European Fiscal Board

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ABBREVIATIONS

Member States

BE Belgium

BG Bulgaria

CZ Czech Republic

DK Denmark

DE Germany

EE Estonia

EI Ireland

EL Greece

ES Spain

FR France

IT Italy

HR Croatia

CY Cyprus

LV Latvia

LT Lithuania

LU Luxembourg

HU Hungary

MT Malta

NL the Netherlands

AT Austria

PL Poland

PT Portugal

RO Romania

SI Slovenia

SK Slovakia

FI Finland

SE Sweden

UK United Kingdom

EA Euro area

EU European Union

EU-28 European Union, 28 Member States

EA-19 Euro area, 19 Member States

Other

AWG Ageing Working Group

CAB Cyclically-adjusted budget balance

CAPB Cyclically-adjusted primary balance

CP Convergence programme

CSR Country-specific recommendation

DBP Draft budgetary plan

DG ECFIN Directorate-General for Economic and Financial Affairs

DSA Debt sustainability analysis

ECB European Central Bank

ECOFIN Economic and Financial Affairs Council

EDP Excessive deficit procedure

EFB European Fiscal Board

EFC Economic and Financial Committee

EFC-A Alternates of the Economic and Financial Committee

EMU Economic and Monetary Union

EPC Economic Policy Committee

GDP Gross domestic product

GFCF Gross fixed capital formation

HICP Harmonised index of consumer prices

IMF International Monetary Fund

MLSA Minimum linear structural adjustment

MTBF Medium-term budgetary framework

MTO Medium-term budgetary objective

NAWRU Non-accelerating wage rate of unemployment

NPLs Non-performing loans

OECD Organisation of Economic Co-operation and Development

OGWG Output Gap Working Group

SB Structural balance

SDP Significant deviation procedure

SGP Stability and Growth Pact

SP Stability programme

SCPs Stability and convergence programmes

SPB Structural primary balance

TFEU Treaty on the Functioning of the European Union

TSCG Treaty on Stability, Coordination and Governance

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FOREWORD

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Chair of the European Fiscal Board

In this second annual report, written half-way through the initial three-year mandate of the European Fiscal Board (EFB), we offer an independent assessment of how the rules-based fiscal framework has performed. The main emphasis is on the euro area and its Member States, though there is also some analysis of non-euro EU countries, to which many of the fiscal rules apply. The focus is on the latest year for which a complete surveillance cycle can be observed, now 2017.

The first annual report of the EFB, published in November 2017 and providing a detailed analysis of the experience in 2016, reached a largely positive conclusion. Despite several examples of non-transparent implementation, our overall evaluation was that the framework had '*succeeded in avoiding on the one hand a major relaxation of the rules, potentially detrimental to the longer-run sustainability of public finances, and, on the other hand, a rigid application of the rules, which could have undermined the continuation of a still fragile recovery*.' The present report is more critical of the 2017 experience, largely due to the strength of the recovery.

In retrospect, 2017 was a watershed in the post-crisis development of the euro area economies. The growth rate of real GDP in the area has turned out, according to the latest estimates, to be 2.4 %; the recovery had clearly become a solid expansion. By contrast, in the spring of 2016, the Commission — like most others — anticipated a continuing sluggishness in performance for 2017. This perception persisted into the autumn of 2016, when the Commission argued that a fiscal stimulus of up to 0.5 % of collective GDP should be undertaken to achieve a faster reduction of the output gap; the Eurogroup maintained its view that no such stimulus would be required beyond the modest expansion foreseen when summing up the draft budgetary plans that had just been submitted.

The change in the structural primary budget balance — still the preferred indicator of discretionary fiscal policy — turned out, in the *ex post* evaluation of spring 2018, to have been slightly contractionary. While this was a more restrictive outcome than the one in the draft budgetary plans, not to speak of the additional stimulus proposed by the Commission, some further consolidation to take account of the change in economic outlook would, with the benefit of hindsight, have been appropriate. Too much of the windfall was spent.

While flexibility is defensible in unfavourable times, such an attitude requires a degree of symmetry as the outlook improves. If state-contingency of the rules becomes a one-way street, adjusting only to accommodate slow growth, longer-run sustainability of public finances is endangered. This is particularly the case when, as largely happened in 2017, the opportunities offered by the strength of the expansion are used in a lopsided way, i.e. primarily by less-indebted countries.

The 2017 experience therefore offers rich material for reflection at a time when economic growth has continued to surprise on the upside. It illustrates the difficulties of forecasting a year ahead — and not becoming prisoners of outdated forecasts. It also illustrates the momentum in a process to show forbearance in fiscal consolidation; once applied, flexibility is very difficult to modify or roll back, as Member States come to rely on it.

After examining the implementation of the fiscal rules in the Member States and the Commission's efforts to recommend an appropriate fiscal stance for the entire euro area, the EFB concludes that rules should still play a central role in fiscal governance. But the existing rules need to be reviewed critically with a view to simplifying them and improving compliance. We are concerned that progress on this major issue has been postponed into the 2020s by both the Commission and the Council.

We recognise that independent national fiscal institutions have provided a valuable decentralised element of surveillance which can help make national policies more transparent and improve ownership. We review briefly the experience of two fiscal councils — in the United Kingdom and Slovakia — that have, in different ways, made important contributions to the quality of fiscal governance. However, our review of the contributions from councils in countries which faced difficulties in complying with the rules in 2017 leaves us with the impression that there is quite a long way to go before the problems with the rules we have analysed will be eased.

In the final section of our report we follow up on our preliminary reflections from last year on how the rules could be simplified and enforced with flexibility. The

key is to reduce the number of rules and indicators and retain only one overall objective, a targeted path for reducing the debt ratio in countries above the long-term reference value in the Treaty of 60% of GDP, and one operational rule, an expenditure benchmark. These features appear to reflect an emerging consensus in a number of contributions by outside observers — international institutions as well as a number of economists — as to the way forward. All relevant contributions, including very recent ones, will need to be examined further, before the revision of the EU fiscal rules reaches the official EU agenda.

We illustrate how our proposal could be enforced, while retaining countercyclical features. Rather than developing further the detailed catalogue of criteria for forbearance which has evolved since the crisis, we propose that rules-based surveillance in the future should comprise a general escape clause to be applied parsimoniously and after the case for it has been subjected to independent economic judgement. The perception that the border between economic and political reasoning has become blurred has contributed to the tensions in the recent practice of surveillance.

1. EXECUTIVE SUMMARY

This report documents the work of the European Fiscal Board (EFB). In terms of both structure and ambition, it follows the precedent set in 2017. In accordance with the tasks mandated by the European Commission, the report first and foremost offers a comprehensive and independent assessment of the implementation of the Stability and Growth Pact. The rolling window of the assessment is moved forward by one year to 2017, so as to cover the latest full annual fiscal surveillance cycle of the EU. The report also puts forward a proposal for the future evolution of the EU's fiscal framework. Building on preliminary ideas outlined last year, the report expands on a more granular proposal on how to make the Stability and Growth Pact simpler and stronger.

In 2017, the economic situation of the euro area and the EU was solid and significantly better than expected. Since the double-dip of 2012-2013, economic activity posted the fourth consecutive annual increase in the single currency area; the fifth in the EU. In both regions, real GDP increased by 2.4 % on the previous year, the fastest rate in 10 years and by roughly half a percentage point more than the Commission expected in spring 2016 when it kicked off the 2017 fiscal surveillance cycle. Due to statistical revisions of previous years, the level of economic activity in 2017 was revised upward too: real GDP turned out to be almost 2 % higher than expected in spring 2016. Labour market conditions improved markedly with the rate of unemployment approaching levels observed during previous boom periods. Although picking up on the previous year, the reaction of inflation to economic activity remained comparatively muted.

Public finances visibly benefited from the solid economic recovery. In both the euro area and the EU, the general government budget deficit narrowed to around 1 % of GDP, posting an improvement of more than half a per cent of GDP on the previous year. Debt-to-GDP ratios declined for the third year running. The structural primary budget balance — the balance net of interest expenditure, cyclical components and one-off and other temporary measures — improved, although only marginally, after 2 consecutive years of deterioration. In spring 2018, which marked the end of the 2017 fiscal surveillance cycle of the EU, the Commission estimated that 13 Member States — representing around 38 % of EU GDP (42 % in the euro area) — were at or above their medium-term budgetary objective, the position that safeguards the long-term sustainability of public finances; more than twice as many as in spring 2016.

In some countries, windfalls were used to increase government expenditure. The measurable improvement of 2017 headline balances masks a noteworthy development. In the euro area, only part of the higher-than-expected government revenues went to reducing the deficit; on average around one third was used to raise expenditure levels above plans presented in the 2016 stability programmes. In the hypothetical case that all euro area countries had implemented their original expenditure plans for 2017, growth and revenue windfalls would have implied a headline deficit of 0.7 % of GDP as opposed to 0.9 % of GDP. The adjustment of expenditure levels differed across countries: while some managed to reduce expenditure levels below their original targets, others made full use of the windfall gains. The first group included countries where the fiscal position was already comparatively sound; the second group encompassed countries where the fiscal position was comparatively weak.

An opportunity was missed to reduce high debt levels faster. Improving fiscal positions, both nominal and structural, coupled with falling debt ratios, are positive signs. However, the current EU fiscal surveillance did not inspire all governments to take full advantage of the improved economic and fiscal conditions. In spring 2018, following a series of backward revisions of national accounts and changes to the commonly agreed method for estimating potential output, the level of euro area potential GDP in 2017 was adjusted upwards by close to 2 % compared to spring 2016, by the same amount as actual GDP; around one third of this revision was due to the exceptional revision of GDP in Ireland. At expenditure levels targeted in the 2016 stability programmes, such an upward shift alone would have generated a revision in the estimated structural budget balance of the euro area of close to 1 % of GDP. At a time when the economy was markedly improving and countries should have started building fiscal buffers, the revision of potential GDP supported an unwarranted sense of safety. Hence, 2017 was an example of how the otherwise bemoaned quality of potential output estimates in some cases motivated the use of windfalls rather than accelerating debt reduction. The recently stated intention of giving more prominence to the expenditure benchmark, the more stable measure of compliance, was not followed through with on a consistent basis.

The implementation of the Stability and Growth Pact did not adapt to the much improved macroeconomic conditions. In its 2017 annual report, the EFB argued that some modulation of flexibility and discretion across the cycle was preferable to a very strict and unconditional implementation of EU fiscal rules. In spite of the much improved economic situation and balance of risks in 2017, the overall thrust in the implementation and interpretation of rules was not adjusted. Elements of asymmetry in the Pact precluded any adaptation of the adjustment requirements to the macroeconomic situation, and elements of judgement continued to be used to soften the constraints imposed by the rules. The degree of forbearance is reflected in the national distribution of the fiscal adjustment. Especially high-debt countries and countries in the excessive deficit procedure minimised fiscal consolidation, while some countries with fiscal space decided to do more than required. As a result, the opportunities offered by the stronger-than-expected recovery were used in a lopsided fashion: less by those who should have taken advantage of the opportunity and more by those who already enjoyed a more comfortable fiscal position.

Among the decisions taken in the 2017 fiscal surveillance cycle, some deserve to be highlighted. All EU countries have benefited from the economic expansion in 2017, and differences in economic growth and cyclical slack have narrowed markedly. However, several countries exhibited idiosyncrasies that played a role in the way the EU fiscal rules were applied. We will start with the cases where the Commission and the Council decided to take firm action.

- In light of conspicuous slippages on the expenditure side of the budget, the Council, acting on a recommendation by the Commission, launched a significant deviation procedure for *Romania* in spring 2017. This was a first since the introduction of the procedure in 2011.

- As *Romania* failed to correct the significant deviation in 2017, a new Council recommendation was issued in spring 2018. In tandem, the Council launched a significant deviation procedure for *Hungary*. The Commission had signalled risks of a significant deviation for both countries already in spring 2016 when assessing their convergence programmes.

There were also a number of noteworthy cases where the Commission and the Council applied a certain degree of forbearance. As a reminder, the EFB does not assess the implementation of the Stability and Growth Pact from a legal point of view but from an economic perspective.

- In spring 2016, the fiscal requirement for *Slovenia* was set below the adjustment implied by the agreed matrix of adjustment requirements. The departure was decided on account of uncertainty surrounding the available real-time estimates of the output gap. This was the first such case since the introduction of the matrix in 2015.

- In its final assessment of compliance of *Slovenia* and *Portugal*, the Commission made an *ad hoc* correction to the expenditure benchmark by adjusting the underlying medium-term rate of potential GDP growth. For Slovenia, the adjustment was instrumental to ensure compliance.

- *Italy* was the only euro area country where nominal GDP growth in 2017 turned out measurably lower than initially projected, due to a lower-than-expected increase of the GDP deflator. The budgetary plans for 2017 presented in spring 2016 were predicated on forecasts which the Italian independent fiscal council had characterised as on the high side — for both inflation and real GDP growth — but which the Commission found plausible.

- In its final assessment of *Italy*, the Commission found the country broadly compliant on account of (i) a generous reading of the structural balance; (ii) the possibility of carrying forward flexibility and unusual event clauses from previous years, although the safety margin against breaching the 3 % of GDP reference value was not observed; and (iii) an exception in the quantification of the refugee and earthquake-related costs in 2017.

- In its final assessment of *Belgium*, the Commission stated that available evidence was not sufficiently robust to conclude that there was a significant deviation from the required fiscal adjustment. The benefit of the doubt was granted, although the relevant elements of the Commission 2018 spring forecast would have supported such a conclusion. The Commission referred to a statement made by the Belgian authorities after the 2018 spring forecast according to which a shift in the timing of corporate income tax payments was likely to have permanent positive effects on the budget. The Commission's conclusion creates a risky precedent.

- In the same assessment of *Belgium*, the Commission also referred to higher-than-expected inflation in 2017 as an argument to explain deviations from the adjustment path. In previous years, higher-than-expected inflation was typically seen as a factor making compliance with EU fiscal rules easier. Moreover, although minor, the estimated effect of

higher-than-expected inflation came on top of budgetary plans that already intended to exploit the full margin of error in the assessment of compliance.

- *Belgium* and *Italy* were not placed under the excessive deficit procedure, even though their debt-to-GDP ratio did not decline at the rate required by the debt reduction benchmark of the Stability and Growth Pact. The debt reduction benchmark was *de facto* suspended. Priority was given to the deficit criterion, by assessing compliance with the recommended deficit adjustment, including important elements of flexibility and margins of broad compliance of 0.5 % of GDP in a single year or 0.25 % of GDP per year on average in 2 consecutive years.

- *France* and *Spain*, the two remaining countries under the excessive deficit procedure in 2017, continued to follow a nominal strategy. Against the backdrop of better-than-expected economic growth, the governments of both countries decided again to substitute consolidation measures with revenue windfalls.

In a few cases, independent national fiscal councils played an important role in raising relevant issues. Since the 2011 six-pack reform of the Stability and Growth Pact, elements of independent assessment in the EU fiscal framework have grown in importance. As a minimum, national fiscal councils, which have been established in virtually all EU Member States, assess or produce the macroeconomic forecasts underpinning the government's budgetary plans. Many national fiscal councils also review compliance with national and/or EU fiscal rules. In the 2017 fiscal surveillance cycle of the EU, very few national fiscal councils raised or had to raise critical questions on the budgetary policy of their respective governments, not least because economic developments surprised on the upside. Notable exceptions were the Italian and Romanian fiscal councils. The Italian Parliamentary Budget Office raised doubts about the prudence or feasibility of the government's budgetary plans already in spring 2016 and reiterated concerns in autumn of the same year. Similarly, starting in 2016, the Romanian fiscal council repeatedly signalled how the government's expenditure plans would (i) be in conflict with national fiscal rules and (ii) amount to a clear pro-cyclical fiscal expansion. Hungary, by contrast, is an example where the national fiscal council did not flag major problems for 2017 in the face of evident expenditure slippages in both plans and implementation.

The fiscal stance for the euro area was appropriate in spite of shifting Commission guidance. The year 2017 marked a change in the general orientation of the fiscal policy in the single currency area. In contrast to the previous 2 years, the fiscal stance — as measured by the change in the structural primary budget balance — turned marginally restrictive. Such an outcome can be considered appropriate in light of significantly better-than-expected economic growth. Indeed, the marginally restrictive fiscal stance did not hamper the solid and broad-based economic recovery in the euro area. An appropriate outcome was achieved in spite of a prominent shift of policy guidance. Following the Commission's assessment of the 2016 stability programmes and on the basis of its own 2016 spring forecast, in July 2016 the Commission and the Eurogroup agreed that a broadly neutral fiscal stance would be appropriate for the euro area in 2017. In November 2016, and although the economic outlook for 2017 had hardly deteriorated, the Commission concluded that a fiscal expansion of 0.5 % of GDP would be desirable. The Eurogroup, by contrast, stuck to its initial view.

Recent initiatives to simplify the Stability and Growth Pact are unlikely to succeed. On the back of growing concerns among Member States, extensive discussions took place in the course of 2016 between the Commission and the competent Council committees on how to improve the transparency and predictability of the Stability and Growth Pact. An agreement was reached at the end of 2016 to put stronger emphasis on the expenditure benchmark instead of the structural budget balance. However, the implementation of the agreement has not achieved the stated objective, because it leaves relevant secondary EU legislation untouched. It is difficult to imagine that Member States would forego options offered by current legislation, if the expenditure benchmark turned out to be more restrictive than the structural budget balance. This view is confirmed by a first experience in 2017: the Commission and the Council agreed to *ad hoc* modifications of the expenditure benchmark or to privilege the structural budget balance when assessing compliance *ex post*; examples are Slovenia, Portugal and Italy. Against the backdrop of the solid economic recovery, the medium-term rate of potential GDP growth upon which the expenditure benchmark is built increased significantly less than the estimate of potential GDP growth in 2017, thus imposing a tighter constraint on government expenditure growth.

The flexibility clauses under the Stability and Growth Pact fell short of expectations. The year 2017 was the third year in which the Commission and the Council applied the flexibility provisions of the Stability and Growth Pact agreed in 2015. The EFB's independent assessment is less favourable than the Commission's. The matrix modulating the required fiscal adjustment over the economic cycle does not take into account the tendency to underestimate economic

good times (on which we provided evidence in the report published in June 2018; see EFB, 2018). Hence, windows of opportunity to speed up fiscal adjustment are likely to be missed. Also, in several cases the Commission decided to deviate from the requirements implied by the matrix based on a discretionary assessment of cyclical conditions. Compliance turned out to be an issue, too. Among the Member States that were granted flexibility, some missed even the reduced requirement by a measurable margin, indicating that in contrast to expectations, flexibility has not improved ownership. Overall, the matrix of adjustment requirements is an emblematic example of the more general quest to adjust EU fiscal rules to a complex economic reality: both rules and process are made increasingly detailed at the cost of transparency and credibility.

Incremental reforms of the Stability and Growth Pact have reached their limit; a more fundamental overhaul is needed. The current EU fiscal framework is the result of successive legislative reforms coupled with a series of agreements on how to interpret existing provisions. In most cases, reforms and new interpretations did not alter the existing structure of the framework; rather, they added in an incremental fashion new elements in a well-meant attempt to make the rules as complete as possible and strengthen the role of the Commission. However, the mounting degree of specification of the rules and the more prominent role of the Commission in the surveillance process have given rise to important and interrelated elements of criticism: (i) the distinction between economic judgement and political expediency has become progressively blurred, nurturing tensions among decision makers; (ii) the implementation of the rules is increasingly perceived as lacking transparency and even-handedness; and (iii) the enforcement of rules has become looser. In such a context, any new addition is destined to fail; it only magnifies the underlying predicaments of the current system without solving them. A more fundamental review and reform of EU fiscal rules is needed.

Some convergence of views on how to reform the Stability and Growth Pact is emerging. The idea of overhauling the Stability and Growth Pact is not new. Growing difficulties and concerns with the implementation of the current system of EU fiscal rules have inspired a number of proposals that converge on key elements in a future reform; most importantly, they all aim at a radical streamlining of rules and procedures. The European Fiscal Board shares this view. Starting from the broad brushstrokes of last year's annual report, the Board details a reform plan. The plan is built around one ultimate objective — the long-term sustainability of public finances — to be achieved with one operational mechanism — the control of government expenditure while debt is above 60 % of GDP. Implementation and monitoring would focus on important deviations over the medium term rather than smaller ones in any given year. General escape clauses, to be used parsimoniously following advice by an independent assessor, would take care of significant and unforeseen contingencies. To strengthen enforcement, access to a future central fiscal capacity, such as discussed in our June 2018 report, would be conditional on observing the provisions of the reformed fiscal framework.

A simplification of EU fiscal rules needs to be combined with a reform of governance. Simplification is a necessary, albeit not a sufficient, condition for an effective reform of the Stability and Growth Pact. The current system started off as a very simple and clear set of rules to be faithfully interpreted and implemented by the Guardian of the Treaty, the European Commission. The expression 'Guardian of the Treaty' very much underscores the expectations of the early days. Over time, tensions tested the original division of labour between the Commission and the Council. By now, interaction between the two institutions is characterised by more frequent discussions on how to exercise the many elements of discretion implied by the current set of rules and procedures. The progressive codification of all possible aspects of fiscal surveillance is the result of those discussions. In the end, however, rather than ensuring an even-handed application of discretion, the codification has affected the transparency and credibility of the rules. As long as current governance arrangements are not reviewed, a simplification of the rules as such will not do; it might merely provide a temporary respite.

The roles of the assessor and the decision maker need to be better demarcated. The ultimate decision on how to implement the commonly agreed fiscal rules must rest with the institutions that have been assigned the executive and legislative power. Under the current Treaty, these institutions are the Commission and the Council. Over the years, and for good reason, the Commission has evolved towards a more conventional executive which prepares and takes decisions, taking into account also political considerations. In the field of EU fiscal surveillance, this change gives rise to conflicts with the original role of the Guardian of the Treaty. To address this conflict, assessing whether commonly agreed rules have been followed needs to be clearly separated from deciding how to follow up on the analysis. Different institutional arrangements might be envisaged, including stronger safeguards within the Commission to protect the economic assessment from broader political considerations prior to the decision stage.

2. EX-POST EVALUATION OF THE IMPLEMENTATION OF THE EU'S FISCAL FRAMEWORK

The macro-economy of the euro area and the EU gained considerable momentum in 2017. Real GDP increased by 2.4 % in both areas, more than half a percentage point faster than anticipated in spring 2016 when Member States presented their updated stability and convergence programmes. The rate of unemployment fell to levels observed during previous cyclical peaks. At the end of the 2017 EU fiscal surveillance cycle, 13 Member States were estimated to have achieved their medium-term budgetary objective (MTO), more than twice as many compared to spring 2016 when the 2017 surveillance cycle started.

Although favourable, the bird's-eye view masks a number of important issues. First, the improvement of fiscal positions in 2017 differed markedly across Member States. Some took full advantage of better-than-expected economic conditions and even reduced expenditure levels compared to plans, while others used windfall gains to adjust government expenditure (net of one-off increases) upward. The first group included euro area countries where the fiscal position was comparatively sound, whereas the second group comprised countries where the fiscal position was weaker. If all euro area countries had implemented the expenditure levels presented in their 2016 stability programmes, the aggregate budget deficit would have narrowed to 0.7 % of GDP, rather than showing a deficit of close to 1 % of GDP.

Second, the fact that windfalls were only partly used to improve fiscal positions is also due to the unreliable quality of potential GDP estimates, the linchpin of the EU surveillance toolbox. On the back of statistical revisions of national accounts plus changes of the commonly agreed method for estimating potential output, in spring 2018 the level of 2017 euro area potential GDP was up by close to 2 % compared to spring 2016 — by the same amount as actual GDP. At unchanged expenditure levels, such a revision alone would have implied a correction of the structural budget balance of the euro area of close to 1 % of GDP. Such an improvement compared to initial projections inevitably entices governments. As a result, the pro-cyclical properties of the structural budget balance came to pass.

Third, the implementation of the Stability and Growth Pact (SGP) did not adapt to the much improved macroeconomic conditions. For countries with weaker fiscal positions, implementation largely followed the practice of previous years when the euro area and the EU economies showed signs of weakness. Some forbearance may have been justified in spring 2016 when the Commission and the Council issued guidance for 2017 and the balance of risks was still perceived to be tilted to the downside. However, in the course of 2017 and then in spring 2018, the implementation of the rules continued to rely on elements of flexibility and judgement introduced to accommodate difficult economic times, while the economic conditions had improved markedly. In sum, 2017 was a clear example of both the asymmetry of the EU fiscal rules and the notorious difficulty of getting the timing of discretion right.

Amid concerns of excessive complexity and lack of transparency, the Commission and the Council agreed on some innovations to the implementation of the SGP. However, these initiatives did not achieve their stated objectives of simplifying the rules, because: (i) they added new elements without resolving potential conflicts with existing provisions and methods; and (ii) they were coupled with initiatives going in the opposite direction bearing witness to the persisting tendency to find and codify new forms of flexibility. As a result, complexity and opacity have actually increased. Three initiatives deserve to be mentioned.

(i) At the end of 2016, the Commission and the Council agreed to give prominence to the expenditure benchmark when assessing compliance under the preventive arm of the SGP. The agreement was motivated by the view that the expenditure benchmark provided a more stable and intuitive reference for fiscal policy than the revision-prone and more technical structural budget balance. In spite of the agreement, in the course of the 2017 surveillance cycle, the expenditure benchmark was adjusted in an ad hoc manner for a number of countries to lower the consolidation requirement. Such adjustments are in conflict with the stated objective of simplifying the implementation of the preventive arm and making it more transparent and credible.

