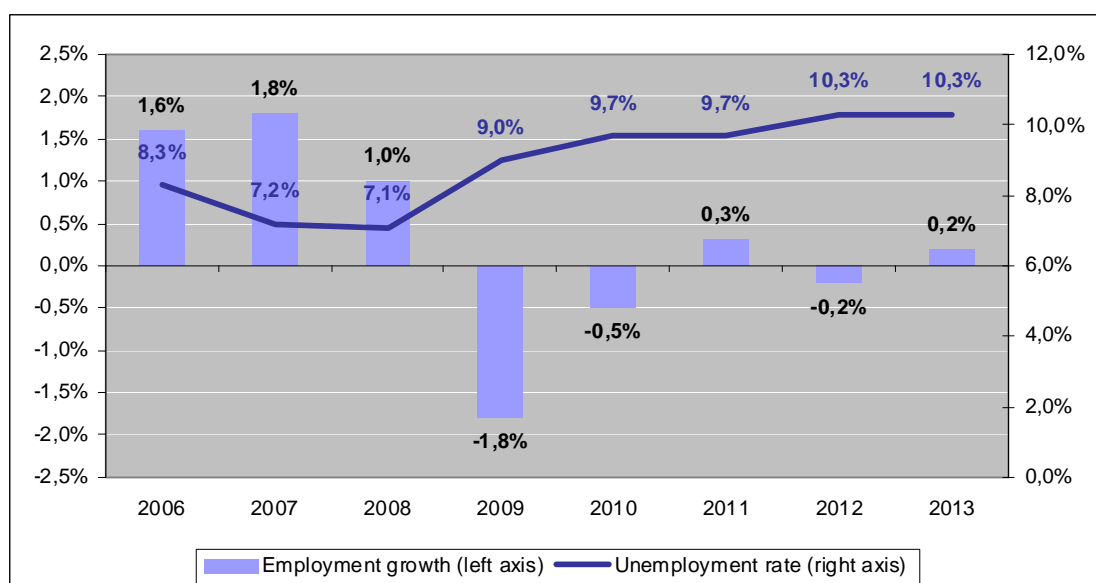
Source: Eurostat (2007-2011) and DG ECFIN (2012-2013)

#### 5.2.4. The labour-market situation is expected to stabilise

Current labour market developments reflect both the heritage of the 2008-09 recession and the stagnation of 2011-12. Improvements during the early stages of the 2009-11 recovery had been limited. Since companies had adjusted their labour input by reducing the number of hours worked per employee rather than cutting headcounts, the expansion first saw a normalisation in terms of working hours but no or only marginal employment growth.

With employment falling in the second half of 2011, the unemployment rate increased to 10.3% in 2012 and is expected to remain at that level in 2013 (see Figure 8).

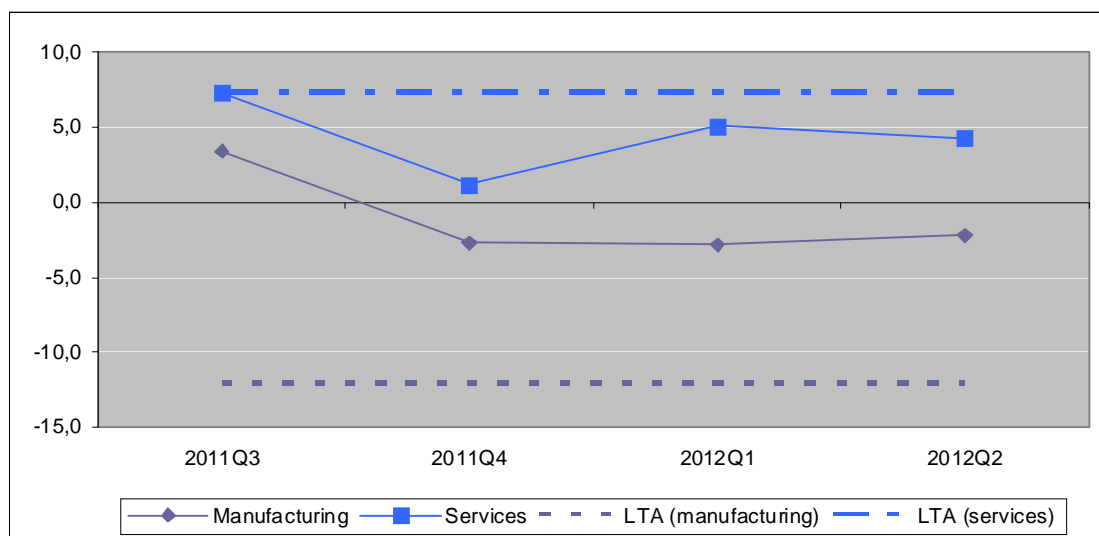
**Figure 8: Employment growth and unemployment rate within the EU-27 (2006 – 2013)**