(ii) The Commission and the Council also agreed to introduce the expenditure benchmark in the corrective arm of the SGP. While the agreement still needs to be tested in practice — it will only be applied to new Council recommendations under an excessive deficit procedure — it is not going to solve current predicaments. Unlike in the preventive arm, the expenditure benchmark is not anchored in secondary EU legislation. It is difficult to assume a Member State would accept a negative assessment of compliance derived from the expenditure benchmark if established indicators (the nominal and the structural budget balance) supported a different verdict. Most importantly, the introduction of the expenditure benchmark is not going to prevent Member States from pursuing a 'nominal strategy', i.e. using cyclical windfalls to meet nominal deficit targets, because the latter remain the ultimate reference when assessing compliance under the excessive deficit procedure.

(iii) In 2017, the Commission, without the formal agreement of the Council, prepared the ground for a new margin of discretion to be used in 2018. The initiative consists in extending the

assessment of compliance beyond the question of whether the required fiscal adjustment is achieved or not. Apart from stretching the interpretation of the Pact, the initiative is also emblematic of the main difficulty of fiscal discretion: it often turns out to be ill-timed. Economic growth in 2018 is much more solid than at the time the new margin of discretion was designed.

The 2017 surveillance cycle, including the innovations discussed above, also confirmed two interlinked developments that had already emerged in 2016: (i) a growing competition between EU institutions over who exercises the discretion emanating from the many elements of flexibility and judgement; and (ii) a stronger bilateral dimension in a framework intended to ensure multilateral surveillance. New interpretations by the Commission of existing rules have given rise to lengthy and at times contentious exchanges with the Member States in the competent Council committees. The discussions were either resolved by a written agreement or by formal opinions of the Council committees. In an increasing number of cases, Member States solicited the opinion of the Council legal service. In parallel, the many elements of discretion fostered bilateral exchanges between the Commission and individual Member States interested in a particular application of discretion. Because such bilateral exchanges typically take place in the guidance phase of the surveillance cycle, they give rise to expectations on the part of the Member States that are difficult to ignore later on when multilateral surveillance comes in.

Virtually all EU countries have benefited from the better-than-expected economic expansion in 2017; differences in growth and economic slack have narrowed significantly. Nevertheless, there were a number of country-specific developments that had to be addressed or that played a prominent role in the way the EU fiscal rules were applied. Starting with the cases where the Commission and the Council decided to take firm action, in spring 2018 a significant deviation procedure was launched under the preventive arm of the SGP for Romania and Hungary. For Romania, it was the second such procedure in a row, having received the first recommendation already in spring 2017. However, since non-euro area countries are not subject to the sanctions of the SGP and conditionality of the European Structural and Investment Funds de facto only applies to the corrective arm of the Pact, the procedure has so far been largely inconsequential.

There were also several cases where the implementation of the SGP involved considerable discretion and forbearance:

- Slovenia: In spring 2016, the fiscal adjustment requirement for 2017 was set below the one implied by the matrix of requirements. The departure was decided on account of uncertainty surrounding the real-time estimates of the output gap. This was the first such case since the introduction of the matrix of requirements in 2015.

- Slovenia and Portugal: In its final assessment of compliance, the Commission made an ad hoc correction to the expenditure benchmark notably by adjusting the underlying medium-term rate of potential growth which caps government expenditure growth. In the case of Slovenia, without such an adjustment the expenditure benchmark would have supported the conclusion of non-compliance.

- Italy: In contrast to all other euro area countries, nominal economic growth in 2017 turned out measurably lower than initially projected, on account of a lower-than-expected increase of the GDP deflator. The budgetary targets for 2017 presented in spring 2016 were predicated on forecasts which the Italian independent fiscal council had characterised as on the high side but which the Commission found plausible.

- Italy: In its final assessment, the Commission found the country broadly compliant with the SGP on account of: (i) a generous reading of the structural budget balance; (ii) the possibility of carrying forward flexibility and unusual event clauses from previous years, although the safety margin against breaching the 3 % of GDP threshold was not respected; and (iii) an exception in the quantification of the refugee-related costs in 2017.

- Belgium: The final assessment of the Commission concluded that there was not sufficient evidence to establish a significant deviation from the required fiscal adjustment, although the 2018 spring forecast would have supported such a conclusion. The Commission took into account a statement by Belgian authorities according to which a decision to front-load the payment of corporate income taxes would produce a lasting increase in revenues. In the same assessment, the Commission also referred to higher-than-expected inflation, and linked to it higher expenditure, as an argument for justifying a temporary deviation from the adjustment path towards the MTO. In the past, higher-than-expected inflation had typically been characterised as a factor facilitating compliance with EU fiscal rules. Although minor, the reported effect of higher-than-expected inflation came on top of budgetary plans that already exploited the fairly generous margins of broad compliance of 0.5 % of GDP.

- Belgium and Italy: The two countries were not placed under the excessive deficit procedure, although their debt-to-GDP ratios did not decline at the pace required by the debt reduction benchmark of the SGP. The debt reduction benchmark was de facto suspended by consistently stressing the so-called 'other relevant factors'. Priority was given to the deficit criterion, by assessing compliance with the recommended deficit adjustment, including elements of flexibility, the margins of compliance and other elements of forbearance.

- France and Spain: The two countries under the excessive deficit procedure continued to follow a 'nominal strategy' in 2017. Against the backdrop of better-than-expected economic growth, the governments of both countries decided once more to replace consolidation measures with revenue windfalls.

2.1. MAIN MACROECONOMIC AND FISCAL DEVELOPMENTS

Economic activity in the euro area and the EU gained considerable momentum in 2017. Real GDP grew by 2.4 % in both regions, the highest rate in 10 years. There were also successive and important upward revisions of past GDP data. In sum, the level of 2017 real GDP of the euro area and the EU turned out more than 1.5 % higher than had been assumed in spring 2016 when the 2017 EU fiscal surveillance cycle started. Domestic demand remained the main engine of growth, driven by resilient private consumption and recovering investment.

On the back of solid growth, the labour market improved markedly. Employment in both the EU and the euro area grew at 1.6 % in 2017, the highest rate since 2007. As a result, the unemployment rate approached levels typically observed during previous boom periods. Headline inflation, as measured by the annual increase in the harmonised index of consumer prices, rose to 1.5 % in the euro area and 1.7 % in the EU, from 0.2 % and 0.3 % respectively in 2016. Core inflation, which excludes energy and unprocessed food prices, crawled higher in 2017 to 1.1 % in the euro area and 1.3 % in the EU, from 0.8 % in 2016. The persistence of inflation at levels below target is mainly attributed to contained wage growth, due to various factors including the impact of structural reforms, positive labour supply shocks in the form of immigration, and low-inflation expectations.

The European banking sector made progress in 2017 in reducing the high levels of non-performing loans (NPLs), while credit growth to the non-financial private sector remained on a positive trend ([1])([2]). However, the total volume of NPLs still remained high (4.6 % of total gross loans and advances) in the EU and higher than 10 % in five euro area countries ([3]). Moreover, the exceptional support from the European Central Bank's (ECB) standard and non-standard policy measures remained substantial.

Turning to public finances, the fiscal positions improved markedly in 2017. In both the euro area and the EU, the budget deficit declined by 0.6 % of GDP on the previous year, to 0.9 % and 1 % of GDP respectively, the lowest level since 2007. Gross government debt declined for a third consecutive year to close to 89 % of GDP in the euro area and to 83 % of GDP in the EU.

Budgetary outcomes in 2017 were also markedly better than originally planned, i.e. compared to the targets set out in the 2016 stability and convergence programmes (SCPs), mostly thanks to higher-than-expected nominal GDP growth (see Graph 2.1). The three notable exceptions were Spain, Italy and Portugal, where budget deficits came in higher than expected. In Spain, the difference was marginal (see Graph 2.2). In Portugal, the slippage was largely due to the one-off deficit-increasing impact of the recapitalisation of a public bank (Caixa Geral de Depósitos), amounting to 2 percentage points of GDP. In Italy, the difference also includes the budgetary impact of measures involving domestic banks (liquidation of Banca Popolare di Vicenza S.p.A. and Veneto Banca S.p.A; precautionary recapitalisation of Monte Paschi di Siena S.p.A) of about 0.4 percentage points of GDP ([4]).

Italy also stands out as the only large euro area country where nominal GDP growth came in measurably below the official projections underpinning the budgetary plans presented in spring 2016, due to a lower-than-expected increase in the GDP deflator. Among non-euro area countries, only the United Kingdom recorded lower-than-projected economic growth. In Romania, the budgetary outturn in per cent of GDP was in line with plans, as laid down in the country's 2016 convergence programme. However, since nominal GDP growth came in much higher than projected (12.6 % as opposed to 6.1 % in the 2016 convergence programme), sticking to the headline target implied conspicuous expenditure slippages. A more detailed discussion of forecasts and budgetary plans is provided in Section 2.2.2.

The improvement of fiscal positions in the euro area and the EU compared to plans — and on the previous year — is a positive development, yet conceals important interconnected issues. First, there are stark differences across countries, especially in the euro area. Some countries, typically those with comparatively sound fiscal positions, achieved budgetary results that even went beyond the mechanic effect of higher-than-expected GDP, that is, they put in some extra effort to

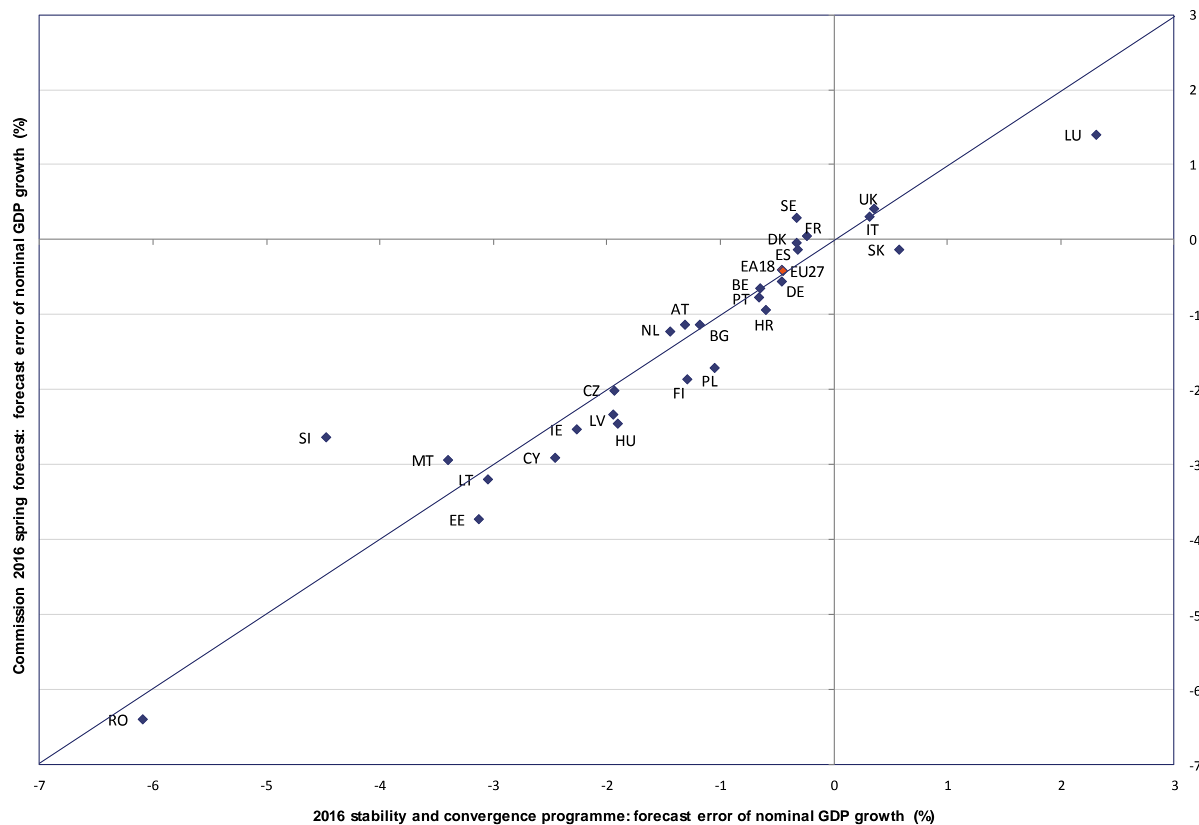
([1]) Commission Staff Working Document accompanying the Communication from the Commission to the European Parliament, the Council and the European Central Bank 'First progress report on the reduction of non-performing loans in Europe', 23.1.2018, SWD (2018) 33 final/2. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018SC0033R(01)&from=EN

([2]) European Central Bank, Monetary Developments in the euro area: April 2018, Press Release 29 May 2018. https://www.ecb.europa.eu/press/pr/stats/md/html/index.en.html

([3]) See IMF (2017).

([4]) Prior to the Eurostat decision of 31 March 2018 on the statistical treatment of the banking rescue operations in Italy, the Commission included a debt-increasing impact of 1 % GDP (0.7 % of GDP for the winding down of Banca Popolare di Vicenza S.p.A. and Veneto Banca S.p.A; 0.3 % of GDP for the precautionary bank recapitalisation of the Monte Paschi di Siena). https://ec.europa.eu/eurostat/documents/1015035/8683865/Advice-2018-IT-Recording-of-Veneto-and-Vicenza-liquidation.pdf/1e96fe77-b82d-4efa-9b0f-099d68cb0822

Graph 2.1: **Forecast errors of nominal GDP growth in 2017: Commission 2016 spring forecasts versus 2016 stability and convergence programmes**



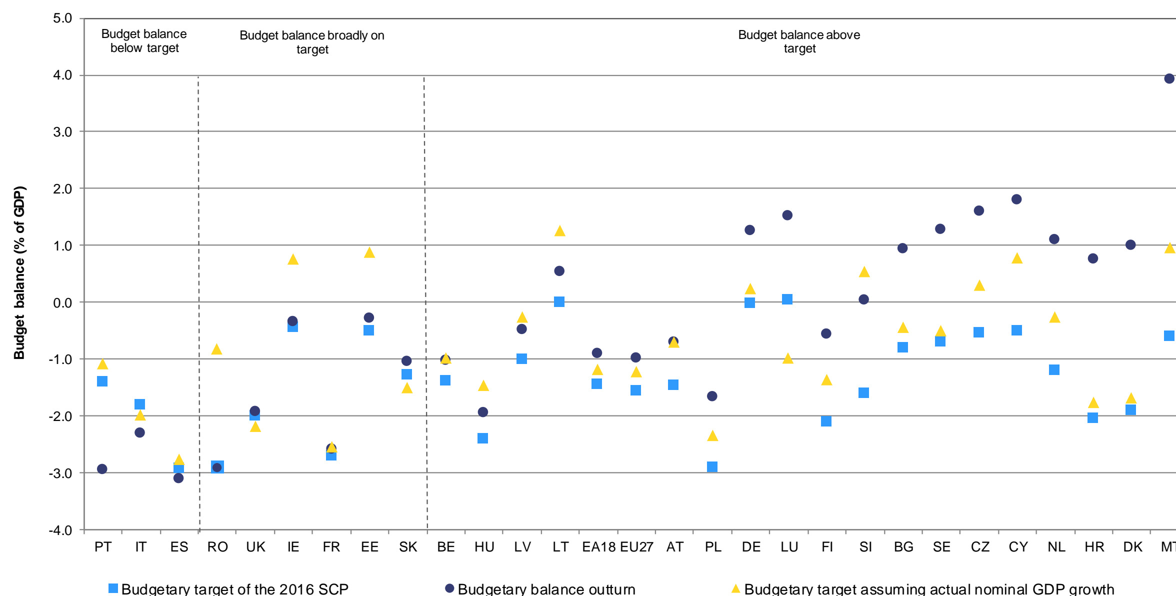
Notes: (1) EU27 and EA18 refer to the EU and the euro area excluding Greece. Greece did not submit a stability programme in 2016 because Member States undergoing a macroeconomic adjustment programme are exempt from the reporting requirements of the European Semester. (2) The forecast error is defined as the difference between the forecast of nominal GDP growth and actual nominal GDP growth. Points below (above) the 45-degree line indicate countries for which the Commission forecast was lower (higher) than the one of the SCP. For example, for Estonia the Commission 2016 spring forecast projected nominal GDP growth of 5.3 %, while the 2016 stability programme projected 5.9 %. As nominal GDP growth turned out at 9 %, the negative forecast error of the Commission was larger. By contrast, for Slovenia, the Commission spring forecast was 4.4 % of nominal GDP growth, as opposed to 2.6 % in the 2016 stability programme. Nominal GDP growth turned out at 7.1 %, i.e. the negative forecast error of the Commission was smaller.
Source: European Commission, 2016 stability and convergence programmes.

adjust expenditure. Other euro area countries, mostly those with comparatively weaker fiscal positions, used windfall gains to adjust expenditure levels upward (net of one-off increases). If all euro area countries had stuck to their original expenditure levels for 2017, the headline budget deficit in the euro area as a whole would have narrowed to 0.7 % of GDP, as opposed to close to 1 % of GDP. About one third of the revenue windfalls went into higher spending (see Table 2.1). In some countries (i.e. Italy, France and Belgium), upward revisions in spending plans were much more marked.

Second, the toolbox of EU fiscal surveillance, or the way the toolbox was applied, did not caution against the use of the budgetary windfalls that emerged in the course of 2017. Specifically, the notorious volatility of potential output estimates — a key ingredient to the structural budget balance — signalled an important improvement of the underlying fiscal position. On the back of statistical revisions of national accounts and changes in the commonly agreed methodology for estimating potential output, in spring 2018 the level of euro area potential GDP in 2017 was up by close to 2 % compared to spring 2016. Of note, the size of the upward revision was the same as for the level of actual GDP, which was another way of saying that the revision of GDP was considered to be fully structural (as opposed to cyclical) (5). Since potential GDP is the denominator of the structural budget balance, an upward revision of close to 2 % produces important effects. At unchanged expenditure levels, it implies a revision in the structural budget balance of close to 1 % of GDP. On the face of it, such a revision compared to initial projections signals new fiscal space at a time when in light of the improving economic conditions countries should have started to build fiscal buffers. An assessment of budgetary developments based on the expenditure benchmark — the second key measure in the toolbox of EU fiscal surveillance — would have

(5) A measurable part of the revision of 2017 euro area real GDP originated in Ireland where, in the second half of 2016, the level of aggregate economic activity of 2015 and subsequent years was revised up by more than 25 %. However, as Ireland only accounts for around 2.5 % of euro area GDP, more than half of the upward revision of 2017 potential GDP between spring 2016 and 2018 is due to other factors.

Graph 2.2: **General government budget balance in 2017: outturn versus target in the 2016 stability and convergence programmes (SCPs)**



Notes: (1) EU27 and EA18 refer to the EU and the euro area excluding Greece. Greece did not submit a stability programme in 2016 because Member States undergoing a macroeconomic adjustment programme are exempt from the reporting requirements of the European Semester. (2) Countries are ordered by increasing difference between the outturn and the 2016 SCP target. (3) Yellow triangle=budgetary target assuming actual nominal GDP growth. It aims to show what the 2017 budgetary targets could have been, if national authorities had known the actual rate of nominal GDP growth at the time of preparing the 2016 SCPs. It is calculated as the sum of (i) the budgetary target in 2017 and (ii) the product of the semi-elasticity of the budget balance and the difference between actual nominal GDP growth and the forecast of nominal GDP growth in 2017. For example, in their 2016 convergence programme the Romanian authorities set a budgetary deficit target of 2.9 % of GDP in 2017, on the basis of an annual nominal GDP growth of 6.5 %. However, nominal GDP growth in 2017 turned out at 12.6 %. Other things being equal, the higher rate of nominal GDP growth would have supported a deficit target of 0.8 % of GDP. The difference compared to the deficit outturn of 2.9% is explained by a conspicuous increase in government spending.
Source: European Commission, 2016 stability and convergence programmes, own calculations.

supported more cautious conclusions. However, although at the end of 2016 the Commission and the Council had agreed to give more prominence to the expenditure benchmark, in many cases the structural budget balance was considered more reliable (see Sections 2.2.1 and 2.2.2 for details).

2.2. APPLICATION OF THE STABILITY AND GROWTH PACT IN 2017

This section offers an assessment of how the SGP was implemented in 2017. It is based on a careful study and review of all relevant documents produced by the Commission and the Council. Providing an overview of how the SGP is implemented in a given year is a major challenge. The SGP has become increasingly complex, as evidenced by the overall length of the *Vade Mecum on the SGP*. Conceived as a manual for practitioners, its last edition exceeds 220 pages.

Although there are several publicly available documents that regularly offer summaries of how certain aspects of the rules and procedures of the SGP have been applied ([6]), they are often fairly technical and do not offer a full overview of the individual annual assessment cycle of EU fiscal surveillance. The EFB and its secretariat have invested considerable time to provide what, we believe, is a more general yet comprehensible review of the implementation of the SGP.

This section consists of four parts. The first examines recent innovations introduced to the EU fiscal framework by the Commission and the Council. The second and third part assess the implementation of the SGP in 2017, under the preventive and corrective arm of the Pact respectively, across the different stages of the annual fiscal surveillance cycle — outlined in Graph 2.3 — and with a focus on significant cases or developments. The final part includes tables showing a complete chronological overview of the 2017 annual fiscal surveillance cycle for all EU countries.

With a continued effort to provide a comprehensive review of the implementation of the SGP, this year's review covers all EU Member States rather than just the participants in the euro area.

2.2.1. Recent innovations in the EU fiscal framework

The main innovations introduced in the EU fiscal framework in 2016-2017 responded to two opposing aims: (i) reducing the complexity of the SGP; and (ii)

([6]) The most prominent example is the Commission's annual Public Finances in EMU report. See European Commission (2018a) for the latest edition.

Table 2.1: **Forecasts, targets and outturns in the euro area and the EU: 2017**

		Spring 2016		Spring 2018	Revisions	
		Commission forecasts (SF16)	Stability and convergence programmes (SCPs)	Outturn	Outturn vs SF16	Outturn vs SCPs
		year-on-year % change			**percentage points**	
Euro area - 18 [1]	Real GDP	1.7	1.7	2.3	0.6	0.6
	Nominal GDP	3.1	3.1	3.5	0.4	0.4
	Potential GDP	1.1	1.3	1.5	0.4	0.2
	Total revenue	2.8	2.9	3.7	0.9	0.8
	Total expenditure	2.2	1.8	2.4	0.2	0.5
	Primary expenditure	2.4	2.1	2.7	0.3	0.6
		billion euro			**percent**	
	Real GDP	9973	9983	10152	1.8%	1.7%
	Nominal GDP	10858	10874	10991	1.2%	1.1%
	Potential GDP	10015	N/A	10187	1.7%	-
	Total revenue	4995	4996	5071	1.5%	1.5%
	Total expenditure	5170	5147	5172	0.0%	0.5%
	Primary expenditure	4939	4919	4958	0.4%	0.8%
		% of GDP			**% of GDP**	
	Output gap, % of potential GDP	-0.4	-0.6	-0.4	0.0	0.3
	Budget balance	-1.6	-1.4	-0.9	0.7	0.5
	Primary balance	0.5	0.7	1.0	0.5	0.3
	Structural primary balance	0.7	1.0	1.3	0.6	0.3
		year-on-year % change			**percentage points**	
EU-27 [1]	Real GDP	1.9	2.0	2.4	0.5	0.5
	Nominal GDP	3.3	3.2	2.8	-0.5	-0.4
	Potential GDP	1.4	1.6	1.7	0.3	0.1
	Total revenue	3.2	3.3	3.2	0.0	-0.1
	Total expenditure	2.4	2.2	1.7	-0.7	-0.4
	Primary expenditure	2.6	2.2	1.9	-0.7	-0.4
		billion euro			**percent**	
	Real GDP	13734	13932	13977	1.8%	0.3%
	Nominal GDP	15177	15437	15149	-0.2%	-1.9%
	Potential GDP	13758	N/A	13987	1.7%	-
	Total revenue	6784	6799	6789	0.1%	-0.2%
	Total expenditure	7053	7035	6937	-1.7%	-1.4%
	Primary expenditure	6742	6712	6638	-1.5%	-1.1%
		% of GDP			**% of GDP**	
	Output gap, % of potential GDP	-0.2	-0.4	-0.1	0.1	0.5
	Budget balance	-1.8	-1.5	-1.0	0.8	0.6
	Primary balance	0.3	0.6	1.0	0.7	0.4
	Structural primary balance	0.4	0.8	1.1	0.7	0.3

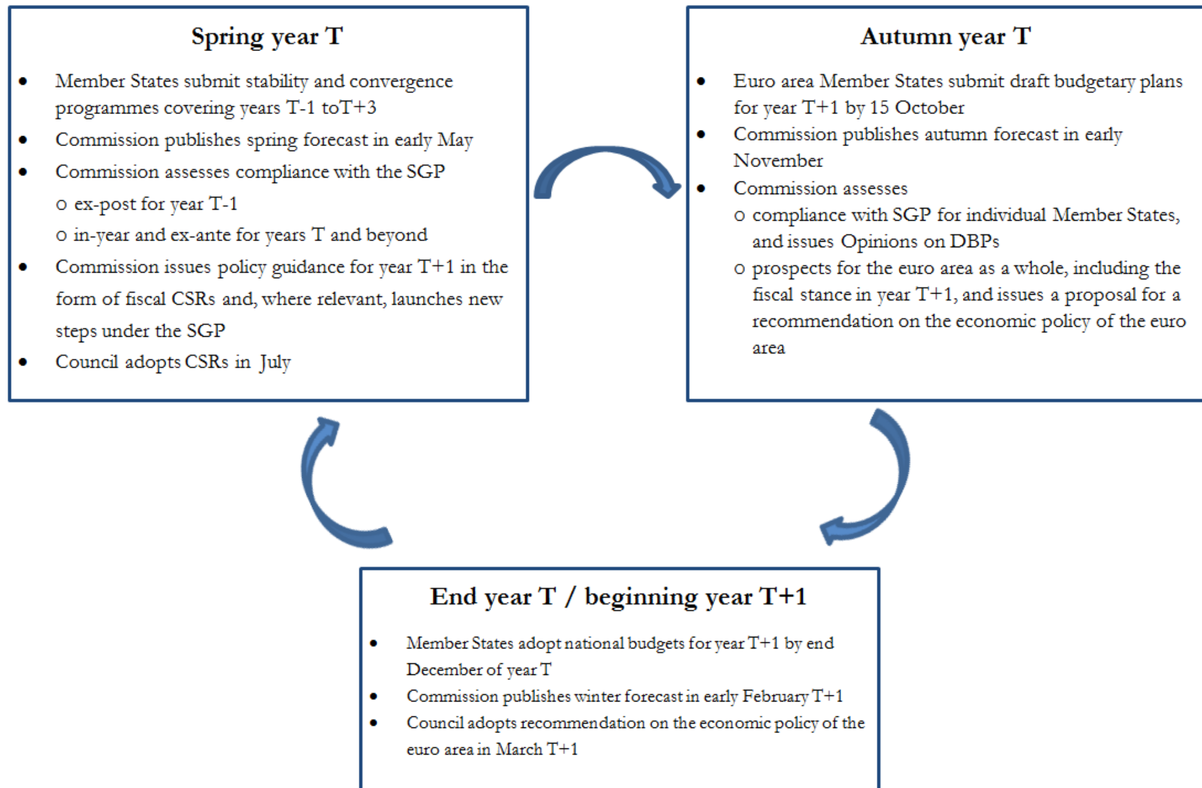
Notes: (1) EU-27 and EA-18 refer to the EU and the euro area excluding Greece.
Source: European Commission; stability and convergence programmes.

giving greater emphasis to economic considerations in assessing compliance under the preventive arm of the Pact.

The increasing complexity of the SGP had given rise to growing calls to simplify EU fiscal rules and procedures and to make their implementation more transparent. The Five Presidents' Report on *Completing Europe's Economic and Monetary Union* of June 2015 set the tone. It included the objective of improving the clarity, transparency, compliance and legitimacy of the EU fiscal rulebook. In November 2015, the Eurogroup called on the Commission to make the implementation of the SGP more transparent and predictable [7]. Along similar lines, during its rotating EU Presidency in the first half of 2016, the Netherlands expressed the intent to improve the working of the SGP and to support steps towards a simpler and more transparent EU fiscal framework. In April 2016, the European Court of Auditors issued a special report reviewing the implementation of the excessive deficit procedure (EDP) in 2008-2015. Among other things, the report advised the Commission to make the implementation of the EDP more transparent.

(7) http://www.consilium.europa.eu/en/press/press-releases/2015/11/23/eurogroup-budgetary-plans/pdf

Graph 2.3: **The annual cycle of EU fiscal surveillance**



Source: European Commission.

In parallel to the push for simplification and transparency, discussions took place in the Commission on how to add new elements of economic judgement and flexibility. Those discussions were fuelled by persistently low economic growth and low inflation in some euro area countries, which made compliance with the rules more difficult.

The innovations to the EU fiscal framework were introduced through four sets of initiatives: (i) an agreement between the Commission and the Council to give a more prominent role to the expenditure benchmark when assessing compliance in the preventive arm of the SGP; (ii) an agreement to incorporate the expenditure benchmark into the corrective arm of the SGP; (iii) a refinement of the EU commonly agreed methodology for the estimation of the output gap; and (iv) a new margin of discretion in assessing compliance under the preventive arm of the SGP.

A more prominent role for the expenditure benchmark in the preventive arm of the SGP

One of the first initiatives to simplify the EU fiscal framework was to give more prominence to the expenditure benchmark. The initiative took the form of an opinion of the Economic and Financial Committee (EFC) dated 29 November 2016 and endorsed by the ECOFIN Council on 6 December 2016 ([8]). Opinions of the EFC to clarify the interpretation of the SGP are not new but still rare. The opinion was triggered by the Commission Communication on 'Steps towards Completing Economic and Monetary Union' (COM(2015) 600) of 21 October 2015, which sought a clarification and a simplification of the way rules are implemented in close consultation with the Member States.

The novelty introduced with the opinion is that fiscal requirements are to be defined in terms of both the year-on-year change in the structural balance and the expenditure benchmark. Up until then, and in line with the provisions of Regulation (EC) 1466/97, the expenditure benchmark only played a role in assessing compliance, while the adjustment requirement was defined exclusively in terms of the structural budget balance.

This change was motivated by the view that the methodology underlying the estimation of the structural budget balance was too complex and surrounded by

([8]) Improving the predictability and transparency of the SGP: A stronger focus on the expenditure benchmark in the preventive arm (Opinion of the Economic and Financial Committee), 29 November 2016. http://data.consilium.europa.eu/doc/document/ST-14814-2016-INIT/en/pdf.

notorious measurement uncertainties. The expenditure benchmark, by contrast, is considered to be a clearer and more stable reference for governments in preparing and implementing their budgets and for the Commission and the Council in assessing compliance with the rules ([9]).

The EFC opinion has also brought a number of useful clarifications on how to assess compliance under the preventive arm of the SGP. Firstly, it formalises a practice already followed by the Commission in recent years according to which the indications provided by the structural budget balance and the expenditure benchmark are *always* qualified through an overall assessment, including when both indicators point to a significant deviation. Secondly, the opinion highlights strengths and weaknesses of the two indicators that are to be taken into account when the Commission assesses compliance with the preventive arm. Thirdly, the impact of one-off measures is automatically excluded from the calculation of the expenditure benchmark, thus eliminating one important source of discrepancy *vis-à-vis* the structural budget balance. Finally, in order to enhance transparency, both the Commission and Member States agreed to provide a more detailed quantification than previously required by the Code of Conduct of discretionary revenue measures underpinning the calculation of the expenditure benchmark ([10]).

The 2017 edition of the *Vade mecum on the SGP* and the *Code of Conduct of the SGP*, as revised in May 2017, incorporate the main elements of the EFC agreement. The two documents are now fully aligned; previous differences on when an overall assessment of compliance is necessary have been eliminated.

While the expenditure benchmark has clear advantages over the structural budget balance, one important caveat needs to be highlighted in relation to the EFC opinion. The expenditure benchmark is built around the medium-term growth rate of potential GDP — estimated as the 10-year average of potential GDP, comprising 5 years of outturn data, the year underway and 4 years of forward-looking data. The medium-term growth rate of potential GDP is much more stable than the estimate of potential output growth of a single year. However, the EFC opinion states that the single-year estimate of potential GDP growth underpinning the calculation of the structural balance may better reflect structural shifts in potential output growth compared to its 10-year average, especially in the present circumstances where the latter includes '*the large negative impact the economic and financial crisis had on the estimates for potential GDP growth*'.

This argument clearly conflicts with the main reason for preferring the expenditure benchmark to the structural budget balance in the first place: stability and predictability. It seems to be motivated by short-term consideration: when there is a sustained economic recovery such as the current one, the real-time estimate of potential output growth of the current year tends to be higher than the medium-term average. Therefore, replacing estimates of medium-term growth with estimates of potential output growth of a single year makes fiscal requirements looser and, ultimately, gives rise to pro-cyclical fiscal policies.

Introducing the expenditure benchmark in the corrective arm of the SGP

Since the 2005 reform of the SGP, fiscal targets under the corrective arm of the Pact have been expressed in structural and nominal terms. While assessing compliance with nominal targets is straightforward, gauging fiscal effort by means of the structural budget balance, or its change, is surrounded by important measurement issues. Over the years, successive attempts have been made to address the measurement issues. However, this has been at the cost of increasing complexity and introducing several elements of judgement (see Larch and Turrini 2010).

On 29 November 2016, the EFC adopted an opinion, subsequently endorsed by the ECOFIN Council on 6 December 2016 ([11]) which introduces the expenditure benchmark as a third indicator in the corrective arm of the Pact. In particular, the EFC opinion clarifies that Council recommendations to countries found to have an excessive deficit will, on top of setting annual deficit targets in both headline and structural terms, also define an expenditure benchmark. That is to say, it will set an upper bound for the nominal growth rate of government expenditure (net of discretionary revenue measures) consistent with the targets for the nominal and structural budget balance. In the same vein, the assessment of compliance will take into account the

([9]) The expenditure benchmark was introduced with Regulation (EU) No 1175/2011 amending Council Regulation (EC) No 1466/97.

([10]) The EFC opinion has also introduced some other technical refinements to the surveillance metrics. The most relevant is the formulation of the expenditure benchmark in nominal terms using the GDP deflator from the Commission's spring forecast of the preceding year. Before that, the average GDP deflator from the Commission spring forecast and from its autumn forecast of the preceding year was used. Therefore, at the time of setting fiscal requirements it was not possible to define the applicable expenditure benchmark.

([11]) Improving the Assessment of effective action in the context of the excessive deficit procedure — A specification of the methodology (Opinion of the Economic and Financial Committee), 29 November 2016. http://data.consilium.europa.eu/doc/document/ST-14813-2016-INIT/en/pdf

expenditure benchmark too. The new approach will only affect future EDP recommendations. The assessment of compliance with existing Council recommendations will follow the previous approach, described in the *Code of Conduct of the SGP* ([12]) and the 2016 version of the *Vade Mecum on the SGP* ([13]).

The stated objective of the EFC opinion is to provide some degree of simplification, as the expenditure benchmark involves variables directly controlled by policy makers at national level. The expenditure benchmark is presented as having considerable advantages in terms of predictability, stability, communication and actual policy making ([14]). However, a critical assessment of the new approach raises the following concerns. Firstly, the agreement is to be applied within the existing legal framework, but issues rooted in the current legal provisions cannot be remedied by adding new indicators. The so-called nominal strategy explained in Section 2.2.3 is a clear case in point, where Member States use windfalls gains to meet nominal deficit targets rather than implement a structural fiscal adjustment. Nominal deficit targets have their legal basis in the Treaty and, based on current practice, are given priority. The EFC opinion is explicit in this respect; it states that '*if the intermediate headline deficit target has been met, the procedure will not be stepped up even if the policy commitments have not been delivered*' ([15]).

Secondly, the EFC opinion has not clarified which measure bears more weight. In particular, it is not clear what happens in case of conflicting signals, with the expenditure benchmark suggesting non-compliance and the structural balance suggesting compliance. Only the structural balance is mentioned in Council Regulation (EC) 1467/97, the legal basis of the corrective arm of the SGP. Even if the EFC opinion leaves the final judgement to the Commission — '*The Commission uses qualitative economic judgement in making its final assessment where relevant, in particular of the outcome of the expenditure benchmark, as part of the careful analysis which the Commission uses to determine whether the Member State concerned has delivered or not on its policy commitments*' ([16]) —, the standing of the expenditure benchmark in the corrective arm still needs to be tested.

Thirdly, the agreement gives rise to new inconsistencies. The implementation of the expenditure benchmark in the corrective arm differs from the one in the preventive arm of the Pact. In the preventive arm, the expenditure benchmark is derived from the medium-term growth rate of potential output. In the corrective arm, the expenditure benchmark is derived from the budgetary targets of the Council recommendation. As a result, the underlying rates of medium-term economic growth and, in turn, the benchmark for expenditure growth are not the same. For example, if the EFC opinion had been applied to the Council recommendation for France in March 2015, the estimated expenditure benchmark for 2017 — i.e. the cap for the nominal growth rate of government expenditure, net of discretionary revenue measures — would have been a 0.8 % year-on-year change By contrast, on the basis of the Commission 2015 winter forecast underpinning the Council recommendation mentioned above, the expenditure benchmark under the preventive arm would have been a 1.5 % year-on-year change.

Overall, the stated objective of the EFC opinion to simplify the current rules of the corrective arm of the SGP and to add transparency will be difficult to achieve. In the absence of a more comprehensive review of the EU fiscal rules, efforts to address weaknesses by introducing new elements only add to the prevailing degree of complexity and opacity.

The margin of discretion in assessing compliance under the preventive arm of the SGP

While the Commission and the Council have sought to simplify the rules and procedures, the entrenched tendency to find and codify new forms of flexibility has continued. Most importantly, the Commission has moved ahead with the implementation of the margin of discretion, a new interpretation of how to assess compliance under the preventive arm of the Pact.

The 2018 edition of the *Vade Mecum on the SGP* ([17]), published on 23 March 2018, includes a dedicated annex on how the Commission intends to implement this extra layer of discretion. According to that annex, the assessment of compliance will not just focus on whether a Member State has delivered the recommended fiscal adjustment or not (as measured by the structural budget balance and/or the expenditure benchmark). It will also include a qualitative assessment of the country's economic conditions taking into account the right balance between stabilisation and sustainability needs. Although the Commission is on the record for saying that it intends to apply the margin of discretion only in the 2018 surveillance cycle, the margin of discretion does not come with a formal expiry date.

([12]) *Code of Conduct of the Stability and Growth Pact*, revised version of 15 May 2017, footnote 2, page 3. http://data.consilium.europa.eu/doc/document/ST-9344-2017-INIT/en/pdf

([13]) Vade Mecum on the Stability and Growth Pact - 2016 edition https://ec.europa.eu/info/publications/economy-finance/vade-mecum-stability-and-growth-pact-2016-edition_en

([14]) For more information, see European Commission (2018), p. 46.

([15]) See footnote 12, page 5, last sentence.

([16]) See footnote 12, page 5, fourth paragraph.

([17]) https://ec.europa.eu/info/sites/info/files/economy-finance/ip075_en.pdf

Importantly, the *Vade Mecum on the SGP* also highlights that not all Member States agreed on the use of the margin of discretion. In fact, the *Code of Conduct of the SGP*, which constitutes a commitment by both the Commission and the Council, does not include the margin of discretion.

The Commission officially signalled its intention to apply the margin of discretion in the explanatory part of the country-specific recommendation (CSRs) adopted in May 2017 ([18]). It clarified that the margin would apply only to Member States for which the matrix of requirements implies a fiscal effort of 0.5 % of GDP or more. The Commission also indicated that '*the assessment of the 2018 Draft Budgetary Plan and subsequent assessment of 2018 budget outcomes will need to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of […] public finances*'; see, as an example, paragraph 10 of the 2017 CSR for Belgium ([19]).

The Commission proceeded with applying the margin of discretion when assessing the draft budgetary plans for 2018. In its Communication of 22 November 2017, it indicated that, for countries with a fragile recovery, the required adjustment could be lowered to strike a balance between stabilisation and sustainability needs ([20]). In practical terms, for Member States found at risk of a significant deviation in 2018, the Commission complemented the overall assessment of the fiscal adjustment with a qualitative examination of economic conditions. The Commission concluded that, for Italy and Slovenia, a lower fiscal adjustment than the one recommended in spring 2017 could be considered adequate.

Although a complete assessment of the implementation of the margin of discretion can only be made once the 2018 surveillance cycle is completed, some general observations are in order. By announcing in spring and autumn 2017 that it would use a margin of discretion, the Commission has informed the Council about how it intends to do its overall assessment of compliance under the Pact. At the same time, it has created expectations on the part of the Member States concerned, before the Council is formally involved in the assessment of compliance and in spite of the fact that all Member States have not agreed to the margin of discretion.

([18]) https://ec.europa.eu/info/publications/2017-european-semester-country-specific-recommendations-commission-recommendations_en

([19]) https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations-belgium.pdf

([20]) https://ec.europa.eu/info/sites/info/files/economy-finance/com-2017-800-en.pdf

Member State expectations will be difficult to ignore in the final assessment, especially if they take measures in response to the Commission' indications. As a result, the margin of discretion introduces a bilateral dimension to the EU fiscal surveillance, involving interactions between the Commission and individual Member States, as opposed to the multilateral dimension defined in the Treaty. Peer pressure is gradually replaced by Commission surveillance.

Moreover, the margin of discretion relies on an extensive interpretation of key provisions of the preventive arm of the SGP. Article 6(3) of Regulation (EC) No 1466/97 refers to an '*overall assessment'* of compliance. The expression was introduced with the six-pack reform of 2011, when the expenditure benchmark was established alongside the structural budget balance as a second measure to assess compliance. Since the two measures do not always support the same conclusion, the reference to an *'overall assessment'* was meant to determine which of the two measures would, in a given context, be the more reliable indicator of the actual fiscal adjustment. The Commission's interpretation underpinning the margin of discretion extends the concept of the *'overall assessment'* to include considerations that go beyond the question of whether the required fiscal adjustment was achieved or not. In particular, it allows for the possibility of finding a country compliant even if both measures indicate a shortfall with the required adjustment. While such an extended interpretation may not give rise to any legal issues, it is questionable from an economic perspective.

Finally, the *Vade Mecum of the SGP* falls short of providing an operational definition of when a recovery is to be considered fragile. It only provides some very general references to a situation of persisting high rates of unemployment, subdued core inflation and a large current account surplus. As a result, determining whether a recovery is fragile will rely on judgement.

A more reliable estimation of the output gap

Output gap estimates play an essential role in the preventive arm of the SGP: in setting the required fiscal adjustment, assessing a country's eligibility for flexibility clauses, gauging the actual fiscal effort, and assessing whether a Member State has reached its MTO. However, output gap estimates are subject to considerable uncertainty. In March 2016, the Ministers of Finance of eight Member States (Italy, Spain, Latvia, Lithuania, Luxembourg, Portugal, Slovenia and Slovakia) sent a letter to the Commission expressing their concerns about the commonly agreed method for estimating potential output and the output gap. The letter also suggested complementing the output gap with

other indicators. A similar request was made a month later at the informal ECOFIN Council in Amsterdam.

Against this backdrop, and based on proposals by the Commission, in October 2016 the EFC agreed to two innovations. First, as part of the commonly agreed method, the approach for estimating the labour component of potential output was revised ([21]). Second, a new tool was introduced to check the plausibility of the output gap estimates of the commonly agreed method. The plausibility tool uses complementary economic indicators that are known to be correlated with the business cycle, such as capacity utilisation in the manufacturing industry, the short-term unemployment rate, wage inflation and confidence indicators ([22]). If the difference between the alternative estimate and the estimate of the commonly agreed method exceeds a given threshold, the output gap estimate from the commonly agreed method is taken to be surrounded by a high degree of uncertainty. In that case, an alternative output gap estimate can be used for fiscal surveillance purposes. However, the alternative (and more 'plausible') level of the output gap has to lie within the range delimited by the commonly agreed method and the central estimate of the plausibility tool. The Council decided to apply the constrained judgement for a trial period of up to 2 years ([23]).

Ultimately, the two innovations fell short of Member States' expectations, especially because the plausibility tool turned out to have very limited implications in practice. In March 2017, the Ministers of Finance of France, Italy, Portugal and Spain sent a new letter to the Commission in which they reiterated their concerns about the reliability of the output gap estimates of the commonly agreed method and the limited use of the plausibility tool. They proposed that other elements should be considered such as, for instance, an indicator of labour hoarding to better capture the behaviour of firms in the aftermath of the crisis. The underlying motivation of the letter was that, in the wake of the crisis, estimates of potential output growth had dropped significantly, making adjustment requirements under the SGP more demanding.

In October 2017, the EFC formally mandated the Output Gap Working Group (OGWG), a dedicated expert group of the Economic Policy Committee (EPC), to examine possible country-specific amendments to the commonly agreed methodology ([24]).

In March 2018, after intense discussions in the OGWG, the EPC agreed on a limited number of country-specific changes ([25]). More far-reaching requests by Italy and Slovenia did not find enough support among Member States. The OGWG is currently examining additional country-specific requests that are likely to have an impact on the 2018 surveillance cycle.

The plausibility tool and the process for dealing with country-specific elements may prove useful to address reservations with the commonly agreed method. However, they have inevitably led to more complexity and introduced new elements of judgement. As for the process of dealing with country-specific issues, it has certainly favoured a more structured and transparent dialogue among Member States and with the Commission. At the same time, detailed information on the agreed country-specific changes and on the impact these changes have on the estimation of potential GDP, the output gap and, ultimately, on the structural balance, is lacking.

Table 2.2: **Revisions in 2017 potential and actual GDP levels: spring 2016 versus spring 2018 vintages**

	revision in 2017 potential GDP % (A)	revision in 2017 actual GDP % (B)	% (A-B)
IE	28.2	26.7	1.5
IT	1.4	0.6	0.8
ES	1.6	1.1	0.5
SI	3.7	3.3	0.4
SE	0.3	0.0	0.3
CY	5.5	5.3	0.2

Source: European Commission.

The need for more transparency is particularly impelling given the ample revisions in potential GDP estimations observed in the 2017 surveillance cycle. In six countries (see Table 2.2), the revision in the level of potential GDP between the spring 2016 and spring 2018 vintages of Commission forecasts was even higher than the revision in actual GDP. While it is not possible with the available information to exactly quantify their impact,

([21]) See Hristov et al. (2017a).
([22]) See Hristov et al. (2017b).
([23]) For a more detailed description of the plausibility tool and constrained judgement, see Section II.3 of European Commission (2018a), or Annex 18 of the 2018 edition of the *Vade mecum on SGP*.

([24]) Amendments to the commonly agreed method addressed well-defined country-specific peculiarities (e.g. Luxembourg's cross-border workers), measurement issues (e.g. Latvia's capital depreciation rate; Italy's sentiment indicator for services) or statistical improvement to the current approach (e.g. a method to identify the variance bounds of the cycle, as proposed by Italy).
([25]) The decision was taken on the basis of a written technical report from the OGWG after having informed the EFC Alternates on the implications for fiscal surveillance.

country-specific changes to the commonly agreed method have certainly had an important role in driving the revisions and, consequently, in determining the specific countries' cyclical positions.

2.2.2. Implementing the preventive arm of the Stability and Growth Pact in 2017

At the end of 2017, 25 EU Member States were subject to the preventive arm of the SGP, three more compared with the previous year, as Croatia, Portugal and the United Kingdom successfully corrected their excessive deficits in the course of the year (see Table 2.3).

Country-specific fiscal requirements for 2017

The annual cycle of EU fiscal surveillance starts in the spring of each year when the Council adopts the CSRs. It does it on the basis of the information provided in the stability and convergence programmes and the Commission spring forecast, and on the basis of a recommendation from the Commission. The CSRs include the required fiscal adjustment which national governments are expected to consider when preparing the budgetary plans for the following year.

Table 2.3: **Member States' status under the Stability and Growth Pact**

		2016	2017
Preventive arm	**euro area**	BE* DE* EE IE* IT* CY* LV LT LU MT NL* AT* SI* SK FI*	BE* DE* EE IE* IT* CY* LV LT LU MT NL AT* SI* SK FI* **PT***
	non euro area	BG CZ DK HU* PL RO SE	BG CZ DK **HR*** HU* PL RO** SE **UK***
Corrective arm	**euro area**	ES FR PT	ES FR
	non euro area	HR UK	-

Notes: (1) * Member States with a debt-to-GDP ratio above 60 %. ** Member States under a significant deviation procedure (SDP). (2) Bold indicates a change from the corrective to the preventive arm of the SGP.
Source: European Commission.

In May 2016, the Commission addressed fiscal recommendations to 13 euro area countries out of 16 (Belgium, Ireland, Italy, Cyprus, Latvia, Lithuania, Malta, the Netherlands, Austria, Portugal, Slovenia, Finland and Slovakia) and to 7 non-euro area countries out of 9 (Bulgaria, Denmark, Croatia, Hungary, Poland, Romania and the United Kingdom) ([26])([27]). For all these countries, the reference for defining the required fiscal adjustment was the matrix of adjustment requirements introduced in 2015 (see Box 5.1). The notable exception was Slovenia for which the Commission decided that a structural adjustment of 0.6 % of GDP was more appropriate than the 1.0 % of GDP implied by the matrix of adjustment requirements. The Commission justified the departure from the matrix by referring to the uncertainty surrounding the output gap estimates of the commonly agreed method, particularly in light of the still high unemployment rate, the large economic contraction in 2008-2013 and the impact of the ongoing structural reforms. The Commission used alternative *ad hoc* output gap estimations to corroborate its conclusion.

Five countries did not receive a fiscal CSR (Estonia, Czech Republic, Germany, Luxembourg and Sweden) as they were estimated to be at or above their MTO. The SGP is not prescriptive in such cases; countries are considered compliant as long as they do not fall short of their MTO. Exceeding an MTO is not in conflict with the SGP. Nevertheless, the Council called on Germany to increase public investment — especially in infrastructure, education and research — with a view to boosting potential growth.

The role of macroeconomic forecasts

The Commission macroeconomic forecasts are an essential element in the successive stages of EU budgetary surveillance. They define the macro-context in which the Commission (i) sets the fiscal requirements in line with the EU rules, (ii) assesses the compliance of governments' plans with the requirements, (iii) decides whether the draft budgetary plans need to be revised in light of a risk of a serious non-compliance with the SGP, and (iv) checks the eligibility criteria for countries to invoke flexibility clauses. Therefore, the quality and track record of the Commission's macroeconomic forecasts have a major bearing on the quality of the EU surveillance as a whole.

Graph 2.2 in Section 2.1 shows that, in 2017, nominal GDP growth surprised on the upside in most countries. Italy, Luxembourg and the United Kingdom are the few exceptions where nominal growth turned out to be lower than projected in both the governments' plans and the Commission forecast. In the case of the United Kingdom, the negative growth surprise is likely to be linked to the impact of Brexit, while the growth forecasts of very small and open economies like Luxembourg are notoriously more uncertain.

The preventive arm of the SGP requires that projections underpinning the medium-term national fiscal plans '*shall be based on the most likely macro-fiscal scenario or on a more prudent scenario*' ([28]). Moreover, since the two-pack

([26]) The Commission recommendation and CSRs adopted by the Council are available at: https://ec.europa.eu/info/european-semester/european-semester-timeline/eu-country-specific-recommendations/2016-european_en

([27]) No CSRs were addressed to Greece because it was still under a macroeconomic adjustment programme.