Source: Eurostat (2006-2011) and DG ECFIN (2012-2013)

Accordingly, in the Commission surveys, employment expectations in the EU industry and services sectors declined towards the end of 2011 and remained at low levels in the first quarter of 2012. The employment expectations in the EU for manufacturing remained above the long-term average and the employment expectation in services remained slightly below the long-term average (see Figure 9).

**Figure 9: Employment expectations in 2011 – 2012 (balance)**



*Source: DG ECFIN*

Further on, the expected rebound in economic activity should help to stabilise the labour market situation. Due to the usual lag of responses in employment to changes in economic activity, however, it will take time to see any improvements in the labour market. The situation is also expected to benefit increasingly from reform efforts, which have been undertaken in several parts of the EU. They should become effective with the kind of time lag already seen in countries, which had already undertaken such measures some time ago.

Overall, in 2013 employment is forecast to increase moderately in the EU and to stabilise in the euro area. As a result the upward trend in unemployment rates is expected to be broken in the EU and the euro area.

It should be reminded that it is not the first time when the unemployment rate increases in the European Union and reaches a comparable level. In 2000 – 2004, the unemployment rate increased from 8.5% to 9.1%, before dropping to 7.1 % in 2008.

#### 5.2.5. *Compensation in the public sector versus the total economy*

The Commission considers that it is important to compare the situation of employees in the public sector to the total economy in the EU. For this purpose, it is appropriate to use the compensation of employees, which measures the total labour cost for all employees, defined as gross wages including overtime and bonuses, together with benefits received in kind and employer social contributions<sup>8</sup>, both in the public sector

<sup>8</sup> As a consequence, it reflects changes in the employment rate and changes in welfare policy as well as the wage level.

(general government sector<sup>9</sup>) and in the total economy. It should be noted that data on the total economy include those for the public sector. The weight of the public sector in the total economy is of the order of 22 %.

Compensation in the private sector is highly correlated to economic cycles: compensation of employees in the total economy increased by 5.2 % in 2007 and 4.4 % in 2008 but dropped to -0.3 % in 2009 at the heart of the financial turmoil, when the GDP fell by 4.3 %. Compensation in the public service may not necessarily follow economic cycles. For example, in 2009, compensation of employees in general government increased by 3.4 %.

The annual increase in compensation of employees in the public sector is expected to increase from 0.4 % in 2011 to 0.8 % in 2012 and to increase further to 1.3 % in 2013. Compensation in the total economy increased by 2.6 % in 2011 and is forecast to increase at a faster pace (1.9 % in 2012 and 2.3 % in 2013) than compensation in the public sector (see Figure 10).

During the 2009 recession, salary increases in the total economy were minimal, while salary adjustments in the public sector remained moderate. However, this has changed as soon as the recession ended, resulting in stronger salary increases in the total economy, while salary adjustments in the public sector remained subdued due to governments' efforts to adjust budget deficits. From 2004 to 2011, compensation in the EU increased in nominal terms by 28.4 % in the public sector and by 27.9 % in the total economy. According to the 2012 Spring European Economic Forecast, it is likely to rise to 31.1 % in the public sector by 2013 (starting from 2004) against 33.3 % in the total economy (see Figure 11).

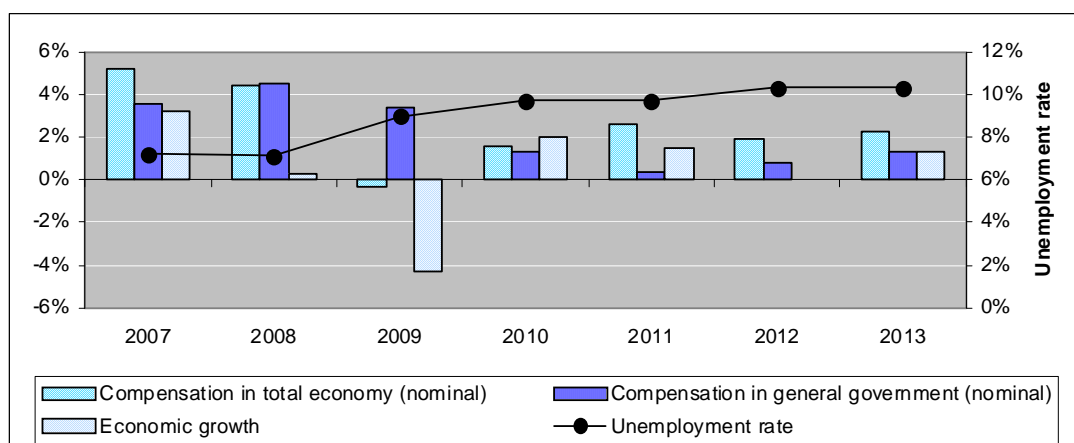
Nominal compensation per employee is expected to grow at annual rates of about 2.1 % in 2012 and 2013. This will result in a cut of real salaries in 2012, due to a higher inflation rate (2.6 %), but will produce an increase in real salaries in 2013, with the inflation dropping to 1.9%. The situation is expected to be less positive for employees in the public sector, with a lower increase in compensation. The loss of purchasing power in the public sector would amount to 1.8 % in 2012 and is in line with the specific indicator forecast issued by Eurostat on the basis of information supplied by the Article 65 Working Group in March 2012, according to which national officials in central government are expected to lose 1.6 % of their purchasing power. This clearly shows that the upcoming salary adjustment in the EU Institutions is closely correlated to salary increases in the public sector and is fully in line with the economic and social situation in the Union, in spite of higher salary increases in the total economy.

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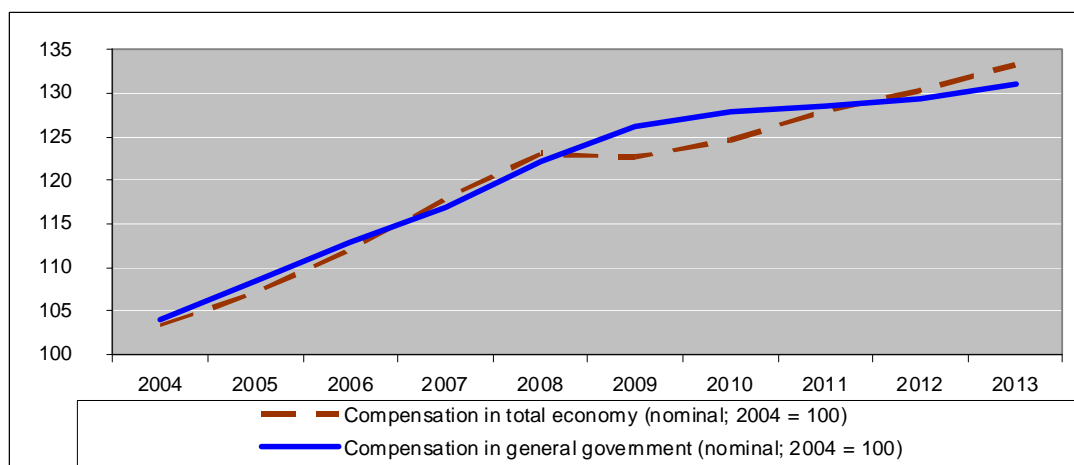
The public sector stands for general government throughout this section. The general government sector includes all institutional units which are other non-market producers whose output is intended for individual and collective consumption, and mainly financed by compulsory payments made by units belonging to other sectors, and/or all institutional units principally engaged in the redistribution of national income and wealth. Institutional units include general government entities and some non-profit institutions and autonomous pension funds. The general government sector is divided into four sub-sectors: central government, state government, local government and social security funds.