([28]) Article 7(2a) of Regulation (EC) 1466/97 underpinning the preventive arm of the SGP.

reform of the SGP in 2013, stability programmes should be based on macroeconomic forecasts that have been produced or endorsed by an independent body ([29]). The Code of Conduct on the two-pack adds specific requirements for the involvement of independent bodies in producing or endorsing macroeconomic forecasts, including situations when views between the independent body and the Ministry of Finance diverge ([30]).

In the case of Italy, the country's Parliamentary Budget Office (PBO), an independent fiscal institution, highlighted already in March 2016 that the growth projections underpinning the 2016 stability programme were positioned in the '*higher part of the forecast range used for its assessment*'. The Commission's assessment of the 2016 stability programme acknowledged the PBO's conclusion but assessed the government's macroeconomic forecast as plausible (see also Section 3.3). In autumn of the same year, the PBO doubled down and solicited a correction of the deficit target for 2017 presented in the draft budgetary plan (from 2 % to 2.3 % of GDP) before endorsing the programme scenario. Even after the government made the correction, the PBO noted that growth beyond 2017 was above the upper bound of its forecast range, and thus not prudent. By that time, the Commission too had revised its own growth projections downward.

The Commission regularly assesses the accuracy of its own forecasts. The most recent report focuses on forecasts of GDP, inflation and the government general balance over a long (1969-2014) and shorter (2000-2014) period ([31]). It finds that, in line with other international institutions, Commission forecasts are relatively accurate and largely unbiased. However, its year-ahead forecasts appear to have been slightly overestimating GDP growth, in particular in the crisis and post-crisis years. The tendency to overestimate GDP growth was particularly evident in Italy and, to a lesser extent, France, in both the longer and shorter sample periods. In the recent period (2000-2014), also the growth forecasts for Denmark and Portugal seem to exhibit a positive bias ([32]).

([29]) See Regulation (EU) 473/2013.
([30]) http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf
([31]) European Commission (2016).
([32]) The year-ahead forecast for inflation is negatively biased for two Member States: Italy (-0.87) and Latvia (-1.9) and positively biased for Sweden (0.42). The bias for Italy is no longer statistically significant in the shorter sample (2000-2014).

Draft budgetary plans for 2017: managing risks of non-compliance under the two-pack reform of 2013.

In the autumn of 2016, 16 euro area countries under the preventive arm of the SGP presented a draft budgetary plan as required by Regulation (EU) 473/2013 ([33]).

Although the budgetary plans of several Member States pointed to an insufficient fiscal adjustment, the Commission did not request updated plans, finding no cases of '*particularly serious non-compliance*'. Article 7(2) of Regulation (EU) 473/2013 empowers the Commission to issue a negative opinion if it identifies a case of '*particularly serious non-compliance*'.

In line with the procedure outlined in the Code of Conduct of the two-pack ([34]), a week after receiving the draft budgetary plans, the Commission started consultations in the form of an exchange of letters with three countries found at risk of non-compliance based on the content of the budgetary plans: Italy, Cyprus and Finland. Letters were also addressed to three other countries found at risk of non-compliance based on the Commission 2016 autumn forecast: Belgium, Lithuania and Portugal. The letters were intended to seek clarifications on a number of points, including the assumptions underlying macroeconomic and budgetary projections. In the case of Belgium and Italy, the Commission's letter recalled that compliance with the preventive arm of the SGP was a relevant factor in assessing compliance with the debt rule of the Pact, that is, when preparing the report under Article 126(3) TFEU (see Section 2.2.3).

Most of the Member States replied by giving reassurances to the Commission of their commitment to abide by the SGP rules and provided some more information on their budgetary plans. A few countries (Cyprus, Italy and Portugal) questioned the Commission's assessment, referring to the uncertainty surrounding output gap estimates from the commonly agreed methodology and insisting that their own calculations were more appropriate.

([33]) Portugal was among the 16 countries, although at the time it was still under the corrective arm of the SGP. However, it was expected to correct its excessive deficit by the end of 2016.
([34]) 'Specifications on the implementation of the Two Pack and Guidelines on the format and content of draft budgetary plans, economic partnership programmes and debt issuance reports': http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/2014-11-07_two_pack_coc_amended_en.pdf

Box 2.1: The preventive arm of the Stability and Growth Pact (SGP) in a nutshell

Legal basis: Article 121 of the Treaty on the Functioning of the European Union (TFEU) and Council Regulation (EC) 1466/97 '*on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies*', amended in 2005 and 2011. Elements of the Two Pack (2013) complement the legal basis of the preventive arm of the SGP.

Objective: To promote sound management of Member States' public finances by requiring national governments to achieve and maintain their medium-term budgetary objective (MTO).

MTO: A country-specific budgetary target, expressed in structural terms, i.e. corrected for the budgetary impact of the economic cycle and temporary and one-off factors. It is built by considering a country's debt level and the sustainability challenges posed by the costs of an ageing population. It is defined to allow automatic stabilisers to operate freely, while preventing the deficit from breaching the 3 % of GDP Treaty reference value under normal cyclical fluctuations.

Adjustment path: Member States that are not at their MTO are required to implement a fiscal adjustment. The required annual adjustment amounts to 0.5 % of GDP as a benchmark and can be modulated according to prevailing cyclical conditions and the level of government debt. The matrix of adjustment requirements introduced in 2015 details the degree of modulation around the benchmark (see Box 5.1).

Compliance indicators: Compliance with the requirements of the preventive arm is assessed using a two-pillar approach. The assessment of the estimated annual change of the structural balance (the first pillar) is complemented by an expenditure benchmark (the second pillar), which limits the increase of government spending relative to potential GDP growth in the medium term, unless funded by new revenue measures.

Temporary deviations: Under certain conditions, the SGP allows for temporary deviations from the MTO or the adjustment path towards it. Flexibility may be requested by Member States to support investment or major structural reforms. Specific unusual events outside the control of government and severe economic downturns can also be taken into account.

Significant deviation: A deviation from the MTO — or the adjustment towards it — is significant if larger than 0.5 % of GDP in one year or 0.25 % of GDP on average over 2 consecutive years.

Significant deviation procedure: If, on the basis of outturn data, the final assessment concludes that there was a significant deviation from the MTO or the adjustment towards it, the Commission launches a significant deviation procedure (SDP) so as to give the Member State concerned the opportunity to return to the appropriate adjustment path. To that end, the Commission issues a warning under Article 121(4) TFEU. The warning is followed by a Council recommendation, based on a Commission proposal, for the policy measures needed to address the significant deviation.

Sanctions: If a Member State under a SDP fails to take appropriate action by the given deadline a decision on no effective action and the imposition of sanctions for euro area countries, in the form of an interest-bearing deposit, are possible. The interest-bearing deposit is transformed into a non-interest bearing deposit if an excessive deficit procedure is launched (see Box 2.2).

More detailed information on the preventive arm can be found in the *Vade Mecum on the SGP* and the *Code of Conduct of the SGP*.

The Commission issued its opinions on the draft budgetary plans on 16 November 2016 [35]. Seven countries (Belgium, Italy, Cyprus, Lithuania, Slovenia, Finland and Portugal) were found at risk of non-compliance with the preventive arm of the Pact, as the Commission's assessment indicated a significant deviation from the required adjustment path. For Italy, Cyprus and Finland, the risk of non-compliance directly emerged from the projections of the draft budgetary plans, after recalculating the structural balance based on the commonly agreed methodology, rather than from the Commission's own forecast.

Four countries (Ireland, Luxembourg, the Netherlands and Austria) were assessed as broadly compliant with the preventive arm of the Pact, meaning that the Commission assessment pointed to some deviation from the required adjustment path. It is worth mentioning that Austria would have been assessed as being at risk of non-compliance had the *preliminary* estimate of the additional budgetary impact of refugees

[35] The Commission opinions on the draft budgetary plans for 2017 can be found at https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/annual-draft-budgetary-plans-dbps-euro-area-countries/draft-budgetary-plans-2017_en

and security measures in 2016 (0.4 % of GDP) not been taken into account for 2017.

On 5 December 2016, when discussing the Commission opinions, the Eurogroup issued a detailed statement warning about the lack of fiscal discipline in some Member States. It called on those risking non-compliance to take timely additional measures ([36]). The Eurogroup also called on countries at or above their MTO (Germany, Luxembourg and the Netherlands) to use their favourable budgetary situation to strengthen domestic demand and potential growth.

Overall, the exercise of reviewing the draft budgetary plans for 2017 was not very effective in achieving the original objective of the exercise. Introduced in 2013 with the two-pack reform of the SGP, the assessment of draft budgetary plans aims to identify and correct at an early stage any risks of deviating from the recommended budgetary targets, ultimately by asking Member States to provide an updated budgetary plan. In the past, some countries have spontaneously committed to additional measures following a specific request by the Commission (e.g. Austria in May 2014; Italy, Austria and France in October 2014). However, there was no such commitment to additional measures in 2017.

Effectiveness is likely to be regained if the Commission issues a negative opinion. To that end, a different interpretation of a '*particularly serious non-compliance*' is required (e.g. by explicitly including in the Code of Conduct of the two-pack the case '*if the fiscal effort envisaged in the DBP points to a risk of a significant deviation*' among the situations where a '*particularly serious non-compliance*' is found). The design of the procedure has some imperfections. Under the current approach, the decision to request a revised draft budgetary plan is based on the information provided by the government. Conversely, the assessment of compliance is based on the Commission forecast. This dichotomy may generate confusion and, worse still, it creates an incentive for Member States to submit overoptimistic plans showing compliance with the SGP.

The concept of broad compliance in the *ex ante* assessment

The preventive arm of the SGP provides for a margin of error, by stipulating that some deviation from the adjustment path towards the MTO does not lead to new procedural steps. A deviation is not significant if it is below 0.5 % of GDP in a single year, or cumulatively over 2 consecutive years. The margin is motivated by the fact that gauging discretionary fiscal policy is inherently difficult: the two indicators used in the preventive arm — the structural balance and the expenditure benchmark — are subject to some measurement error.

However, the measurement uncertainty mainly arises *ex post*, when the assessor actually engages in the measurement exercise, not *ex ante*. For a given point estimate of fiscal and macroeconomic variables and an agreed method for calculating potential output and the structural budget balance, the results of the forward-looking assessment should be unequivocal: either the plans are in line with requirements or they are not ([37]). Applied *ex ante*, the margin of broad compliance creates an incentive to systematically exploit it already in the planning phase of the budgetary process which ultimately affects the speed of adjustment towards the MTO.

Table 2.4: **Assessment of compliance of the draft budgetary plans with the preventive arm of the SGP**

	2014	2015	2016	2017	2018	Ex-ante average deviation SB	Ex-ante average deviation EB
BE						-0.2	-0.4
DE						1.4	1.0
EE						-0.2	-0.2
IE						0.2	-0.3
IT						-0.6	-0.5
CY						-0.5	-0.8
LV						0.1	-0.3
LT						0.0	-0.5
LU						0.8	0.1
MT						-0.3	-1.0
NL						-0.1	0.2
AT						-0.4	-0.2
PT						-0.6	-0.9
SI						-0.7	-0.9
SK						-0.3	-0.2
FI						-0.4	-0.3

Notes: (1) Green, yellow and red correspond respectively to an assessment of 'compliance', 'broad compliance' and 'risk of non-compliance'. (2) 'SB' refers to the structural balance; 'EB' to the expenditure benchmark. (3) The assessment of compliance follows an 'overall assessment' based on the Commission forecast, which also includes deviations over 2 years and the possible application of 'unusual event clauses'. (4) Only euro area countries submit draft budgetary plans.
Source: European Commission.

According to Table 2.4, which is an update of Table 5.1 in last year's annual report, *ex ante* deviations are a recurring feature in the surveillance process, especially for some Member States. Since 2013, more than half of all euro area countries have regularly planned a deviation from the required adjustment laid down in the fiscal recommendations of the Council. The average planned deviation from the required change of the structural budget balance amounts to -0.4 % of GDP per year and -0.6 % of GDP per year for the expenditure benchmark.

The systematic recourse to the margin of broad compliance in the planning phase has continued in 2017

([36]) http://www.consilium.europa.eu/media/24211/20161205-draft-eg-statement-dbps-eg-final.pdf

([37]) It would be different if point estimates came with a probability distribution reflecting past errors, in which case conclusions could be drawn on how likely compliance may be.

and 2018 when the recovery has been solid. The conclusion or finding of broad compliance generates a general perception that the budgetary plans are sounder than they actually are. This perception may also contribute to a more lenient budgetary execution.

The in-year assessment

In spring 2017, the Commission assessed the convergence programmes and national reform programmes of non-euro area countries. The assessment indicated the risk of significant deviation from the required adjustment path for Romania and Hungary.

In the case of Romania, the Commission opened a significant deviation procedure based on 2016 outturn data. In particular, the Commission issued a warning to Romania on 22 May 2017, followed by a Council recommendation on 16 June 2017, requesting Romania to correct the observed significant deviation from the adjustment path toward the MTO. It called on Romania to take the necessary measures to ensure an annual structural adjustment of 0.5 % of GDP ([38]). On 22 November 2017, the Commission concluded that no effective action had been taken by Romania in response to the Council Recommendation of 16 June 2017 and put forward a proposal for a revised Council recommendation raising the fiscal adjustment requirement for 2018 to 0.8 % of GDP. The Council adopted the recommendation on 5 December 2017 ([39]).

The system of sanctions introduced by the six-pack reform of the SGP of 2011 does not apply to countries outside the euro area. In addition, the possibility of requesting a re-programming of the EU funds under the European Structural and Investment Fund (ESIF) Regulation appears legally uncertain and cumbersome, due to a lengthy procedure and the need to involve different institutions, including the Member State concerned ([40]).

Of note are also the concerns the Commission expressed on Italy's fiscal developments in autumn 2017. On 22 November, in parallel to its opinion on the 2018 draft budgetary plan, the Commission issued a letter to the Italian government ([41]), highlighting a risk of non-compliance with EU fiscal rules in 2017, especially in light of its still very high public debt. The Commission also recalled the consequences of a significant deviation from the required adjustment towards the MTO for compliance with the debt reduction rule ([42]). The Commission asked for clarifications on the sizeable deterioration in the structural balance in 2017, while underlining the importance of avoiding backtracking on structural reforms, notably on pensions.

On procedural grounds, the letter was somewhat unusual. Normally, a report under Article 126(3) TFEU is issued to assess whether an excessive deficit procedure should be launched when a Member State appears to be in breach of the deficit and/or debt criteria (see Section 2.2.3 for more details).

Final assessment in the spring 2018

In the spring of 2018, the Commission and the Council made their final assessment of compliance for 2017. Overall, compliance with the requirements of the preventive arm of the SGP in 2017 was more favourable than in the *ex-ante* and in-year assessments. Compliance indicators had improved for most of the countries. This is explained by both (i) higher-than-expected economic growth and (ii) the use of flexibility and unusual event clauses. Graph 2.4 shows that, for most of the countries, the expenditure benchmark was more binding than the structural balance indicator, i.e. it indicated a smaller budgetary improvement (see also the part on the indicators of compliance in this chapter).

Of the 16 euro area countries under the preventive arm of the SGP, 12 were found to have complied with the recommended fiscal adjustment. Three euro area countries showed some deviation from the adjustment path towards the MTO (Slovenia, Portugal, and Italy). In the case of Belgium, while compliance indicators pointed to a significant deviation from the adjustment path towards the MTO, the Commission considered that evidence was not sufficiently robust to conclude that there was a significant deviation. The Commission explained its choice by the uncertainty surrounding

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([38]) http://data.consilium.europa.eu/doc/document/ST-9999-2017-INIT/en/pdf

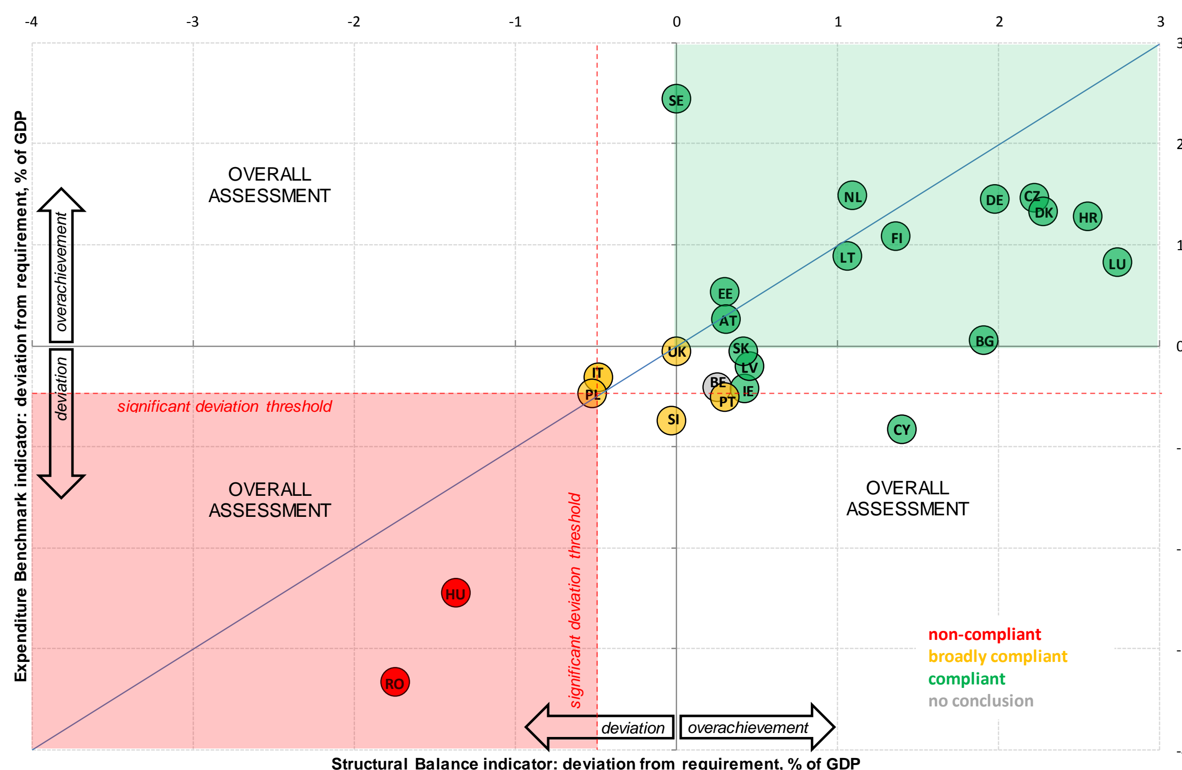
([39]) http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017H1220(01)&from=EN

([40]) Article 23 of the Regulation (EU) No 1303/2013 provides that the Commission may request a Member State to review and propose amendments to its Partnership Agreement only in three cases: i) to support the implementation of *relevant* country-specific recommendations; ii) to support the implementation of relevant Council recommendations under a macroeconomic imbalance procedure; iii) to maximise the growth and competitiveness impact of the available ESI Funds. Under current rules, it appears difficult to demonstrate a direct link between the implementation of a fiscal recommendation (i.e. compliance with the SGP) under the preventive arm of the SGP and structural investment challenges, which are the primary objectives of ESI funds.

([41]) https://ec.europa.eu/info/sites/info/files/economy-finance/letter-to-italy-20171122.pdf

([42]) Italy fell short of the debt reduction benchmark in 2015. In spring 2016, the Commission concluded, after assessing all relevant factors, that an EDP should not be opened, provided that Italy ensured broad compliance with the preventive arm. However, outturn data for 2016 showed that broad compliance was only achieved thanks to flexibility clauses which, in turn, were granted subject to Italy being broadly compliant with the preventive arm in 2017.

Graph 2.4: **2017 ex post assessment of compliance with the preventive arm of the Stability and Growth Pact**



Notes: (1) A negative number represents a deviation from the required fiscal adjustment. A deviation is considered 'significant' if greater than 0.5% of GDP (the red area). A positive number indicates an overachievement (the green area). (2) Circle colours: green, yellow and red correspond respectively to an assessment of 'compliance', 'broad compliance' and 'non-compliance', based on the Commission's spring 2018 assessment. A grey circle is used for the case of Belgium where the Commission's assessment was not conclusive.
Source: European Commission.

corporate income tax revenues, in particular whether higher-than-expected tax intakes were temporary or permanent [43]. In its 2018 spring forecast, following established practice, the Commission assessed the revenue increase as temporary (i.e. a *one-off*) as it originated in a change in the timing of the collection of corporate income tax [44]. As a result, the positive budgetary impact of the measure was excluded from both the structural budget balance and the expenditure benchmark. However, the Belgian government contested this assessment, arguing that the enacted measure included a structural component.

The case of Belgium raises several considerations. Firstly, it was the first time the Commission did not reach a conclusion in its final assessment of compliance. This creates a precedent which *de facto* introduces a new category beyond the three already foreseen by the *Code of Conduct of the SGP* (i.e. compliant, broadly compliant and non-compliant). Secondly, Belgium was among the countries that were considered to be at risk of non-compliance already in the planning phase of the 2017 surveillance cycle; i.e. Belgium had already exploited the margin of broad compliance *ex ante*. The 0.5 % of GDP margin of compliance is precisely meant to account for uncertainty. Thirdly, it seems that not all views were taken into account in the Commission assessment. In March 2018, the High Council of Finance (HCF), the independent fiscal institution in Belgium, together with the Federal Planning Bureau (FPB), noted that the corporate income tax measure in question would positively impact government revenues between 2017 and 2019 and that the impact would abate after that, thus suggesting a temporary effect of the measure [45]. However, the Commission in its assessment only mentioned the analysis carried out by the National Bank of Belgium, which corroborated the government's view. Finally, it remains unclear when compliance with the preventive arm of the SGP in 2017 will actually be assessed for Belgium. According to the Commission '*the permanent impact […] will only be measurable ex post after a longer time span of some years*' [46]. This seems to suggest

[43] In 2017, corporate income tax revenues increased substantially following the introduction of a higher surcharge for non-payment of advance tax payments and grants, to be deducted from the overall surcharge if timely advance payments are made.

[44] European Commission (2015), page 58, Section 3.3.3.

[45] Avis: Trajectoire Budgétaire en préparation du Programme de Stabilité 2018-2021: https://www.conseilsuperieurdesfinances.be/sites/default/files/public/publications/csf_fin_avis_2018_03_0.pdf

[46] Commission assessment of the 2018 stability programme for Belgium, p. 18.

that clarity may only be reached in a distant future with no practical implications, in the sense that procedural steps are unlikely to be taken even if a later assessment were to conclude that Belgium had not been compliant (see Section 2.2.3).

Turning to the non-euro area countries, Hungary and Romania were found to have deviated significantly from the adjustment path towards the MTO. Consequently, on 23 May 2018 the Commission opened a SDP for the two countries ([47]). In the case of Romania, the Commission also issued a recommendation for a Council decision concluding that Romania's response to the Council Recommendation of 5 December 2017 had been insufficient and a new SDP was launched. The absence of sanctions for non-euro area countries makes the procedure largely ineffective.

On 22 June 2018, the Council adopted recommendations requesting the two countries to correct the significant deviation from the adjustment path towards the MTO. Since Hungary was estimated to be in good economic times, the Council recommended Hungary achieve a structural adjustment of 1.0 % of GDP in 2018, in line with the minimum effort resulting from the matrix of adjustment requirement. In the case of Romania, given the need to correct for the cumulated deviation in 2016 and 2017 and the risk of breaching the 3 % of GDP reference value, the Council recommended Romania achieve a structural adjustment of 0.8 % of GDP in both 2018 and 2019.

The flexibility and unusual event clauses

In 2017, 8 Member States were granted temporary deviations from the required adjustment: Belgium, Italy, Latvia, Lithuania, Hungary, Austria, Slovenia and Finland (see Table 2.5).

The allowances approved by the Council were largely in line with those requested by Member States with the exceptions of Latvia and Lithuania. Their initial requests to allow for the budgetary impact of major structural reforms (0.5 % of GDP for Latvia and 0.6 % of GDP for Lithuania) were not granted because the two countries did not meet one key condition: the respect of the safety margin. The *Commonly agreed position on flexibility in the SGP*, endorsed by the ECOFIN Council on 12 February 2016, provides that an appropriate safety margin needs to be continuously preserved so that the deviation from the MTO or the adjustment path does not lead to an excess over the 3 % of GDP Treaty reference value for the deficit. The temporary deviations for Latvia and Lithuania were therefore lowered to 0.1 % and 0.4 % of GDP, respectively.

In the case of Finland, compliance with the safety margin was attained thanks to an update of the output gap estimate with the plausibility tool (see Section 2.2.1). According to the Commission 2017 spring forecast, Finland's structural deficit was estimated at 1.3 % of GDP in 2017, above the minimum benchmark of 1.1 % of GDP which would ensure a safety margin against breaching the 3 % of GDP reference value under normal cyclical fluctuations. However, by using the revised output gap, the structural deficit was re-estimated at 1.0 % of GDP ([48]), very close to but below the minimum benchmark. The Commission assessment also referred to a public statement by the Finnish government, which committed to stand ready to take any additional measure to ensure the safety margin was observed.