**Figure 10: Changes in compensation of employees within the EU-27, total economy versus general government (2007 – 2012)**



Source: Eurostat (2007-2011) and DG ECFIN (2012-2013)

**Figure 11: Cumulative changes in compensation of employees in the EU, total economy versus general government (2004 – 2012)**



Source: Eurostat (2004-2011) and DG ECFIN (2012-2013)

**Table 11: Changes in compensation of employees in the EU (annual % change)**

	2004	2005	2006	2007	2008	2009	2010	2011	2012*	2013*
<b>General government</b>	4,1	4,3	3,9	3,6	4,5	3,4	1,3	0,4	0,8	1,3
<b>Total economy</b>	3,4	3,6	4,6	5,2	4,4	- 0,3	1,6	2,6	1,9	2,3

Source: Eurostat (2004-2011) and DG ECFIN (2012-2013)

#### 5.2.6. Changes in purchasing power of national civil servants in central public administration (additional forecast)

An additional forecasting exercise carried out by Eurostat in the end of May showed that the loss of purchasing power in the public sector will be lower than previously forecasted, i.e. 1 %<sup>10</sup> in the eight reference Member States and 1.4% in the EU27. This is due to an important salary increase in Germany granted by the federal

<sup>10</sup> UK has not submitted revised data

government to public sector employees and which will also apply to federal civil servants. The above loss of purchasing power will be applied to EU staff through the method. There are no events that should be reflected in the salary adjustment and that the method has not been able to capture. Therefore, there are no any objective reasons to inflict a higher loss of purchasing power on European civil servants going beyond that applied by the Member States to their civil servants. Moreover, it should be reminded that, due to the elements of double counting and the Council's refusal to adjust the salaries in 2011, the loss of purchasing power in the EU Institutions since 2004 has been more than double (7.6 %) compared to the national civil services (3.6%).

Member States have also been asked to forecast salary changes from 1 July 2012 until the end of the year, however, a number of them found it difficult to provide Eurostat with reliable figures, thus preventing Eurostat from drawing a reliable forecast. Nevertheless, it should be pointed out that none of the Member States is forecasting a salary cut in the second half of 2012 and at least nine Member States have envisaged salary increases for national civil servants. Therefore, the exception clause should not be applied. This is fully in line with the reasoning of the Court of Justice in Case C-40/10, where the Court stressed that the *'clause enables account to be taken of the consequences of a deterioration in the economic and social situation which is both serious and sudden where, under the 'normal method', the remuneration of officials would not be adjusted quickly enough'*. As Member States do not envisage any pay cut in the second half of 2012, but forecast salary increases, there is no reason to depart from the 'normal method' by taking into account salary adjustment in the Member States outside the reference period.

Altogether, even though due to the consolidation of public finances salary increases in the public sector are expected to remain subdued, this will not be the case in the total economy. Salary adjustments below the inflation will continue eroding salaries of national officials and EU civil servants in 2012 and, if the new method is adopted to come to effect in 2013, any further loss in purchasing power of national officials would be applied to the EU staff.

## 6. CONCLUSION

It follows from the foregoing considerations and analysis that the legal criteria of Article 10 of Annex XI are not met during the reference period of 1 July 2011 to mid-May 2012. In 2012 the EU economy is expected to stagnate before moving towards contained growth. The salaries in total economy are expected to increase by 2.1 % in 2012 and 2013, although salary increases in the public sector will be lower corresponding to the lower rates of compensation of employees.

No event has been identified that has not been or could not be captured by the normal application of the method.

In 2012 the real salaries of EU staff would go down in line with the loss of purchasing power of national civil servants. After the reference period, at least nine Member States are estimating a salary increase and none of them forecast a salary cut. Therefore, there is no reason to depart from the 'normal method' by taking into account salary adjustment in the Member States outside the reference period.

Therefore, the Commission considers that it is not appropriate to submit a proposal under Article 10 of Annex XI to the Staff Regulations.

The Commission recalls again that, in reply to the difficult general economic context, it has submitted a draft proposal to the European Parliament and the Council which would lead to significant savings in the next years and to even higher savings in the long term. The proposal includes a new and revised method as well as amendments to the mechanism of the exception clause.