Table 2.5: **Flexibility and unusual event clauses granted for 2017, % of GDP**

	Flexibility clauses			Unsual event clause			
	Investment	Structural reform	Pension reform	Refugee	Security	Natural disaster	Total
BE					0.02		**0.02**
IT				0.16		0.19	**0,39[c]**
LV		0.10					**0.70[a]**
LT		0.40	0.10				**0.50[b]**
HU					0.17		**0,25[c]**
AT					0.03		**0.41[c]**
FI	0,10[d]	0.50					**0.72[c]**

Notes: a) The total amount for Latvia includes an allowance for the systemic pension reform granted in 2015 (0.6 % of GDP in 2017). Latvia requested an additional deviation of 0.5 % of GDP under the structural reform clause in 2017. The deviation granted was lower (0.1 % of GDP) to observe the safety margin against the risk of breaching the 3 % of GDP Treaty reference value. b) Lithuania requested a deviation of 0.5 % of GDP under the structural reform clause in 2017. The deviation granted was lower (0.4 % of GDP) to observe the safety margin. c) The total amount indicates the allowed deviation from the MTO and includes the allowances granted in 2015 and 2016. d) In the case of Finland, the Commission final assessment did not consider the investment clause allowance due to the actual decline in public investment.
Source: European Commission.

In the spring of 2018, the Commission assessed whether structural reforms for which flexibility was granted had effectively been implemented. In the case of Lithuania, the Commission noted that the pension reform had entered fully into force in 2018 but argued that it might not be sufficient to address the falling adequacy of pensions in the future ([49]). In the case of Latvia, the

https://ec.europa.eu/info/sites/info/files/economy-finance/01_be_sp_2018_assessment_revised.pdf

([47]) In line with Article 121(4) TFEU and Article 10(2) of Council Regulation (EC) No 1466/97, the Commission issued a warning to Hungary and Romania on 23 May 2018 about a significant deviation in 2017.

([48]) The departure from the output gap estimates of the commonly agreed methodology was also used to assess the eligibility of the investment clause with respect to the cyclical position of the Finnish economy, as the revised 'alternative' output gap was estimated larger than -1.5 % of GDP in 2017.

([49]) In its assessment of the draft budgetary plan for 2018 the Commission already considered that 'measures related to the pension reform have been implemented from the start of 2017,

Commission noted that the implementation in 2017 '*broadly follow[ed] the announced plans to increase the provision of public health services and to reduce waiting times*'. Conversely, for Finland, the Commission did not discuss whether the structural reform had been implemented. Yet, it assessed whether Finland met the eligibility conditions for the investment clause, in particular whether actual public investment did not decline. Outturn data for 2017 showed a reduction in public investment compared to the previous year. Hence, the Commission did not factor in the allowance under the investment clause in its assessment.

The combination of different types of flexibility made the definition of fiscal requirements particularly challenging. Two arrangements deserve to be mentioned: (i) the Commission extended by 1 year the application of the refugee clause; and (ii) the Commission applied to the unusual event clause the same provision agreed under the structural reform and public investment clauses for Member States at, or close to, the MTO. Regarding the first decision, the application of an unusual event clause should, in principle, not go beyond 2 years, considering its exceptional and temporary nature. The persistence of such costs over a longer period would rather indicate a permanent shift in government expenditure. However, in the autumn of 2016, the refugee clause, which was first activated in 2015, was extended by another year to 2017, mainly because of the protracted refugee crisis in Italy.

As for the temporary deviation to be granted to Member States at, or close to, their MTO, the commonly agreed position of the Commission and the Council on flexibility provides that in order to ensure equal treatment, allowances under the flexibility clauses are adjusted according to Member State's position with respect to the MTO (see Box 5.1). In 2017, the Commission considered that the same provision should be applied to the unusual event clause too [50]. According to the Commission 2018 spring forecast, four countries benefiting from flexibility or unusual event clauses were estimated to be either at their MTO or likely to reach it before the end of the period during which the clauses applied (Finland, Italy, Hungary and Austria). For these countries, the total allowed deviation in 2017 included elements granted in the 2 previous years.

The case of Italy is instructive (see Table 2.6). Allowed deviations apply to either the change or level of the structural balance, whichever leads to the least stringent requirement. A deviation in terms of change affects the adjustment path towards the MTO and applies to countries that are still relatively far from their MTO. By contrast, when the structural balance stands near the MTO, the deviation is in level and refers directly to the distance from the MTO (for more detailed explanations, see Box 5.1). Based on the matrix of adjustment requirements, the required change in the structural balance for Italy in 2017 would have been an improvement of 0.6 % of GDP. Correcting for the allowed deviation of 0.35 % of GDP granted for that year, the structural deficit would have moved from 1.42 % of GDP in 2016 to 1.17 % in 2017. However, taking into account deviations granted in previous years, the largest allowable level of the structural deficit was 1.21 % of GDP.

It is worth noting that, according to the Commission 2018 spring forecast, Italy's structural deficit in 2017 was 1.7 % of GDP, above both the required structural target (1.2 % of GDP) and its minimum benchmark (1.5 % of GDP) which ensures a safety margin against the risk of breaching the 3 % of GDP deficit reference value under normal cyclical fluctuations. According to the common provisions agreed between the Commission and the Council, the appropriate safety margin should continuously be preserved. Hence, it is doubtful whether allowances for flexibility clauses should be carried forward as was the case for Italy.

Table 2.6: **The fiscal adjustment requirement for Italy in 2017**

	Structural balance	% of potential GDP
a)	In 2016 (starting position)	-1.42
b)	MTO (target)	0.00
	Required change in the structural balance in 2017	
c)	Matrix-based requirement	0.60
d)	Deviation granted in 2017	-0.35
e)	Corrected requirement (= c+d)	0.25
f)	Structural balance in 2017 taking into account corrected requirement (= a+e)	-1.17
	Comparison against the allowed deviation from the MTO	
g)	Deviation granted in 2017	-0.35
h)	Deviation granted in 2016	-0.83
i)	Deviation granted in 2015	-0.03
j)	Total allowed deviation from the MTO (= g+h+i)	-1.21
k)	Most demanding level of the structural balance in 2017 (= b+j)	-1.21
	Actual requirement for 2017	
l)	Least stringent level of the structural balance (minimum of f and k)	-1.21
m)	Final requirement (= l-a)	0.21
n)	*p.m. lower requirement due to carry-over from 2015-2016 (= m-e)*	*-0.04*

Source: European Commission, own calculations.

In 2017, a further exception for Italy was introduced in the quantification of the unusual event clause. Generally, the Commission assesses the budgetary impact of

while the labour market and associated reform measures entered into force in July 2017'.

[50] This arrangement has not yet been included in the *Code of conduct of the SGP*.

unusual events on a year-on-year basis ([51]). As an exception, the additional refugee-related expenditure for Italy in 2017 were calculated as the overall cost incurred in 2017 (0.25 % of GDP) net of the deviation already granted in 2015 and 2016 (0.09 % of GDP). As a result, the amount of the refugee clause for 2017 was greater than the annual increase of the migration-related expenditure (0.16 % v 0.05 % of GDP). The exception was motivated by the fact that the costs related to the refugee/migrant crises started to increase in Italy well before 2015, the year of the first application of the refugee clause. Without detracting from the efforts Italy has deployed on the migration front, allowances for unusual events are meant to only reflect the annual change in the structural balance on which the assessment of compliance with the SGP is ultimately based.

In 2017, Italy also requested an additional allowance under the unusual event clause to cover the budgetary costs of an investment plan that aimed to protect buildings against seismic risks. In spring 2017, the Commission granted *ex ante* the requested allowance and confirmed it *ex post* for an amount of 0.19 % of GDP ([52]). Until then, unusual event clauses were used to allow for budgetary costs ensuing from past events rather than costs incurred for preparing for future risks. Nonetheless, in this specific case, the Commission went for a broader approach in light of the linkages between emergency and preventive interventions and the likely reoccurrence of earthquakes.

In sum, as far as the implementation of the unusual event clause is concerned, the principles set by the Commission (i.e. to consider only costs directly linked to the event; to allow deviations only on a temporary basis; to consider only the additional costs compared with the previous year) seem to have been applied with a considerable degree of discretion ([53]).

Indicators of compliance

Under the preventive arm of the SGP, compliance with the required structural adjustment is assessed on the basis of two indicators: the change in the structural budget balance and the expenditure benchmark. In cases where at least one indicator points to a significant deviation from the recommended adjustment, the overall assessment conducted by the Commission is critical in determining compliance with the EU rules.

As indicated in Section 2.2.2, the EFC opinion of December 2016 intends to reduce potential conflicts from diverging signals by giving more prominence to the expenditure benchmark. In actual practice, no prominent shift towards the expenditure benchmark took place in the 2017 assessment cycle. Among the cases where at least one indicator pointed to a (risk of) significant deviation from the required adjustment path, the Commission identified the expenditure benchmark as the more reliable indicator in less than half of the assessments (see Table 2.7).

Table 2.7: **Use of the expenditure benchmark as compliance indicator in the 2017 surveillance cycle**

	spring 2016	autumn 2016	spring 2017	autumn 2017	spring 2018
nr. of overall assessments *of which*:	17	13	15	9	9
at least one indicator points to a (risk of) significant deviation *of which*:	15	8	9	7	6
the expenditure benchmark explicitly referred to as appropriate indicator	1	3	4	4	2

Source: European Commission, own calculations.

In most of the cases, the overall assessments still look at both indicators. However, in most cases, the overall conclusion does not indicate which indicator was considered the most appropriate. In the context of the current economic recovery, the medium-term rate of potential GDP growth (i.e. the 10-year average of potential GDP growth) improves less than the estimates of potential growth of the last year. As a result, the structural balance tends to be less restrictive in the assessment of compliance.

While the EFC opinion of November 2016 added some clarity about how to appraise the relative strengths of the two indicators, it fell short of providing a more complete mapping of the relevant factors behind possible differences. The 2017 surveillance cycle was still characterised by a fair degree of opacity on why in some cases indicators were corrected for some specific factors and which factors tilted the balance towards one indicator or the other.

Graph 2.5 analyses the difference between the two indicators for cases where one indicated a significant deviation from the adjustment path, based on EFB calculations. The salient features of the overall

([51]) Considering that adjustment requirements under the SGP are set in terms of annual change in the structural balance, allowances under the 'unusual event' provisions should only reflect the extent to which incremental costs affect the annual change in the structural balance.

([52]) The total allowance consisted of fiscal incentives for building recovery (0.12 % of GDP), direct interventions to reduce risks (0.03 % of GDP) and specific interventions to reduce vulnerability of school facilities (0.04 % of GDP).

([53]) The principles for assessing costs arising from unusual events are set out in Section 2 of the Commission Communication '2016 draft budgetary plans: an Overall Assessment'. https://eur-lex.europa.eu/resource.html?uri=cellar:5d0db65c-8d14-11e5-b8b7-01aa75ed71a1.0002.02/DOC_1&format=PDF

assessment of compliance carried out by the Commission in spring 2018 for these countries were as follows:

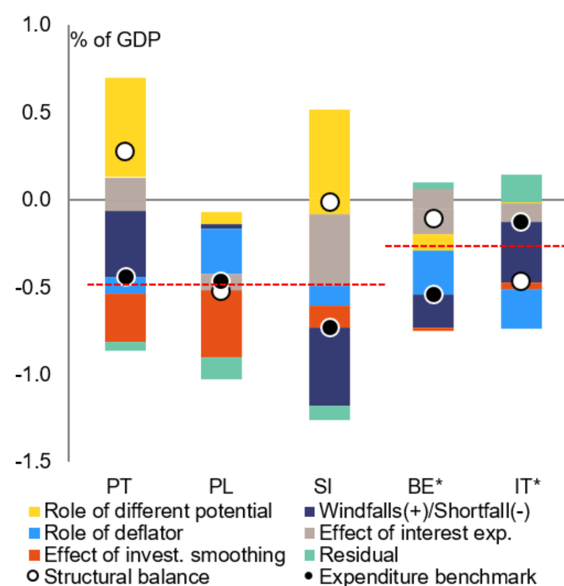
- In the case of Portugal, the expenditure benchmark pointed to a deviation close to the threshold of significance, while the structural balance improved by 0.9 % of GDP. In the overall assessment, the Commission argued that the expenditure benchmark was adversely affected by the medium-term reference rate of potential GDP growth due to a '*very abrupt adjustment of the economy in the crisis […] and [which] appears to be inconsistent with the trend growth prospects of Portugal*', and applied an *ad hoc* update of the medium-term rate of potential GDP growth. As a result, the final assessment only pointed to some deviation from the adjustment path towards the MTO.

- In the case of Poland, the structural budget balance pointed to a significant deviation in 2017. However, the Commission considered the deviation in excess of the margin of error as marginal and did not proceed to further analysis. In 2016-2017 taken together, the structural budget balance also pointed to a significant and more sizeable deviation. However, the Commission analysis did not clarify which factor may have affected the structural budget balance as opposed to the expenditure benchmark and concluded that Poland deviated from the adjustment path towards the MTO but not significantly.

- In the case of Slovenia, the expenditure benchmark pointed to a significant deviation in 2017. As in the case of Portugal, the Commission considered that the expenditure benchmark was negatively affected by the use of the medium-term rate of potential GDP growth, which, given the '*much faster than expected*' economic recovery was considered to be outdated. Like in the Portuguese case, the Commission made an *ad hoc* adjustment to the medium-term rate of potential GDP growth. Consequently, the Commission concluded that Slovenia had not significantly deviated from the adjustment path towards the MTO.

- In the case of Belgium, the expenditure benchmark showed a significant deviation in 2016-2017 taken together, while the structural balance only pointed to some deviation. In the overall assessment, the Commission argued that the expenditure benchmark reflected more appropriately the underlying fiscal effort, but higher-than-expected inflation had had an unfavourable impact on the expenditure indicator. However, the deviation remained significant even after taking account of the inflation effect (blue bar in Graph 2.5). As indicated in Section 2.2.2, the Commission ultimately decided not to draw any firm conclusions because of uncertainty as to how corporate income tax revenues would evolve in the future.

Graph 2.5: **Deviations from the required fiscal adjustment in 2017: change in the structural budget balance and expenditure benchmark**



Notes: The white and black circles indicate the deviations from the required fiscal adjustment as measured by the change in the structural balance and the expenditure benchmark, respectively. A deviation below the dashed red line is significant. The bars refer to the main factors explaining the difference between the two indicators. They should not be understood as a precise estimate but an indication of the relative importance of the different factors. For countries with an asterisk, the assessment was based on the average deviation over 2 consecutive years.
Source: European Commission, own calculations.

- In the case of Italy, while the expenditure benchmark was estimated to have been observed, the structural budget balance pointed to a significant deviation in 2016-2017 taken together. In its overall assessment, the Commission considered that the structural balance was negatively affected by revenue shortfalls. However, the structural balance should be corrected for the effect of a revenue shortfall only if it is transitory. The Commission did not provide any analysis of such a decline in revenues, nor a quantification of its effect on the structural budget balance.

All these cases show that the overall assessment by the Commission is highly judgemental, often lacking a convincing explanation pointing to elements of forbearance. Replicability by an independent assessor remains a challenge. In addition, the approach followed in the final assessment for Portugal and Slovenia raises some concerns. The update of the medium-term rate of potential GDP growth using recent forecasts sets a problematic precedent, not least because it is applied

asymmetrically: it is used only to make the assessment of compliance more lenient.

In sum, in 2017 the Commission, in its overall assessment, interpreted the discrepancies between the two indicators rather in favour of the structural budget balance. This approach contrasts clearly with the stated intention of giving more prominence to the expenditure benchmark. On the contrary, it adds to the problem it purports to solve. The medium-term rate of potential GDP growth is generally considered to provide stability and predictability. Privileging the estimate of potential growth of a single year, especially in times of higher economic growth, goes against setting a prudent benchmark for fiscal policy.

The plausibility of output gap estimates and the use of constrained judgement.

On 25 October 2016, the EFC agreed to use a new tool to check the plausibility of output gap estimates of the commonly agreed method (see Section 2.2.1). Table 2.8 reports the results of the plausibility tool in the successive rounds of the 2017 surveillance cycle. The group of countries whose real-time output gap estimates of the commonly agreed method were found to be outside the margins of the plausibility tool is relatively stable; all countries were flagged at least twice.

However, in all cases but one, the Commission's detailed analysis has never implied a revision of the required fiscal adjustment as per the matrix of adjustment requirements. For example, based on 2018 spring data, the output gap estimate of the commonly agreed method for Croatia was flagged as surrounded by a high degree of uncertainty (see Table 2.8). However, the plausibility range was within the category of normal times as defined by the matrix of adjustment requirements. Hence, the plausibility tool had a very limited impact on the assessment of compliance with the SGP in 2017. The same applied to Italy in autumn 2017.

The notable exception was Finland. The Commission's constrained judgement was crucial in granting the requested flexibility under the structural reform and investment clauses. Based on its 2017 spring forecast, the Commission concluded that the negative output gap was larger than the one of the commonly agreed method. As a result, the structural budget balance, recalculated on the basis of the output gap considered more plausible, was expected to observe the safety margin against the risk of breaching the 3 % of GDP reference value of the Treaty under normal cyclical fluctuations. In addition, the output gap considered more plausible also made Finland eligible for the investment clause.

Table 2.8: **Output gap estimates flagged by the plausibility tool in the 2017 surveillance cycle**

autumn 2016 (year 2016) [plausibility range]	**spring 2017** (year 2016) [plausibility range]	**autumn 2017** (year 2017) [plausibility range]	**spring 2018** (year 2017) [plausibility range]
Austria* [-0.7 , -2.2]	Austria [-0.8 , -1.6]	-	-
-	Cyprus [-0.8 , -1.8]	Cyprus [1.3 , 0.3]	Cyprus [0.7 , -0.4]
Finland* [-1.8 , -3.4]	Finland [-1.8 , -2.5]	Finland [-0.7 , -1.5]	-
-	Croatia [-1.3 , -2.0]	Croatia [0.6 , 0.0]	Croatia* [0.9 , -0.8]
Italy [-1.6 , -2.1]	Italy [-1.7 , -2.2]	Italy* [-0.6 , -1.7]	-
Luxemburg [-1.4 , -3.4]	Luxemburg [-1.0 , -2.6]	-	-
Latvia [1.4 , -0.3]	Latvia [1.6 , -0.2]	-	Latvia [2.0 , 0.3]
-	Netherlands [-0.8 , -1.6]	-	Netherlands [0.2 , -0.5]
Slovenia [-0.3 , -1.5]	-	Slovenia [1.8 , 0.2]	Slovenia [1.4 , 0.1]
United Kingdom* [0.7 , -0.7]	United Kingdom [0.5 , -0.3]	-	-

Notes: An asterisk indicates a large degree of uncertainty, which means that the output gap of the commonly agreed method falls outside the 90 % probability bounds of the estimate derived from the plausibility tool. The first value of the plausibility range is the estimate of the commonly agreed method; the second is the central estimate of the plausibility tool.
Source: European Commission.

So far, the plausibility tool has been applied asymmetrically, i.e. the constrained judgement has been used only in cases where a revision of the output gap implied a lower fiscal requirement for Member States. Given that uncertainty has no specific direction, one would also expect cases where the plausibility tool may lead to more stringent requirements. At the same time, Chapter 5 highlights that the current design of the SGP framework, including the matrix of adjustment requirement, is likely to generate a downward bias of the required adjustment.

2.2.3. The corrective arm of the Stability and Growth Pact

Assessing the existence of an excessive deficit

In 2017, the Commission assessed three countries — Italy, Belgium and Finland — to establish whether an excessive deficit procedure should be launched on account of the debt criterion. The Commission prepared reports under Article 126(3) TFEU in February for Italy and in May for Belgium and Finland. These reports have already been evaluated in the EFB's 2017 annual report. They did not lead to opening excessive deficit procedures, although in the case of Italy the Commission explicitly noted that it would review the case again in the autumn of 2017.

Based on its assessment of budgetary plans for 2018, in November 2017 the Commission concluded that while Finland complied with the debt reduction benchmark, Belgium and Italy did not.

Box 2.2: **The corrective arm of the Stability and Growth Pact (SGP) in a nutshell**

Legal basis: Article 126 of the Treaty on the Functioning of the European Union (TFEU) and Protocol No 12 on the excessive deficit procedure (EDP) annexed to the Treaty. The EDP is detailed in Regulation (EC) 1467/97 on *Speeding up and clarifying the implementation of the excessive deficit procedure*, amended in 2005 and 2011. Regulation (EU) 473/2013 introduced additional provisions for euro area countries especially as regards the excessive deficit procedure.

Objective: To dissuade excessive government deficits and debt and, if they occur, to ensure that the Member States concerned take effective action towards their timely correction.

Main reference values: 3 % of GDP for the general government deficit and 60 % of GDP for gross general government debt. If general government gross debt exceeds 60 % of GDP the differential with respect to the reference value is expected to diminish at a satisfactory pace, i.e. it has to decrease over the previous 3 years at an average rate of 1/20th per year as a benchmark.

Excessive deficit procedure: A procedure of successive steps for countries found to have excessive deficit or debt levels. Whenever the Commission observes a breach of the reference value of either the deficit or the debt criterion, it prepares a report under Article 126(3) TFEU to establish whether an excessive deficit has occurred. The assessment also takes into account 'other relevant factors'. For countries where the Council decides that an excessive deficit exists, it adopts, upon a recommendation from the Commission, a recommendation setting out a (i) deadline for the correction of the excessive deficit, and (ii) an adjustment path for both nominal and structural budget balances. Following an opinion of the Economic and Financial Committee (November 2016), the adjustment path towards the correction of an excessive deficit will also be defined in terms of an expenditure benchmark. That is to say, the new recommendation will define an upper bound for the nominal growth rate of government expenditure (net of discretionary revenue measures), consistent with the targets of the nominal and structural budget balance.

Assessment of effective action: While an excessive deficit procedure is ongoing, the Commission regularly assesses whether a Member State has taken the appropriate measures to achieve the budgetary targets recommended by the Council and aimed at the timely correction of the excessive deficit. The assessment begins by considering whether the Member State has met the recommended targets for the headline deficit and delivered the recommended improvement in the structural budget balance. If the Member State has achieved both, the excessive deficit procedure is held in abeyance. Otherwise, a careful analysis is carried out to determine whether the country concerned has delivered the required policy commitments and the deviation from the targets is due to events outside its control.

Sanctions: Euro area Member States can face sanctions in the form of a non-interest bearing deposit once an excessive deficit is launched. They can also face sanctions in the form of fines if they fail to take effective action in response to Council recommendations. Fines amount to 0.2 % of GDP as a rule and can go up to a maximum of 0.5 % of GDP if the failure to take effective action persists. Beneficiaries of the European Structural and Investment funds, except the United Kingdom, can also see part or of all of their commitments suspended.

Monitoring cycle: The Commission continuously monitors compliance with the Council recommendations and provides detailed updates on the back of its regular macroeconomic forecast exercises, in the context of the European Semester cycle.

More detailed information on the corrective arm of the SGP can be found in the *Code of Conduct of the SGP* and the Commission's *Vade Mecum on the SGP*.

For Belgium and Italy, the Commission also highlighted risks of a significant deviation from the adjustment path to the MTO in 2017. This point was of particular importance, as compliance with the required adjustment under the preventive arm had been established as the key relevant factor in deciding whether an excessive deficit procedure on the basis of the debt criterion should be launched or not. As indicated in Section 2.2.1, the Commission accompanied its opinion on the Italian draft budgetary plan with a letter highlighting the risk of non-compliance and expressed its intention to reassess the country's situation in spring 2018 ([54]). Of note, the Commission did not send a letter to the Belgian authorities. The Commission did not provide reasons for the differentiated treatment.

([54]) Letter by Vice- President Dombrovskis and Commissioner Moscovici to the Italian minister of finance, 22 November 2017. https://ec.europa.eu/info/sites/info/files/economy-finance/letter-to-italy-20171122.pdf

The fact that the Commission did not prepare a report under Article 126(3) TFEU for Belgium and Italy in spite of the established risk of a significant deviation from the adjustment path towards the MTO was criticised on a number of grounds. Firstly, Article 126(3) TFEU clearly requests the preparation of a report by the Commission if a Member State does not, or is not expected to, fulfil the requirements under the deficit and/or debt criterion. The Commission acknowledged this interpretation yet pointed out that the relevant legal provisions did not set a deadline for preparing the report.

Secondly, the choice of the Commission to address a letter to the Italian authorities rather than prepare a report in accordance with Article 126(3) TFEU raised a more fundamental question about the nature of fiscal surveillance, which generally involves the Council. Commission reports under Article 126(3) TFEU are discussed with the Member States in the Economic and Financial Committee of the Council. By contrast, letters from the Commission are bilateral by nature.

Thirdly, the choice of sending a letter can also be criticised on grounds of equal treatment. In the past, the Commission spontaneously prepared reports under Article 126(3) TFEU whenever the deficit and/or debt criterion were assessed not to be met. Cases in point from the recent past were Finland and Croatia [55][56].

In spring 2018, as part of the European Semester package, the Commission eventually prepared new reports under Article 126(3) TFEU for Belgium and Italy after outturn data for 2017 suggested that both countries had once more not complied with the debt criterion [57][58]. The Commission report on Belgium was not conclusive. It stated that there was no '*sufficiently robust evidence to conclude on the existence of a significant deviation in Belgium in 2017 and over 2016 and 2017 together*'. This statement complemented the inconclusive final assessment of compliance under the preventive arm of the Pact. As indicated in Section 2.2.2, the Commission decided not to ascertain a significant deviation from the required adjustment on account of an apparent uncertainty whether an observed increase in corporate income tax revenues was temporary or permanent.

The Commission report on Italy under Article 126(3) TFEU concluded that the country was compliant with the debt criterion, essentially on account of an assessment of broad compliance with the adjustment path towards the MTO in both 2016 and 2017. The conclusion was reached in spite of the fact that the structural budget balance was estimated to have deteriorated measurably in both years. The Commission assessment took account of the allowances granted under the flexibility and unusual event clauses: 0.83 % of GDP in 2016 and 0.35 % of GDP in 2017 [59].

The Commission assessment of compliance with the debt criterion in spring 2018 raised important issues. Firstly, some Member States in the competent Council committee voiced concerns about the way broad compliance with the adjustment path to the MTO had been used to conclude compliance with the debt criterion. In particular, the Commission attributed a prominent role in its assessment of relevant factors to compliance with the adjustment path to the MTO. However, this approach is not codified in the *Code of Conduct of the SGP*, which instead provides that the Commission report should assess the country's past record of adjustment towards the MTO among other relevant factors. More importantly, critics highlighted that the Commission's approach of focusing on the adjustment towards the MTO rather than the debt rule had effectively hampered debt reduction. Since 2015, the Commission issued four reports for Belgium and four reports for Italy. Each time, the Commission concluded that the debt criterion should be considered as complied with, based on its assessment of relevant factors (i.e. adherence to the MTO or the adjustment path towards it).

Secondly, it is clear from both cases that the Commission's opinions on the draft budgetary plan, which pointed to risks of non-compliance with the provisions of the SGP, were ignored without any consequence. However, this has not served as an aggravating factor, as provided for by Regulation (EU)

(55) Commission Report on Finland of 16 November 2015, prepared in accordance with Article 126(3) TFEU. http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/2015-11-16_fi_126-3_en.pdf

(56) Commission Report on Croatia of 15 November 2013, prepared in accordance with Article 126(3) TFEU. https://ec.europa.eu/transparency/regdoc/rep/1/2013/EN/1-2013-905-EN-F1-1.Pdf

(57) Commission Report on Belgium of 23 May 2018, prepared in accordance with Article 126(3) TFEU. https://ec.europa.eu/info/sites/info/files/economy-finance/com_2018_429_en.pdf

(58) Commission Report on Italy of 23 May 2018, prepared in accordance with Article 126(3) TFEU. https://ec.europa.eu/info/sites/info/files/economy-finance/italy_1263_may2018.pdf

(59) Progress with structural reforms for which an allowance was granted in 2016 is expected to be monitored under the European Semester. The Commission report under Article 126(3) TFEU referred to the 2018 Country Report noting that although the reform momentum had been losing steam, Italy had made some progress in addressing the 2017 country-specific recommendations. However, the Commission made no specific reference to whether progress had been made with the reforms for which the structural reform allowance had been granted in the first place.

473/2013, thus raising questions of credibility of the process [60].

Assessing compliance under the EDP

Following the correction of the excessive deficit by Croatia, Portugal and the United Kingdom, and the Council decisions to abrogate the excessive deficit procedure for these countries in the course of 2017, only two countries remained in EDP: France and Spain. The deadlines for correcting the excessive deficit set by the Council were 2017 and 2018, respectively [61][62].

The Commission assessed the draft budgetary plan of France for 2017 as broadly compliant with the requirements of the SGP while noting that the fiscal effort was expected to fall significantly short of the recommended level. The shortfall emerged from both gauges of the fiscal effort: the change in the structural budget balance (the 'top-down' approach) and the direct assessment of individual measures (the 'bottom-up' approach). Moreover, on the basis of its forecast, the Commission identified risks to the durability of the correction of the excessive deficit. In the absence of new policy measures, the deficit was projected to exceed the 3 % of GDP reference value in 2018. The Commission reiterated these views in the course of 2017 in its regular in-year monitoring.

In spring 2018, the Commission assessed France to have corrected its excessive deficit in a durable manner. The headline deficit for 2017 was 2.6 % of GDP, 0.2 percentage point of GDP below the target recommended by the Council, and it was projected to decline further in 2018 and 2019 [63]. However, the estimated fiscal effort in 2017 of 0.5 % of GDP was below the required effort of 0.9 % of GDP. Moreover, in 2015-2017, the period covered by the Council recommendation, the cumulated fiscal effort was estimated at 0.7 % of GDP compared to the 2.2 % recommended by the Council.

A similar development took place in Spain. Based on its autumn 2017 and spring 2018 forecast, the Commission concluded that Spain would achieve the 2017 target of the headline deficit of 3.1 % of GDP, as recommended by the Council on 8 August 2016 [64]. At the same time, the estimated change in the structural balance (including after adjusting for growth and revenue shortfalls) fell short of the required effort; the bottom-up indicator was met only on a cumulative basis over 2016-2017.

Overall, in 2017 France and Spain continued to follow a nominal strategy. Against the backdrop of a stronger-than-expected economic recovery, the two governments opted once again for a strategy that substitutes politically costly consolidation measures with revenue windfalls. This is an issue that was already highlighted in last year's edition of the EFB annual report.

2.2.4. Overview of the 2017 EU fiscal surveillance cycle

Tables 2.9, 2.10 and 2.11 present all stages of the 2017 fiscal surveillance cycle for all euro and non-euro area countries. The overview is organised around the four key moments in the surveillance cycle:

1. spring 2016, when, in line with the provisions of the SGP, the Council set the budgetary adjustment to be implemented by the Member States in 2017;

2. autumn 2016, when the Commission assessed the draft budgetary plans for 2017 submitted by the Member States, including against the requirements set in spring;

3. 2017, the actual reference period during which the Commission and the Council took additional surveillance steps;

4. spring 2018, when, in light of economic and budgetary outturns, the Commission and the Council assessed the actual performance of Member States against the requirements of the Pact and deliberated on whether new surveillance steps were necessary.

More details on how to read the tables are provided in Box 2.3.

[60] Recital 22 of Regulation (EU) No 473/2013 of the European Parliament and the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area. https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32013R0473

[61] Council Recommendation 6704/15 of 5 March 2015 with a view to bringing an end to the excessive deficit in France, ,. http://data.consilium.europa.eu/doc/document/ST-6704-2015-INIT/en/pdf

[62] Council Decision 11552/16 of 2 August 2016, giving notice to Spain to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit. http://data.consilium.europa.eu/doc/document/ST-11552-2016-INIT/en/pdf

[63] Council Recommendation 6704/15, ECOFIN 177 of 10 March 2015 with a view to bringing an end to the excessive deficit in France, http://data.consilium.europa.eu/doc/document/ST-6704-2015-INIT/en/pdf

[64] Commission Opinion C(2017)8015 final of 22 November 2017 on the 2018 Draft Budgetary Plan of Spain,. https://ec.europa.eu/info/sites/info/files/economy-finance/c-2017-8015-en.pdf

Table 2.9: **Application of EU fiscal rules in the 2017 surveillance cycle — The preventive arm of the SGP (see Box 2.3 on how to read the table)**

	Spring 2016			**Autumn 2016**	**2017**	**Spring 2018**					
	Distance to MTO in 2016 % of GDP	**Country-specific recommendation (CSRs) for 2017**		**Commission assessment of draft budgetary plan (DBP)**	**In-year assessment**	**Ex-post Commission assessment**					**Conclusion of the overall assessment and procedural steps after the reference period**
		Required structural adjustment % of GDP	**Flexibility clauses (granted *ex ante*) % of GDP**			**Observed deviation from the required structural adjustment (or MTO) % of GDP**				**Flexibility and unusual event clauses (granted *ex post*) % of GDP**	
						2017		**2016-17**			
						ΔSB	**EB**	**ΔSB**	**EB**		
BE	-2.3	At least 0.6 Use of windfall gains to accelerate debt reduction	-	Risk of non-compliance	Risk of non-compliance	0.3	-0.4	-0.1	-0.5	Security (-0.02)	Given the high uncertainty on the temporary vs. permanent nature of additional corporate income tax revenues, the Commission was of the view that there were not sufficiently robust evidence to conclude on the existence of a significant deviation over 2016 and 2017 together.
						No conclusion					
BG	-0.8	0.5	-	-	Compliant Fiscal CSR removed: above MTO in 2016	1.9	0.1	1.6	0.1	-	-
						Compliant					
CZ	0.3	-	-	-	Compliant	2.2	1.4	2.0	1.0	-	-
						Compliant					
DK	-0.5	0.25	-	-	Compliant	2.2	1.3	2.0	1.3	-	-
						Compliant					
DE	0.9	-	-	Compliant	Compliant	2.0	1.5	1.8	1.0	-	-
						Compliant					
EE	0.0	-	-	Compliant	Compliant	0.3	0.5	0.6	0.5	-	-
						Compliant					
IE	-1.5	0.6 Use of windfall gains to accelerate debt reduction	-	Broadly compliant	Risk of non-compliance	0.4	-0.4	0.1	-0.4	-	Ireland was assessed to have achieved its MTO in 2017.
						Compliant					

(Continued on the next page)

Table 2.9 (continued)

	Spring 2016			Autumn 2016	2017	Spring 2018					
	Distance to MTO in 2016 % of GDP	Country-specific recommendation (CSRs) for 2017		Commission assessment of draft budgetary plan (DBP)	In-year assessment	Ex-post Commission assessment					Conclusion of the overall assessment and procedural steps after the reference period
		Required structural adjustment % of GDP	Flexibility clauses (granted *ex ante*) % of GDP			Observed deviation from the required structural adjustment (or MTO) % of GDP				Flexibility and unusual event clauses (granted *ex post*) % of GDP	
						2017		2016-17			
						ΔSB	EB	ΔSB	EB		
HR	-0.2	At least 0.6 Use of windfall gains to accelerate debt reduction	-	-	Compliant Remain at the MTO as it was already achieved in 2016	2.5	1.3	in EDP		-	-
						Compliant					
IT	-1.7	At least 0.6 Use of windfall gains to accelerate debt reduction	-	Risk of non-compliance	Risk of non-compliance	-0.5	-0.3	-0.4	-0.1	Refugee (-0.16) Natural disaster (-0.19) carry-over (-0.04)	The deviation not assessed as significant on the basis of both indicators (i.e. the ΔSB was considered to be negatively affected by significant revenue shortfalls).
						Broadly compliant					
CY	0.4	Respect the MTO	-	Risk of non-compliance	Broadly compliant	1.4	-0.8	1.3	0.5	-	Cyprus was assessed to have achieved its MTO in 2017.
						Compliant					
LV	-0.6	Ensure deviation from MTO is limited to the systemic pension and healthcare structural reform allowance	Pension reform clause (-0.6) Structural reform clause (-0.1)	Broadly compliant	Compliant	0.5	-0.2	0.7	-0.2	-	The distance to the MTO remained within the allowed temporary deviation related to the pension and structural reform clause.
						Compliant					
LT	-0.2	Ensure deviation from MTO is limited to the systemic pension reform allowance	Pension refom clause (-0.1)	Risk of non-compliance	Compliant: additional allowance granted ex-ante under the structural reform clause (-0.4). Fiscal CSR revised (structural balance allowed to deteriorate by 1.3)	1.1	0.9	1.1	0.6	-	-
						Compliant					
LU	1.9	-	-	Compliant	Compliant	2.7	0.8	2.2	1.4	-	-
						Compliant					

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Table 2.9 (continued)

	Spring 2016			Autumn 2016	2017	Spring 2018						
	Distance to MTO in 2016 % of GDP	Country-specific recommendation (CSRs) for 2017		Commission assessment of draft budgetary plan (DBP)	In-year assessment	Ex-post Commission assessment						Conclusion of the overall assessment and procedural steps after the reference period
		Required structural adjustment % of GDP	Flexibility clauses (granted *ex ante*) % of GDP			Observed deviation from the required structural adjustment (or MTO) % of GDP					Flexibility and unusual event clauses (granted *ex post*) % of GDP	
						2017		2016-17		Assessment		
						ΔSB	EB	ΔSB	EB			
HU	-1.4	0.6	-	-	Risk of a significant deviation	-1.4	-2.4	-0.7	-1.9	Non-compliant	Security (-0.17) carry-over (-0.08)	Significant deviation. On 23 May 2018, the Commission issued a warning letter under art 121(4) TFEU.
MT	-1.6	0.6	-	Broadly compliant	Compliant. Fiscal CSR removed: above MTO in 2016	3.8	1.0	3.1	1.1	Compliant	-	-
NL	-1.0	0.6	-	Compliant	Fiscal CSR removed: above MTO in 2016	1.1	1.5	1.5	1.1	Compliant	-	-
AT	-0.4	0.3	Refugee (-0.09)	Broadly compliant	Broadly compliant	0.3	0.3	0.2	-0.1	Compliant	Refugee (0.03) carry-over (-0.38)	Austria was assessed to have achieved its MTO in 2017 within the margin of tolerance.
PL	-2.0	0.5	-	-	Broadly compliant	-0.5	-0.5	-0.4	-0.2	Broadly compliant	-	No procedural step taken, since the deviation was not assessed as significant based on both indicators.
PT	-2.5	At least 0.6 Use of windfall gains to accelerate debt reduction	-	Risk of non-compliance	Risk of non-compliance	0.3	-0.5	in EDP		Broadly compliant	-	The deviation not assessed as significant after an update of the expenditure benchmark using the most recent estimates of the medium-term growth potential
RO	-1.8	0.5	-	-	Risk of a significant deviation. In spring, warning on the existence of a significant deviation in 2016 and additional recommendation under the SDP. In autumn, no effective action was taken (1)	-1.7	-3.3	-1.7	-2.7	Non-compliant	-	Significant deviation. On 23 May 2018, the Commission issued a warning letter under art 121(4) TFEU.

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Table 2.9 (continued)

	Spring 2016			Autumn 2016	2017	Spring 2018						
	Distance to MTO in 2016 % of GDP	Country-specific recommendation (CSRs) for 2017		Commission assessment of draft budgetary plan (DBP)	In-year assessment	Ex-post Commission assessment						Conclusion of the overall assessment and procedural steps after the reference period
		Required structural adjustment % of GDP	Flexibility clauses (granted *ex ante*) % of GDP			Observed deviation from the required structural adjustment (or MTO) % of GDP					Flexibility and unusual event clauses (granted *ex post*) % of GDP	
						2017		2016-17				
						ΔSB	EB	ΔSB	EB			
SI	-2.8	0.6	-	Risk of non-compliance	Broadly compliant	0.0	-0.7	-0.1	-0.4	Broadly compliant	-	The deviation not assessed as significant after an update of the expenditure benchmark using the most recent estimates of the medium-term growth potential.
SK	-1.6	0.5	-	Compliant	Broadly compliant	0.4	-0.1	0.5	0.1	Compliant	-	-
FI	-1.1	0.6 Use of windfall gains to accelerate debt reduction	-	Risk of non-compliance	Compliant: allowances granted ex ante under the structural reform (-0.5) and the investment (-0.1) clauses. Fiscal CSR revised (structural balance allowed to deteriorate by 0.5)	1.4	1.1	0.6	0.8	Compliant	carry-over (-0.22)	-
SE	0.5	-	-	-	Compliant	0.0	2.4	2.1	2.6	Compliant	-	-
UK	-2.8	0.6	-	-	Broadly compliant	0.0	-0.2	in EDP		Broadly compliant	-	No procedural step taken, since the deviation was not assessed as significant based on the structural balance pillar.

Notes: (1) Based on 2016 outturn data, Romania was found to be in significant deviation from the medium-term budgetary objective. On 22 May 2017, in line with Article 121(4) TFEU and Article 10(2) of Council Regulation (EC) No 1466/97, the Commission issued a warning to Romania that a significant deviation from the medium-term budgetary objective was observed in 2016.
Source: European Commission.

Table 2.10: **Application of EU fiscal rules in the 2017 surveillance cycle — The corrective arm of the SGP: Countries not in EDP (see Box 2.3 on how to read the table)**

	Autumn 2016		2017	Spring 2018		
	Commission assessment of draft budgetary plan (DBP)		Procedural steps during the reference period	Ex-post Commission assessment		Procedural steps after the reference period
	Deficit Rule	Debt Rule (DR) / Transitional Arrangement (MLSA)		Deficit Rule	Debt Rule (DR) / Transitional Arrangement (MLSA)	
BE	Compliant	At risk of non-compliance with the debt rule	**22/05/2017** – The Commission prepared a report under Article 126(3) TFEU after official data and the Commission 2017 spring forecast suggested that Belgium *prima facie* did not comply with the transitional debt rule in 2016 (the last year of the transition period that followed the abrogation of the previous excessive deficit procedure for Belgium in June 2014). Moreover, the Commission forecast did not expect Belgium to comply with the debt reduction benchmark in 2017. The Commission's assessment of relevant factors stressed that (i) the previously unfavourable but improving macroeconomic conditions made them less of a factor to explain lack of compliance with the debt reduction benchmark; (ii) there was a risk of some deviation from the required adjustment towards the MTO in 2016 and 2017 individually, and of a significant deviation in 2016 and 2017 taken together, which could still be corrected in 2017; and (iii) the implementation of growth-enhancing structural reforms in recent years, several of which were considered substantial and projected to help improve debt sustainability. **The report concluded that the debt criterion should be considered as complied with, provided additional fiscal measures were taken in 2017 to ensure broad compliance with the adjustment path towards the MTO in 2016 and 2017 together.** **27/10/2017 –** The Commission sent a letter to the Belgian authorities following the submission of the DBP for 2018, seeking clarifications on the compliance of Belgium's planned fiscal effort in 2017 and 2018 with the requirements of the preventive arm of the SGP and highlighting a risk of significant deviation. The letter also recalled that Belgium's broad compliance with the preventive arm of the SGP was a relevant factor in the report under article 126(3) TFEU and solicited additional fiscal consolidation measures in 2017. **31/10/2017** – The Belgian authorities replied with a letter. **22/11/2017** - The Commission published its Opinion on the DBP of Belgium. The Commission noted that the DBP did not include sufficient information to assess compliance with the debt reduction benchmark. Based on its own 2017 autumn forecast, the Commission noted that the debt reduction benchmark was not projected to be met in 2017. Moreover, the Commission also pointed to a risk of significant deviation from the required adjustment towards the MTO in 2017.	Compliant	Non-compliant	**23/05/2018 –** The Commission prepared a report under Article 126(3) TFEU after official data and the Commission 2018 spring forecast, suggested that Belgium had *prima facie* not made sufficient progress towards compliance with the debt reduction benchmark in 2017. Moreover, the Commission forecast did not expect Belgium to comply with the debt reduction benchmark in 2018 and 2019. The Commission's assessment of relevant factors stressed (i) the previously unfavourable but improving macroeconomic conditions made them less of a factor to explain lack of compliance with the debt reduction benchmark; (ii) at the moment of the assessment, there was not sufficiently robust evidence to conclude on the existence of a significant deviation in Belgium in 2017 and over 2016 and 2017 together; and (iii) the implementation of growth-enhancing structural reforms in recent years, several of which were considered substantial and projected to help improve debt sustainability. **The report concluded that there was not sufficiently robust evidence to conclude as to whether the debt criterion was or was not complied with. The report underscored though that the fiscal adjustment in 2018 did not appear adequate to ensure compliance with the adjustment path towards the MTO in 2018.**
IT	Compliant	At risk of non-compliance with the debt rule	**22/02/2017** – The Commission prepared a report under Article 126(3) TFEU, after official data and the Commission 2017 winter forecast, suggested that Italy had *prima facie* not made sufficient progress towards compliance with the debt reduction benchmark in 2015. Moreover, the Commission forecast did not expect Italy to comply with the debt rule either in 2016 or in 2017. The Commission's assessment of relevant factors stressed: (i) the unfavourable but gradually improving macroeconomic conditions, including low inflation; (ii) the risk of non-compliance with the required adjustment towards the MTO in both 2016 and 2017; and (iii) the slowdown in the implementation of growth-enhancing structural reforms. **The report concluded that unless additional budgetary measures of least 0.2 % of GDP were credibly enacted by April the debt criterion should be considered as not complied with. The Commission informed that a decision on whether to recommend opening an EDP would only be taken on the basis of the Commission 2017 spring forecast, taking into account outturn data for 2016 and the implementation of the additional fiscal measures of 0.2 % of GDP.** **22/05/2017** – The Commission issued a Recommendation for a Council Recommendation on the 2017 National Reform Programme and a Council opinion on the 2017 Stability Programme of Italy. The Recommendation noted that in April 2017 the Italian government adopted the requested additional consolidation measures of 0.2 % of GDP. **Therefore, the Commission concluded that at that stage, no further steps were necessary for compliance with the debt criterion.** The Commission noted that it would reassess Italy's compliance with the debt criterion in autumn 2017 on budgetary implementation in 2017 and budgetary plans for 2018.	Compliant	Non-compliant	**23/05/2018 –** The Commission prepared a report under Article 126(3) TFEU after official data and the Commission 2018 spring forecast, suggested that Italy had *prima facie* not made sufficient progress towards compliance with the debt reduction benchmark in either 2016 or 2017. Moreover, the Commission forecast did not expect Italy to comply with the debt reduction benchmark in 2018 and 2019. The Commission's assessment of relevant factors stressed (i) the improving macroeconomic conditions no longer explained the large gaps with the debt reduction benchmark; (ii) the ex-post compliance with the required adjustment towards the MTO in 2017; and (iii) some progress in adopting and implementing growth-enhancing structural reforms. **The report concluded that after the assessment of relevant factors the debt criterion should be considered as complied with. The report underscored though that the fiscal adjustment in 2018 did not appear adequate to ensure compliance with the adjustment path towards the MTO in 2018.**

(Continued on the next page)

Table 2.10 (continued)

	Autumn 2016		2017	Spring 2018		
	Commission assessment of draft budgetary plan (DBP)		**Procedural steps during the reference period**	**Ex-post Commission assessment**		**Procedural steps after the reference period**
	Deficit Rule	**Debt Rule (DR) / Transitional Arrangement (MLSA)**		**Deficit Rule**	**Debt Rule (DR) / Transitional Arrangement (MLSA)**	
			27/10/2017 – The Commission sent a letter to the Italian authorities following the submission of the DBP for 2018, seeking clarifications on the compliance of Italy's planned fiscal effort in 2017 and 2018 with the requirements of the preventive arm of the SGP. **30/10/2017** – The Italian authorities replied with a letter. **22/11/2017** – The Commission published its Opinion on the DBP of Italy. The overall assessment pointed to a risk of significant deviation in 2017 and 2018. In its Opinion, the Commission also recalled that compliance with the preventive arm of the SGP was a key relevant factor in the report under article 126(3) TFEU issued on 22 February 2017. **22/11/2017** – The Commission sent a new letter to the Italian authorities recalling that broad compliance with the requirements of the preventive arm of the SGP in 2016 was a condition for not opening of an excessive deficit procedure for the breach of the debt rule in 2015. However, outturn data for 2016 showed that broad compliance was only achieved thanks to the flexibility that Italy was provisionally granted in that year for structural reforms and public investment. Part of that flexibility was made conditional on Italy being broadly compliant with the requirements of the preventive arm in 2017. On the basis of the Commission 2017 autumn forecasts Italy's compliance with the preventive arm seemed to be at risk. Thus the Commission requested clarifications on the reasons for the higher-than-expected deficit in 2017 and further information on Italy's overall strategy to reduce the debt. The Commission also stressed the importance of avoiding backtracking on the important structural reforms, notably as regards pensions. **The Commission noted that it would reassess Italy's compliance with the debt criterion in spring 2018, based on outturn data for 2017, and the 2018 budget to be adopted by the Italian Parliament in December**.			
FI	Compliant	At risk of non-compliance with the debt rule	**22/05/2017** – The Commission prepared a report under Article 126(3) TFEU, after official data and the Commission 2017 spring forecast provided evidence of a *prima facie* excess of the debt-to-GDP ratio exceeding the 60 % reference value in 2016. The report found that in 2016, the breach of the debt criterion was no longer fully explained by debt incurred in the form of bilateral and multilateral support to crisis-hit Member States in the context of safeguarding financial stability in the euro area. At the same time, Finland was expected to comply with the recommended adjustment path towards the MTO in 2017 and 2018. Moreover, the debt corrected for the effects of the cycle was assessed to be just below 60 % of GDP in 2016. The Commission's assessment also stressed that Finland had made some progress in implementing structural reforms, which were expected to contribute to enhancing the economy's growth potential and reducing the risks of macroeconomic imbalances. **The report concluded that after the assessment of all relevant factors the debt criterion should be considered as complied with.** **22/11/2017**– The Commission published its Opinion on the DBP for 2018 of Finland. Based on the DBP for 2018 and the Commission 2017 autumn forecast, the debt reduction benchmark was projected to be met in 2017 and 2018.			

Source: European Commission.

Table 2.11: **Application of the EU fiscal rules in the 2017 surveillance cycle — The corrective arm of the SGP: Countries in EDP (see Box 2.3 on how to read the table)**

	Spring 2016	Autumn 2016			2017	Spring 2018		
	EDP status	Requirements % of GDP		Commission Assessment of draft budgetary plan (DBP)	Procedural steps during the reference period	Ex-post assessment % of GDP		Procedural steps after the reference period
	(deadline)	Headline budget balance	Structural adjustment			Headline budget balance	Change in the structural budget balance	
ES	in abeyance (2018)(¹)	-3.1	0.5	At risk of non-compliance **16/11/2016** – The Commission published its Opinion on the DBP of Spain and a Communication on the assessment of action taken. While acknowledging the no-policy-change nature of the budgetary plan, the Commission's assessment indicated that neither the intermediate headline deficit target, nor the recommended fiscal effort would be achieved. The Commission invited Spain to submit an updated Draft Budgetary Plan for 2017. **09/12/2016** – The Spanish authorities submitted an updated DBP. **17/01/2017** – The Commission published its Opinion on the updated DBP. The Commission concluded that the updated DBP was **broadly compliant** with the provisions of the SGP. While the required fiscal effort was expected to be met in 2017 and in cumulative terms in 2016 and 2017, the 2017 headline deficit target was not projected to be met. The Commission therefore invited the authorities to stand ready to take further measures should fiscal developments indicate a heightened risk of not fulfilling the Council's requirements.	**22/05/2017** – The Commission issued a Recommendation for a Council Recommendation on the 2017 National Reform Programme and a Council opinion on the 2017 Stability Programme of Spain. The cumulative fiscal effort in 2016-2017 was expected to be narrowly ensured, while in 2018, on a no-policy-change basis, the fiscal effort was forecast to fall short of the targets set out in the Council Decision under Article 126(9) TFEU of 8 August 2016. **11/07/2017** – The Council adopted a Recommendation on the 2017 National Reform Programme of Spain and its Opinion on the 2017 Stability Programme of Spain. The conclusions of the Recommendation coincided with those of the Commission's Recommendation.	-3.1	0.3	No procedural step was taken as according to the Commission's assessment of the 2018 stability programme of Spain the deficit outturn for 2017 was 3.1 % of GDP thus fulfilling the headline deficit target set by the Council. **23/05/2018** – The Commission published its Opinion on the updated DBP of Spain. The Commission concluded that the updated DBP was broadly compliant with the provisions of the SGP based on an expected timely correction of the excessive deficit. However, the Commission highlighted that neither the headline deficit target nor the required fiscal effort required by the Council Decision of 8 August 2016 would be met in 2018. The Commission therefore invited the authorities to stand ready to take further measures to ensure that the 2018 budget is compliant with the SGP.
FR	in abeyance (2017)	-2.8	0.9 (²)	Broadly compliant (Based on the headline deficit, which was expected to be below the 3 % of GDP reference value in 2017. The fiscal effort was projected to fall significantly short of the recommended level.)	**11/07/2017** – The Council adopted its Recommendation on the 2017 National Reform Programme of France and its Opinion on the 2017 Stability Programme of France. Based on the Commission 2017 spring forecast, the headline deficit was projected to reach 3.0 % of GDP in 2017, but above the target recommended by the Council. For 2018, under unchanged policies, the headline deficit was projected at 3.2 % of GDP, thus exceeding the Treaty reference value and pointing to risks to a durable correction of the excessive deficit. Moreover, the recommended fiscal effort was not projected to be delivered over the period covered by the EDP; the consolidation strategy pursued by France relied primarily on improving cyclical conditions and a continuation of the low-interest-rate environment. **27/10/2017** – The Commission sent a letter following the submission of the DBP for 2018. The Commission noted that the DBP foresaw a headline deficit of 2.9 % of GDP in 2017, which was above the recommended target of 2.8 % of GDP. **31/10/2017** – The French authorities replied with a letter. **22/11/2017** – The Commission issued an Opinion on the DBP for 2018. The Commission 2017 autumn forecast expected the headline deficit to be at 2.9 % of GDP in 2017. However, France was not expected to deliver the fiscal			**23/05/2018** – The Commission issued a Recommendation under Article 126(12) TFEU for a Council Decision abrogating the Decision on the existence of an excessive deficit. **22/06/2018** – The Council adopted the Decision abrogating

(Continued on the next page)

Table 2.11 (continued)

	Spring 2016	Autumn 2016			2017	Spring 2018		
	EDP status (deadline)	Requirements % of GDP		Commission Assessment of draft budgetary plan (DBP)	Procedural steps during the reference period	Ex-post assessment % of GDP		Procedural steps after the reference period
		Headline budget balance	Structural adjustment			Headline budget balance	Change in the structural budget balance	
HR	In abeyance (2016)		At least 0.6		**22/05/2017** - The Commission issued a Recommendation under Article 126(12) TFEU for a Council Decision abrogating the Decision on the existence of an excessive deficit. **16/06/2017** – The Council adopted the Decision abrogating the Decision on the existence of an excessive deficit in Croatia.			
PT	In abeyance (2016)(3)		At least 0.6	At risk of non-compliance (Risk of significant deviation from the structural adjustment recommended by the Council on 12 July 2016)	**22/05/2017** – The Commission issued a Recommendation under Article 126(12) TFEU for a Council Decision abrogating the Decision on the existence of an excessive deficit. **16/06/2017** – The Council adopted the Decision abrogating the Decision on the existence of an excessive deficit in Portugal.			
UK	In abeyance (2016)(4)		0.6		**22/11/2017** – The Commission issued a Recommendation under Article 126(12) TFEU for a Council Decision abrogating the Decision on the existence of an excessive deficit. **5/12/2017** – The Council adopted the Decision abrogating the Decision on the existence of an excessive deficit in United Kingdom.			

Notes: (1) In August 2016, the Council extended the deadline for the correction of the excessive deficit to 2018 while setting the following annual government deficit targets: 4.6 % of GDP in 2016, 3.1 % in 2017 and 2.2 % in 2018. The targets were consistent, on the basis of the updated Commission 2016 spring forecast, with a deterioration of the structural balance by 0.4 % of GDP in 2016 and an improvement of 0.5% of GDP in both 2017 and 2018. The Council also decided that Spain should use all windfall gains to accelerate the deficit and debt reduction, and should adopt and fully implement consolidation measures for 0.5 % of GDP in both 2017 and 2018 in addition to the savings included in the updated Commission 2016 spring forecast. (2) Council recommendation under Art 126(7) TFEU of 5 March 2015 with a view to bringing an end to the excessive government deficit in France. (3) In August 2016, the Council extended the deadline for the correction of excessive deficit to 2016 and set the annual general government deficit target at 2.5 % of GDP in 2016 (not including the impact of the direct effect of potential bank support). The target was, based on the Commission 2016 spring forecast, consistent with an unchanged structural balance with respect to 2015. (4) In June 2015, the Council extended the deadline for the correction of the excessive deficit of United Kingdom by two years. It recommended headline deficit targets of 4.1 % of GDP in 2015-16 and 2.7 % of GDP in 2016-17, consistent with improvements in the structural balance of 0.5 % and 1.1 % of GDP respectively.
Source: European Commission.

Box 2.3: Reading the overview tables 2.9, 2.10 and 2.11

The overview tables in Section 2.2.4 of this annual report aim to provide a comprehensive view for the reference period 2017 of the status and the various steps under the Stability and Growth Pact of the EU Member States. All overview tables are organised by columns that follow the annual cycle of fiscal surveillance.

Table 2.9. Application of EU fiscal rules in euro area in 2017 — The preventive arm

Column 1 — Distance to MTO: the difference between the country-specific medium-term budgetary objective (MTO) and the structural balance in 2016 on the basis of the spring 2016 Commission forecasts underpinning the July 2016 country-specific recommendations by the Council.

Column 2 — Required structural adjustment: the annual fiscal adjustment in structural budget terms the country is required to deliver. It is defined on the basis of the country's cyclical conditions, while taking into account the sustainability needs of its public finances. This is done on the basis of a matrix ([1]) specifying the required adjustment to the MTO as a function of cyclical conditions and debt sustainability. The matrix envisages a higher fiscal adjustment for countries enjoying favourable economic times, with fiscal sustainability risks or debt-to-GDP ratios exceeding the 60 % Treaty reference value. The required structural adjustment is net of any flexibility clauses granted *ex ante* — see column 3.

Column 3 — Flexibility clauses granted *ex ante*: an allowance for a reduction in the structural adjustment the country is required to deliver, granted for 2017 in the context of the assessment of the Stability and Convergence Programmes in spring 2016. A Member State can be granted flexibility for structural reforms — including the specific case of pension reforms; for investments; or for the impact of adverse economic events outside its control — such as natural disasters or the refugee crisis. For example, the required structural adjustment for Austria of 0.3 percentage point of GDP in 2017 was after the 0.09 percentage point allowance under the refugee clause had been deducted. For a comprehensive presentation of how flexibility is taken into account, see Vade Mecum (2018 edition) Sections 1.3.2.3, 1.3.2.4, 1.3.2.5.

Column 4 — Commission overall assessment of the 2017 draft budgetary plan (DBP): was issued in autumn 2016 in line with Regulation (EU) 473/2013. Every year, all euro area countries submit their DBPs by 15 October except when under a macroeconomic adjustment programme (in our reference period, Greece). They are assessed for (ex-ante) compliance with the provisions of the SGP. The overall conclusion of the Commission can be: compliant, risk of (some) deviation ([2]) or risk of significant deviation. In case of risk of some deviation, the DBP is considered to be 'broadly compliant', while in case of risk of significant deviation, the DBP is considered as non-compliant. For a comprehensive presentation of the assessment of compliance with the preventive arm of the SGP, see Vade Mecum Section 1.3.2.7.

Column 5 — In-year assessment: Commission's assessment of compliance with the preventive arm of the SGP between autumn 2016 and spring 2018. For non-euro area countries, the column reports the assessment of the spring 2017 convergence programmes. It also records procedural or other steps taken under the preventive arm of the SGP between autumn 2016 and spring 2018, including cases of '*unfreezing*'. This is the term used to describe the change of the adjustment requirement to the MTO, as the Member State was found to be closer to its MTO in 2017 (t) than expected in spring 2016 (t-1) when the requirement was set and which, had it been delivered, would have implied an overachievement of the MTO.

Column 6 — Observed deviation from the required structural adjustment (or MTO): presents the observed deviation from the fiscal requirement according to both compliance indicators: (i) the change in the structural budget balance (ΔSB) and (ii) the expenditure benchmark (EB). It includes the deviation in 1 year and on average over 2 consecutive years (i.e. 2016 and 2017). Colours: green, yellow and red, correspond respectively to the indicator pointing to a compliance, some deviation or a significant deviation to the MTO or the required path towards it. The assessment is done by comparing the actual change in the structural balance to the required adjustment path as a reference, including an assessment of compliance with the expenditure benchmark. If both indicators confirm the required adjustment, the overall conclusion is of compliance with the preventive arm. In all other cases, the conclusion will depend on an 'overall assessment', which includes an in-depth analysis of both indicators; see the *Vade Mecum* Section 2.

Column 7 — Flexibility and unusual event clauses granted *ex post*: includes any flexibility clauses that are granted for 2017 in the context of the assessment of the Stability and Convergence Programmes in spring 2018.

Column 8 — Conclusion of the overall assessment and procedural steps after the reference period: records procedural or other steps taken following the spring 2018 assessment. For those cases where the country seems not to have delivered the requirements but no procedural steps to have been taken, an explanation is provided.

([1]) The '*Required Structural Adjustment based on matrix*' is based on the matrix for specifying the annual adjustment towards the MTO under the preventive arm of the Pact, as presented in the Commonly Agreed Position on Flexibility in the SGP endorsed by the ECOFIN Council of 12 February 2016. http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf

([2]) 'Some deviation' refers to any deviation which is not significant, namely below 0.5 – as expressed by Articles 6(3) and 10(3) of Regulation 1466/97.

(Continued on the next page)

Box (continued)

Table 2.10. Application of EU fiscal rules in euro area in 2017 — The corrective arm: Countries not in EDP

Column 1 — Deficit rule: the Commission's assessment of the Member State's 2017 draft budgetary plans ([3]) compliance with the 3 % of GDP deficit criterion in autumn 2016.

Column 2 — Debt rule (DR) / Transitional arrangement (MLSA): Commission's assessment of the country's compliance with the debt criterion. A Member State is considered to be compliant with the debt criterion if its general government consolidated gross debt is below 60 % of GDP or is sufficiently diminishing and approaching 60 % of GDP at a satisfactory pace. For Member States that were in EDP on the date the Six Pack was adopted (8 November 2011), special provisions are applied under a transitional arrangement for the 3 years following the correction of their excessive deficit. For a comprehensive presentation of both cases, see *Vade Mecum* Sections 2.2.1.2 and 2.2.1.3.

Column 3 — Procedural steps taken during the reference period: records procedural or other steps under the corrective arm of the SGP taken between autumn 2016 and spring 2018. For 2017, this column presents Reports on the basis of Article 126 (3) TFEU, which is the first step in the EDP, analysing compliance with the deficit and debt criterion in the Treaty.

Column 4 — Deficit rule: see column 1 of this table.

Column 5 — Debt rule (DR) / Transitional arrangement (MLSA): see column 2 of this table.

Column 6 — Procedural steps after the reference period: see Table 2.9 column 8.

Table 2.11. Application of EU fiscal rules in euro area in 2017 — The corrective arm: Countries in EDP

Column 1 — EDP status (deadline): presents the country's status in the EDP procedure in July 2016; in brackets the deadline set by the Council for the correction of the excessive deficit.

Column 2 — Headline budget balance: the Council recommends to Member States in EDP to deliver annual headline deficit targets in order to ensure the correction of the excessive deficit within a set deadline. This column presents the required headline budget balance for 2017.

Column 3 — Structural adjustment: the required annual improvement in the structural balance consistent with the nominal target recommended by the Council and presented in column 1.

Column 4 — Commission assessment of 2017 draft budgetary plans: see Table 2.10 column 4.

Column 5 — Procedural steps taken during the reference period: covers all steps taken under the corrective arm of the SGP in the period between autumn 2016 and spring 2018. All articles referred to in this column are of the Treaty on the Functioning of the European Union.

Column 6 — Headline budget balance: presents the headline budget balance outturn in 2017 or informs that the excessive deficit has been corrected.

Column 7 — Observed structural adjustment: the estimated structural adjustment delivered in 2017 alongside the corrected figure for unanticipated revenue windfalls/shortfalls and changes in potential growth compared to the scenario underpinning the EDP recommendations. For the latter, see *Vade Mecum* 2016 edition, Annex 5.

Column 8 — Procedural steps after the reference period: see Table 2.10 column 8.

([3]) https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/annual-draft-budgetary-plans-dbps-euro-area-countries/draft-budgetary-plans-2017_en

3. INDEPENDENT FISCAL INSTITUTIONS

Independent fiscal institutions (IFIs) play a growing role in fiscal surveillance in the EU and beyond. Their main task is to critically review budgetary developments and fiscal policy decisions, and in some cases to provide independent advice. Alongside credible fiscal rules, effective IFIs are crucial elements of fiscal frameworks that promote sound fiscal policies and sustainable public finances. This is why in the wake of the 2008-2009 global financial crises, and prompted by EU legislation, most EU Member States established IFIs to monitor compliance with national fiscal rules and produce or endorse official macroeconomic projections.

To underscore their importance for EU fiscal surveillance, this chapter takes a look at IFIs from three different perspectives. Following the approach inaugurated with last year's report, the first section includes the portrait of two national IFIs, namely the British Office for Budget Responsibility (OBR) and the Slovak Council for Budget Responsibility (CBR). The second section offers a horizontal discussion of one of the key principles of effective IFIs, namely access to information. Last but not least, the third section reviews the role played by national IFIs in the implementation of the EU fiscal surveillance framework in 2017.

While the UK is set to leave the EU, the OBR offers insights that transcend the country case and can be of interest to the IFI universe as a whole. It was set up in 2010 by an incoming government determined to unmistakably break with the damaging practice followed by previous executives. More specifically, the OBR can be seen as a strong and uncompromising commitment device to restore the credibility of budgetary plans by fully outsourcing budgetary forecasts to a group of independent experts whose impartiality is beyond doubt. The degree of autonomy originally granted to the OBR in preparing budgetary forecasts is unrivalled in the EU, and the OBR has been helpful in preparing realistic and credible budgetary plans.

Although endowed with a more limited and conventional mandate than the OBR, the CBR is a case worthy of note. The founders of the CBR deliberately followed internationally established recommendations and principles of good practice. As a result, the design and conventions of operation of the CBR are very close to what one could casually describe as the template for effectiveness. While such a template may not be sufficient to secure success, it certainly contributed to the credibility of the CBR. Of particular note are very specific safeguards regarding the financing of the Slovak Fiscal Council and its access-to-information arrangement with the government.

The importance of access to information for IFIs cannot be stressed enough. It is not the only but certainly one of the key factors towards improving the effectiveness of the IFIs in the EU. IFIs can live up to their underlying objective of enhancing the transparency of the budgetary process and in turn the accountability of policy-makers only if governments make available all necessary pieces of information. A strong case can be made for securing access to information via a dual system, i.e. one that combines legal provisions with more practical agreements taking the form of memoranda of understanding.

Turning to the 2017 fiscal surveillance cycle of the EU, information collected via a dedicated questionnaire underscores the added value of domestic IFIs but also remaining limitations. The focus is on IFIs in countries for which the Commission had identified in autumn 2016 significant fiscal risks for 2017. To start with, the analysis confirms a considerable degree of heterogeneity across countries in terms of tasks, operational conventions and political constraints. A given budgetary risk led to different reactions depending on the scope of the IFI's mandate and its actual degree of independence. Secondly, even if an IFI was vocal about risks, follow-up by governments could not be taken for granted or may have been muted. While this is an inevitable limitation implied by the advisory role of fiscal councils, comply-or-explain provisions or different channels of communication can make a difference. In particular, the tendency of the fiscal surveillance framework to take the form of more direct negotiations between the Commission and the Member States concerning the application of flexibility provisions, risks marginalising IFIs as they do not participate in those negotiations. Third, there are obvious overlaps and interdependencies between the EU level of fiscal surveillance and the activities of domestic IFIs. National IFIs were, among other reasons, established on the premise that their domestic roots would enhance ownership of and compliance with EU fiscal rules, to the extent that they are duplicated in national fiscal rules. At the same time, experience shows that the assessments of budgetary risks by the European Commission and domestic IFIs do not necessarily converge, giving rise to strategic considerations of whose voice will carry more weight with the national government and the impact on credibility in the event of an open confrontation of views.

3.1. TWO ILLUSTRATIVE CASES: THE UK AND SLOVAKIA

Since 2010, and as part of the new approach on fiscal governance in the European Union, IFIs have been created in virtually all Member States to promote budgetary discipline and thus the long-term sustainability of public finances ([65]). A growing part of the literature has subsequently tried to analyse the effectiveness of these institutions in their role. Following the approach established in the EFB's first annual report, this section takes a closer look at two IFIs. The objective is to draw possible lessons for other EU IFIs and to share best practices.

Several organisations have developed databases and indices to measure the key characteristics of IFIs. Three main indices can be highlighted: the scope index of fiscal institutions (SIFI) published by the European Commission, the IMF's signal enhancement capacity index (SEC), and finally the OECD's index of IFI independence. The first focuses on the scope of responsibilities and tasks assigned to individual councils in the EU ([66]), the second gauges the capacity of fiscal councils to inform the general public about fiscal policy ([67]) and the third the degree of independence ([68]).

In the latest available SIFI (2016), the OBR came first in the ranking with a score of 77 out of 100, while the CBR was close to 45, still below the average of 47.5 points. In the 2017 SEC index, the OBR and CBR ranked first and fifth respectively when considering only EU members. Finally, according to the 2017 OECD's independence index, the OBR ranks first and the CBR eighth. Therefore, the OBR consistently ranks at the top in all three indices, whereas the CBR is gradually moving towards the top part of the ranking.

3.1.1. The Office for Budget Responsibility in the United Kingdom

The OBR was created in 2010 because of a particular need to '*address past weaknesses in the credibility of economic and fiscal forecasting and, consequently, fiscal policy*' ([69]). In the 2000s, fiscal forecasts published by the Treasury were regarded as too optimistic, and the authorities were seen as exploiting their prerogative of not only deciding but also making discretionary changes retroactively to the starting and end dates of the economic cycle over which budgetary targets were judged. The fiscal forecasts were the formal responsibility of the Chancellor of the Exchequer, who was entitled to adopt any figures he wanted, but there was a widespread perception that they were more upbeat than they would have been had Treasury civil servants been left to produce them on their own. As for the methodology, the forecasts were undertaken following a somewhat backward-looking approach; this increased the risk of potentially abrupt revisions during the budget year. Finally, fiscal deficits and debt were not reduced as decisively as in most other industrial countries in the years prior to the crisis, and in its aftermath they systematically increased ([70]).

These perceptions and developments led to a loss of credibility for the government's fiscal management and the general conviction that official forecasts were politically motivated and thus carried an intrinsic positive bias. For these reasons, the incoming coalition government opted for the creation of an independent fiscal institution that, among other duties, would be in charge of producing the official forecasts for the economy and public finances, with the government no longer publishing any forecasts of its own. This specific part of the mandate points to the heterogeneity among IFIs. Thus the official forecasts produced by the OBR need to encapsulate the government's policy decisions, while at the same time being perceived as independent.

More broadly, the OBR is legally regulated by the Budget Responsibility and National Audit Act of 2011 with the role '*to examine and report on the sustainability of the public finances*'. The specific duties of the OBR are: (i) to produce the official forecasts for the economy and public finances (twice a year); (ii) to assess whether the government has met its fiscal targets; (iii) to examine the fiscal impact of the measures announced in the budget bill or autumn statement; and (iv) to analyse the strength of the public sector balance sheet and the long-term fiscal sustainability ([71]). Since its creation, the OBR's mandate has been widened to include an annual

([65]) The literature on IFIs originated in the 1990s. See Wren-Lewis (1996, 2003), Calmfors (2003, 2005, 2010), Jonung and Larch (2006), Kirsanova et al (2007), Debrun et al. (2013), Horvath (2018).

([66]) The index encompasses six elements related to the role of IFIs: (i) the monitoring of fiscal policy and rules; (ii) macroeconomic forecasting; (iii) budgetary forecasting and policy costing; (iv) sustainability assessment; (v) promotion of fiscal transparency; and (vi) normative assessments.

([67]) Beetsma and Debrun (2016).

([68]) OECD IFI Database (2017). The index covers four dimensions: (i) leadership independence; (ii) legal and financial independence; (iii) operational independence; and (iv) access to information and transparency.

([69]) HM Treasury (2014) Charter for Budget Responsibility, ch.2.2, https://www.gov.uk/government/publications/charter-for-budget-responsibility-march-2014-update

([70]) OECD (2016).

([71]) Other documents that include the formal rights and responsibilities of the OBR are: (i) the Charter for Budget Responsibility, in which the government sets out its approach to fiscal policy and management of public finances, (ii) the Framework document that gives greater detail about governance and management arrangements and (iii) a Memorandum of Understanding between the OBR and various government entities specifying working relationships.

assessment of the outlook for welfare spending, a biennial report on fiscal risks (to which the government is legally required to respond) and regular forecasts for tax receipts devolved to the constituent nations of the UK.

For all of the above, the OBR has the legal right to draw on the institutional capacity of the government to provide detailed evidence of individual tax or spending forecasts and measures. The government conducts the costing for the proposed measures, which the OBR scrutinises and to which it suggests amendments during the budget planning process. At the end of this process, the government decides what costing to publish in its own budget documents, but — knowing that any disagreement would be public — to date it has never published an estimate different from that which the OBR has chosen to assume for the purposes of its forecast. The right to draw on civil service expertise across government is highly important, especially in the production of the budgetary forecasts, which involves a vastly disaggregated process that tends to be resource-intensive ([72]). In practice, the OBR's role as monopoly provider of the official fiscal forecast has helped it avoid the difficulties some fiscal councils have faced in securing access to official information, as creating difficulties for the OBR in this regard would make the process of budget preparation more difficult and unpredictable for the government itself.

The main challenge that emanates from the legislation regulating this institution comes precisely from the fact that, to fulfil its duties, the OBR needs to maintain constant contact with fiscal authorities — especially in the weeks running up to budgets and other fiscal events — and this may put its independence into question. This close relationship is particularly essential when gathering the information and data needed to perform the Office's mandate.

Four characteristics are intended to safeguard the OBR's independence. Firstly, the OBR is fully transparent about all its substantive interactions with diverse public officials during the forecasting and costing process ([73]). Information on these interactions is timely published on the institution's official website.

Secondly, the OBR operates on a multiannual budget that has the advantage of being fully transparent, helping to safeguard against political interference. The multiannual budget is agreed with the Treasury, which hosts a specific budget line for the Office. In 2017, its annual budget was slightly over EUR 3 million, the fifth largest budget among European IFIs in 2017 ([74]).

Thirdly, the competence and expertise of staff enhances the external perception of independence. This is particularly important in the initial phase of the development of an IFI, when the confidence in the output produced by such an institution is firmly tied up to the reputation of its senior leadership team and competence.

Finally, while the OBR has a dual accountability to the UK Parliament and the government, neither of these bodies has the right of direction over the Office's analysis. At most, they can request additional analyses and it is the OBR's prerogative to decide whether to comply with such requests or not ([75]).

A series of mechanisms were put in place to ensure a proper supervision by Parliament and help protect the Office's independence. Parliament examines the OBR's budget (via the National Audit Office), and the Treasury Select Committee (TSC) of the House of Commons has the right to veto any appointments or dismissals of the members of the Budget Responsibility Committee (BRC), which leads the OBR. Furthermore, the OBR must send all its reports to Parliament after publication, and its staff must answer parliamentary questions and appear before parliamentary committees. In particular, members of the BRC appear before the TSC to be questioned about forecasts, and Parliament requires the OBR to evaluate the accuracy of its forecasts each year in October ([76]). Finally, all responses to parliamentary questions must be published by the OBR to help enhance the transparency of the Office.

The OBR is also subject to external and Treasury reviews. The first external review was delivered in 2014 and concluded that '*the OBR [had] succeeded in reducing the perception of bias in fiscal and economic forecasting and [had] increased the transparency of its products*' ([77]). The review also acknowledged that these improvements were mainly due to the leadership of the BRC and the capability of the institution's staff. The 2015 HM Treasury review praised the improvements derived from the creation of the

([72]) The OBR has '*the right of access to all government information which it may reasonably require for the performance of its duty*'. The OBR is also '*entitled to require from any person holding or accountable for any government information any assistance or explanation which the Office reasonably thinks necessary for that purpose*' (Budget Responsibility and National Audit Act, 2011).
See https://www.legislation.gov.uk/ukpga/2011/4/contents.

([73]) Interactions are mainly with the HM Treasury, HM Revenue and Customs, and the Department for Work and Pensions.

([74]) OECD IFI Database (2017).

([75]) OECD (2016), OECD Journal on Budgeting, Volume 2015 Issue 2, OECD Publishing, Paris.

([76]) See the 2017 Forecast evaluation report by the OBR at http://obr.uk/fer/forecast-evaluation-report-october-2017

([77]) See the 2014 External review of the OBR at http://obr.uk/docs/dlm_uploads/External_review_2014.pdf

Office, in line with the 2014 external review ([78]). It was intended to assess the effectiveness of the Office in enhancing fiscal credibility and to consider ways to strengthen it. The list of recommendations touched upon several important areas such as legislation, the operational framework, forecast performance, transparency and accessibility of information.

The OBR was also externally reviewed in the IMF's Fiscal Transparency Review of the UK in November 2016. The IMF concluded that the depth and breadth of its economic and fiscal analysis '*can be considered as best-practice, and could be used as a benchmark by other advanced countries*' and that '*while it is still relatively early in its track record, the OBR's forecasting record indicates a lower degree of bias than under the Treasury forecasting regime*'.

Some tentative lessons can be drawn from the OBR. First, the institutional role and the structure of an IFI depend significantly on the public perception and particular events that preceded the establishment of the institution. The distinctive features of the OBR were therefore calibrated to account for the ever-increasing recognition of the past deficit biases and adapted to fit in the national institutional environment, where usually the Executive is powerful relative to Parliament and the Treasury powerful relative to the rest of the Executive in fiscal policymaking. Furthermore, the boundaries of the OBR's mandate were influenced by the *a priori* electoral discussions on the size and composition of the planned fiscal consolidation. The incoming coalition hoped that the newly created OBR's assessment of the fiscal position that it had inherited would strengthen its argument that consolidation was necessary.

Second, recent experience has shown that IFIs can only achieve credibility through a comprehensive policy of openness and transparency ([79]). Full transparency in their work and the way they conduct their operations provides IFIs with the most significant safeguard of their independence and enables them to foster institutional trust and credibility with the public.

Third, in their initial phase of development, the confidence in the products released by IFIs is firmly tied to the reputation of its senior leadership team and to the competence of its supporting staff rather to than its legal bedrock ([80]). The reviews of the OBR so far have recognised that stakeholder confidence was principally ascribed to these features. The OBR has also managed to expand its influence by using an effective communication strategy and by fostering the goal of reaching out to a broader audience, beyond the expert fiscal community. Remarkably, the OBR has retained, in the contentious environment of the 2016 referendum on UK membership of the EU, a high degree of public trust in its ability to provide objective assessments of the macroeconomic outlook and public finances.

3.1.2. The Council for Budget Responsibility in Slovakia

The CBR was envisioned for the first time by Horvath and Ódor (2009) when the dislocations caused by the post-2007 financial and economic crisis had given rise to calls for a new approach to public finances. In 2011, a cross-party committee was established to pin down the idea of an independent assessor. In that same year, the Slovak Parliament approved the constitutional Fiscal Responsibility Act by an almost complete majority ([81]). The law was developed in compliance with the Treaty on Stability, Coordination and Governance (TSCG), an intergovernmental agreement involving most EU countries to promote domestic fiscal rules and IFIs. The law sets out or envisages specific elements for the national fiscal framework: (i) constitutional debt limits; (ii) expenditure ceilings; (iii) stronger fiscal rules for local governments; and (iv) greater fiscal transparency overall. Since its creation in 2012, the CBR has acted as a watchdog to enforce the strengthened fiscal framework.

The references for establishing the CBR were the fiscal councils in the Netherlands, Sweden and Hungary. The initial idea was to set the CBR under the umbrella of the National Council, Slovakia's unicameral parliament. However, after the Hungarian government replaced the previously existing IFI with a much weaker one in 2011, the decision was made to protect the CBR from political interference by providing financing through the budget of the central bank. To avert monetary financing, the Central Bank of Slovakia has the right to ask the government for reimbursement. The 2011 Constitutional Law of Budget Responsibility envisages an overall expenditure ceiling of EUR 2 million. This limit has proven sufficient to meet the CBR's needs; for example, total expenditure in 2017 was EUR 1.1 million.

The four primary functions of the CBR, as outlined in the 2011 law, are: (i) to evaluate the implementation of fiscal rules and transparency rules; (ii) to report on long-term fiscal sustainability; (iii) to assess legislative proposals (on a voluntary basis); and (iv) to monitor and evaluate the budgetary targets. On top of that, the CBR publicly assesses the balanced budget rule introduced in 2014 as an implementation of provisions of the TSCG.

([78]) See the 2015 HM Treasury review of the OBR at https://www.gov.uk/government/publications/hm-treasury-review-of-the-office-for-budget-responsibility

([79]) Jankovics and Sherwood (2017).

([80]) Kopits (2011) identifies the competence of supporting staff as one of four main features of successful IFIs, together with independence, non-partisanship and accountability to the legislature.

([81]) Constitutional Act No 493/2011 on Fiscal Responsibility.

The CBR does not provide normative commentaries on the merits of economic policy, the nature of its work being descriptive. Its functions are both forward-looking when analysing long-term fiscal sustainability and the draft budget, and backward-looking when assessing the government's compliance with fiscal and transparency rules ([82]).

The CBR has no forecasting responsibilities; two other bodies were established for this purpose: the Committee on Tax Revenue Forecasts and the Macroeconomic Forecasting Committee. These committees are advisory bodies to the Minister of Finance and in charge of producing their forecasts at least twice a year as a basis for preparing the budget. Therefore, the CBR is left with a narrower but also more flexible mandate than other European IFIs ([83]).

In terms of internal organisation, the Council's Board has three members: one chair and two ordinary members. They are appointed for a non-renewable seven-year term and have the status of public officials. The Board is supported by a secretariat with a staff of 15.

To fulfil its mandate, the CBR has the right to fully access the necessary data and information from government bodies. There are no formal restrictions on its right to receive information to deliver on its mandate, although in practice, for most IFIs, the government entities have a certain degree of discretion over the details of the information provided and the time of delivery. The right to access information is ensured via a set of memoranda of understanding (MoU) with various government entities and the central bank, which ensures smooth cooperation. Of note, the CBR has direct access to the main fiscal databases maintained by the Ministry of Finance, the State Treasury and the Financial Administration. Agreements with some important counterparties (most notably the Statistical Office) are still missing.

To guarantee transparency, the CBR must, by law, make all of its reports public and is also required to publish the methodology and assumptions used for the analysis of fiscal sustainability on its website. Also, the datasets, procurement information, contracts and any other indirect but relevant information are made available to the public.

([82]) Sanctions related to a breach of the debt limit by the government are triggered automatically after an official publication of the debt level by the Statistical Office.

([83]) Currently, the CBR holds the status of an observer at the Macroeconomic Forecasting Committee, and the Secretariat of the CBR is a regular member of the Tax Revenue Forecasts Committee.

Even though no systematic peer review was envisioned for the CBR in its original regulation, the CBR took the initiative later on to create an advisory panel to provide sound and objective advice on methodological issues to add to the credibility and rigorousness of the institution.

Looking into the setup and activity of the CBR, some tentative lessons can be drawn. First, the design of an IFI should adhere as closely as possible to the internationally recognised practices for IFIs. Operating under these defined standards, such as the OECD principles, provides the young IFI with legitimacy and credibility in the eyes of national stakeholders who then have greater confidence in the activities performed by the CBR ([84]).

Second, the financing arrangements of IFIs should be specific to the institutional culture of each Member State in order to better protect their independence. In this sense, the financing of an IFI through the budget of the central bank provides a long-lasting and robust assurance of its independence. The CBR has scored at the top of the ranking of politically independent institutions in Slovakia, ahead of the Constitutional Court and the National Bank of Slovakia (INEKO, 2018).

Third, an IFI delivers better on its multiple functions if the access to information is ensured in real time and covers all the relevant areas. For such access, bilateral agreements with relevant counterparties have proven to be essential in the case of the CBR.

3.2. THE ACCESS-TO-INFORMATION PRINCIPLE

To be effective and enduring, IFIs must have access to all relevant information held by public authorities. With this in mind, the principle of access to information was introduced via the Commission common principles accompanying the TSCG ([85]). According to these principles, IFIs have the right to request and receive information needed to fulfil their mandate. Furthermore, the OECD acknowledges this right as one of the leading principles that promote effective IFIs ([86]). All IFIs, including those with large resources, need timely access to relevant government and official information, such as data, methodology and other documents. Ensuring unhampered access or the free right to request the appropriate information is a *sine qua non* condition for all EU IFIs to be more effective. Additionally, access to information is also one of the

([84]) The principles are presented in OECD (2014).

([85]) https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52012DC0342

([86]) See OECD Principle 6 for Independent Fiscal Institutions.

primary safeguards for the functional independence of an IFI vis-à-vis government.

IFIs use three main channels to secure their access to information:

- the legal basis — in a broad sense, including the Constitution, organic laws, statutes of IFIs and simple annotations to law articles, depending on the country — giving effect to access to information directly from public counterparts or other bodies;

- through MoUs or cooperation protocols on information-sharing between the IFI and each government ministry, department or agency; these agreements, which may come on top of the legal basis, include details about the process and deadlines to be observed for receiving the necessary information;

- by means of informal contacts for sharing relevant information.

The various arrangements in the 22 Member States that are bound by the Fiscal Compact, the fiscal chapter of the TSCG, are reported in Table 3.1.

Legally, a majority of government entities in the EU provide their IFIs with unlimited access to all relevant information necessary to perform their functions, especially when it comes to assessing budgetary forecasts (including methodologies and assumptions used) ([87]). In addition, some central banks (as in the case of Finland) are required to supply information to their IFIs.

However, the extent to which access to information is underpinned by a broad legal basis is not always a good indicator of the ease with which IFIs actually obtain the necessary information. In Spain, for example, the law establishing the Independent Authority of Fiscal Responsibility (AIReF) laid down widespread legal protocols for accessing information. However, the implementing protocols that followed reduced the degree of information that the AIReF was entitled to receive ([88]). Consequently, in May 2016, the AIReF filed a case against the central government (OECD, 2017; Escrivá et al, 2018). In March 2018, a decree removed many of the limitations, and AIReF is currently in the process of agreeing on a MoU with the Ministries of Public Finances and of the Economy to ensure a smooth flow of information ([89]). In the case of Finland, the IFI is equipped with instruments to enforce sanctions in case of non-compliance by the government.

In Luxembourg, the National Council of Public Finance has set up its informal relationship for sharing information with government entities based on goodwill. In some cases, IFIs have no explicit statutory guarantees or MoU, nor specific restrictions, to secure their access to information. However, in these countries, there is a clear understanding that the respective IFIs need to be provided with the relevant data necessary to discharge their functions.

Table 3.1: **Arrangements for access to information across EU IFIs**

Legal basis	BE[(1)], DE, EE, IE, EL, ES[(2)], FR, IT, CY, LV, LT, LU[(3)], MT, NL, AT, PT, SI, SK, FI, BG, DK, RO
Additional MoU / cooperation protocols	[BE[(4)]] IE, ES[(5)], IT, LV, NL , SI, SK

Notes: (1) Only if the correction mechanism is activated. (2) Restricted by numerous exceptions until March 2018. (3) Right to require the hearing of public administration representatives to acquire information. (4) In the future, the High Council of Finance could participate in an existing protocol. (5) Under discussion.
Source: European Fiscal Board and European Commission (2018b).

Access to government information by IFIs is subject to a vast array of legal limitations in most Member States. These restrictions cover protected information on national security, tax returns, legal proceedings, and banking. According to the OECD principles, these restrictions should be adequately accounted for in the legislation.

As a demonstration of their goodwill, governments should make relevant inputs available to IFIs free of charge. If allowing cost-free access is not feasible, the IFIs should be provided with an adequate multiannual budget to cover such recurring costs (e.g. for actuarial services) ([90]).

Experience from across the EU has shown that most of the IFIs experienced an improvement in the flow of information from the central government level in 2016 compared to the year before (Jankovics and Sherwood, 2017). However, the data on budgetary procedures at the non-central government level (e.g. social security and state-owned enterprises) is still scarce. The same goes for the methodological details on how the government performs the costing of its policy measures.

Despite the importance and effectiveness of informal working relationships between the IFIs and governments on granting access to appropriate

([87]) See for example Italy, Slovakia, Portugal, Lithuania, Latvia, and Estonia.
([88]) This situation was acknowledged by the European Commission (2017) in its report on the transposition of the Fiscal Compact.
([89]) See AIReF's press release of 15 March 2018 on the decree: http://www.airef.es/documents/10181/745524/2018+04+06+Notadeprensaestatuto_EN.pdf/
([90]) See OECD (2014), page 3.

information, it is desirable that such relationships be complemented by a dual pledge system. This system would entail that the access is codified in legal provisions and reinforced through specific mechanisms with all levels of government. The advantage of such a system is that discretion of the government in ensuring access to information is significantly reduced. The existence of formal corrective instruments that could be activated in case of disputes would also make access to information easier.

3.3. THE ROLE OF IFIS IN THE 2017 EU FISCAL SURVEILLANCE CYCLE

This section assesses the role played by national IFIs in the 2017 fiscal surveillance cycle. It first analyses their role in producing or assessing official forecasts; it then assesses whether they identified risks to budgetary targets, made any recommendations in this regard and had any impact. It mainly focuses on the seven euro area countries for which, in autumn 2016, the Commission concluded that their 2017 draft budgetary plans (DBPs) risked not complying with the obligations under the SGP. The seven countries are Belgium, Italy, Cyprus, Lithuania, Portugal, Slovenia and Finland. The analysis largely draws on replies to a dedicated questionnaire circulated by the EFB in early 2018. The analysis also covers two non-euro area Member States — Hungary and Romania — for which the Commission opened a significant deviation procedure in spring 2018 after having ascertained non-compliance with the requirements of the preventive arm in 2017.

While all EU IFIs share the same goal of fostering fiscal discipline, in practice they are not identically mandated nor equipped to fulfil this role. Their tasks have been defined in several legal documents at the EU level and made operational with national legal instruments ([91]). The tasks include monitoring compliance with national fiscal rules and producing or endorsing the macroeconomic projections underpinning the budget. The EU legislation, however, sets only minimum requirements, on the basis of which Member States can freely design their own institutions (Jankovics and Sherwood, 2017). The portraits depicted in the EFB's 2017 annual report and in Section 3.1 of this chapter show the importance of country-specific contexts in explaining the diversity of IFIs.

The IFIs' replies to the EFB questionnaire confirm substantial differences across national institutional setups. The main differences include the IFIs' role in macroeconomic projections, the fiscal rules against which they assess compliance, the timing of assessment, and their formal means to influence the draft budgets and their implementation — but also the constraints that they face.

A first main characteristic that differs among IFIs is their role in preparing the macroeconomic forecasts underpinning the budget. In Belgium and Slovenia, a separate IFI — the Federal Planning Bureau and the Institute of Macroeconomic Analysis and Development, respectively — is in charge of producing the forecasts. As a result, the 'Public sector borrowing requirement' section of Belgium's High Council of Finance (HCF) and Slovenia's Fiscal Council are not mandated to assess or endorse the macroeconomic forecasts ([92]). In the other euro area countries under consideration, the IFIs assess and/or endorse the government's own forecasts. With the exception of Italy, all found that the governments' macroeconomic scenarios for 2017 were plausible.

In Italy, the Parliamentary Budget Office (PBO) did not endorse the government's policy macroeconomic scenario in autumn 2016, as it found the GDP growth projections too optimistic. The divergence between the government and the PBO was due to a different quantification of the impact of budgetary measures. This is why the PBO only endorsed the government's trend scenario, constructed on a no-policy-change assumption, but not the policy scenario, which included the measures provided for in the government's plans. Following a parliamentary hearing, the government was forced to use a more conservative approach in designing its policy scenario, and on 17 October 2016, the PBO endorsed the forecast for 2017 ([93]). Of note, in spring 2016 the PBO had already flagged that the government's projections underpinning the stability programme were on the optimistic side, while the Commission found them plausible at the time (see Section 2.2.1).

A second major difference among IFIs' mandates is whether they assess compliance with EU fiscal rules, national fiscal rules or both. In most of the countries under consideration, IFIs are not required to assess

([91]) The EU documents include Council Directive (EU) 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States (https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32011L0085), the Fiscal Compact (https://www.consilium.europa.eu/media/20399/st00tscg26_en12.pdf), and 'two-pack' Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area (https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32013R0473).

([92]) While not assessing the current forecasts, the Slovenian Fiscal Council will be mandated from 2020 on to conduct an ex-post assessment of the accuracy of the IMAD's forecasts.

([93]) Endorsement letter of 17 October 2016, http://en.upbilancio.it/wp-content/uploads/2016/10/Lettera-validazione-QMP-DPB-2017_EN.pdf.

compliance directly with the SGP but rather with national fiscal rules. Since national rules replicate more or less closely the EU rules, the assessment can be identical to, or complemented by, an assessment against the EU rules. In Cyprus, for instance, the national legislation makes specific reference to EU regulations and directives. In Slovenia, the legislation does not define whether the assessment of compliance is conducted against EU or national rules; the set of applicable rules depends on whether the MTO has been reached ([94]). The situation in Belgium is more complex. The HCF first issues guidance on a budgetary trajectory for the general government that aims to ensure compliance with the EU fiscal rules, and on how to allocate this trajectory to the various layers of government. On this basis, all government levels are then supposed to agree on national and sub-national targets, and it is against these targets that the HFC ultimately assesses compliance.

When assessing compliance, IFIs do not all intervene at the same stage of the surveillance cycle and they do so more or less frequently: it can be in spring or in autumn, and *ex ante*, in-year or *ex post*. In 2017, the impact of their recommendations for corrective measures, if any, remained limited, in particular due to institutional and political constraints.

The Italian PBO provides an example of a potentially influential IFI, although its actual impact on the 2017 budget proved limited. The PBO assesses risks to budgetary plans several times: twice a year (in spring and autumn) and on an *ex ante*, in-year and *ex post* basis. Its reports are published and presented in the Italian Parliament. The PBO does not have a mandate to issue direct recommendations to the government on measures needed to comply with the fiscal rules; nonetheless, in case of significant diverging opinions between the government and the PBO, the Finance Ministry can be asked, upon request of only one third of the members of the parliamentary budgetary committees, to explain the differences in a public hearing. This is in line with the comply-or-explain principle that the EFB discussed in last year's annual report. For 2017, however, the parliamentary budget committees did not activate the comply-or-explain principle, although the PBO had repeatedly flagged risks of non-compliance with the required structural effort and the debt rule in several consecutive reports in 2016 and 2017. This is partly because the Italian Parliament was aware, through the government's fiscal planning documents but also informally and through the media, of ongoing discussions between the government and the Commission towards more flexibility in the EU fiscal rules, to which Italy's national rules are closely linked. For the same reason, the Parliament approved the government's fiscal plans that postponed the achievement of the MTO.

In Belgium, the HCF is in a nearly opposite situation, as it steps in at the beginning and end of the surveillance cycle. After issuing its initial guidance on the budgetary path, it intervenes via its *ex post* assessment in July t+1. At the time of the *ex post* assessment, it theoretically has a powerful tool at its disposal, as it can trigger a correction mechanism if it identifies a significant deviation from the national or sub-national targets ([95]). This is, however, only possible if the various government levels previously reached an agreement on targets. For 2017, as in previous years, no consensus was reached, and the HCF could only conduct a theoretical assessment of compliance in its July 2018 report — without any formal power to identify a significant deviation or to activate the correction mechanism. In addition, it is at the discretion of the HCF to monitor progress with targets during the surveillance cycle, signal potential risks and issue in-year recommendations; but this is conditional on an agreement on targets among the government levels. In 2017, for lack of agreement, this was not possible either.

In three other euro area countries for which the Commission had identified risks of non-compliance in autumn 2016, the IFIs issued consistent assessments, but without triggering any decisive recommendations.

- In autumn 2016, Portugal's Public Finance Council pointed to risks regarding both the level and change in the structural balance in 2017, but did not issue any public advice to the government ([96]).

([94]) The required structural effort is defined in line with the SGP until the MTO is reached.

([95]) As per the Fiscal Compact, Italy also has an automatic correction mechanism on the structural balance that the government must activate in case of a significant deviation observed with ex-post data. The PBO carries out assessments related to the correction mechanism and presents them to Parliament or the general public. Until 2016, ex-post data on the structural balance did not show a significant deviation from requirements, at least according to the Commission's more flexible interpretation of the fiscal rules. Therefore, the mechanism was not activated. For 2017, ex-post data indicated a significant deviation and the PBO reported on this to Parliament during the hearing on the 2018 Economic and Financial Document (EFD), Italy's medium-term fiscal planning document. However, the trend fiscal scenario published by the outgoing government in the EFD showed that the deviation would be corrected at unchanged legislation during the planning horizon of the document.

([96]) Some IFIs may be reluctant to issue public advice because of incentives: they need to issue their opinions ahead of the Commission, i.e. without having the full set of technical information provided by the Commission and necessary to assess compliance. If the IFI makes strong recommendations but the subsequent assessment by the Commission differs from that of the IFI only because of revised data, this may be detrimental to the IFI's reputation.

- Also in autumn 2016, Finland's National Audit Office signalled risks of non-compliance with the preventive arm and recommended taking additional measures, but this proved unnecessary when updated data came in and suggested that the improvement in the macroeconomic environment was sufficient to ensure compliance.

- In Slovenia, the fiscal council had not yet been established in autumn 2016, and it could only mention risks and recommend an additional structural effort shortly after it was set up in March 2017. However, the fiscal council faced some practical issues with the government, which hindered its assessment and limited its impact. In particular, some data needed to calculate compliance with the expenditure benchmark were missing in the first draft stability programme assessed by the fiscal council; more general issues of data availability were subsequently settled in dedicated MoUs. Moreover, the government disagreed with the fiscal council on the coverage of the national fiscal rule, arguing that the domestic legislation did not explicitly require the government to follow the expenditure benchmark nor the debt rule until the MTO was reached, and that the domestic legislation did not define a pace of reduction for the structural deficit.

The fiscal council in Cyprus did not identify any risks with regard to the SGP for 2017. In Lithuania, the Budget Policy Monitoring Department identified a risk that the structural deficit could slip beyond the MTO but did not recommend any corrective measures, as this is not within its mandate.

As non-euro area Member States are not required to submit draft budgetary plans, IFIs could only assess risks to compliance in 2017 on the basis of the draft budget laws.

- In Romania, the fiscal council had already been critical of the government's draft 2016 budget which led to the first significant deviation procedure (see Subsection 2.2.2). In February 2017, it again issued a negative opinion on the draft 2017 budget, as it '*deviate[d] deliberately and substantially from the fiscal rules imposed by both national laws and European treaties*' ([97]). The fiscal council warned the government of the danger of targeting deficits close to 3 % of GDP, especially as the budgetary slippage observed in 2016 was likely to persist in following years. It recommended taking structural measures to increase the revenue collection rate and the efficiency of public spending. When assessing updated measures in the course of 2017, the fiscal council reiterated its warning ([98]). Unfortunately, these warnings were ignored.

- In Hungary, the fiscal council only very timidly hinted to risks to fiscal plans for 2017. In April 2016, the government's draft budget law targeted a structural balance of 2.1 % of GDP in 2017 ([99]). This was a clear breach of the domestic structural balance rule, according to which the draft budget should respect the MTO of 1.5 % of GDP each year. The fiscal council noted that '*the structural deficit [was] set to increase and [was] likely to exceed the targeted level laid down in the Hungarian and European regulations*' but added that '*the draft budget [did] not contain sufficient information to assess compliance with the structural balance rule*'. As it did not expect the planned breach would lead to the opening of an EDP, the fiscal council only recommended that the government justify how that deficit target complied with both the EU and national requirements ([100]). There were two reasons for this unassertive tone. One was that, until July 2018, the fiscal council was not explicitly charged with monitoring all domestic and EU fiscal rules, but only the constitutional debt rule. It thus commented very briefly on compliance with the other rules, on its own initiative ([101]). The second reason was more political: at the end of 2010, the Hungarian government made important changes to the national fiscal council established in 2008, curtailing its independence and effectiveness (Kopits and Romhányi, 2013).

Overall, in 2017, certain IFIs played a useful role in assessing forecasts and risks of deviation. While the actual impact on fiscal policy differed, all cases illustrate the statutory role of IFIs, namely to enhance the transparency of the budgetary process. In Italy, the PBO's decision not to endorse the government's policy macroeconomic scenario proved decisive in convincing the government to revise its deficit projections. In Romania, the fiscal council voiced strong concerns about the government's risky strategy and made recommendations for correction. In some other cases, the role of IFIs remained restrained because of

([97]) http://www.fiscalcouncil.ro/OpinionStateBudget2017.pdf

([98]) http://www.fiscalcouncil.ro/Opinii2017lbengleza.pdf

([99]) http://www.parlament.hu/irom40/10377/10377.pdf (p. 231, in Hungarian)

([100]) http://www.parlament.hu/documents/10181/56621/KT+vélemény+2017/f15788ac-e0a1-4649-851a-fd3f35864ad5 (in Hungarian)

([101]) In July 2018, the Hungarian authorities amended the Stability Law by explicitly charging the fiscal council to monitor all domestic rules set at the general government level, as the previous arrangement was deemed to be in breach of the 2011/85 Directive requirement, which stipulates that the domestic fiscal framework should include arrangements on '*the effective and timely monitoring of compliance with the rules, based on reliable and independent analysis carried out by independent bodies or bodies endowed with functional autonomy vis-à-vis the fiscal authorities of the Member States*'.

institutional constraints and lack of information. This was in particular the case in Belgium, where the lack of consensus among government levels confined the role of the HCF to a theoretical assessment. In Italy, the Parliament did not activate the comply-or-explain procedure although the PBO repeatedly signalled risks of a significant deviation; this was partly because of ongoing discussions between the government and the Commission towards more flexibility in the fiscal rules. Moreover, several IFIs responding to the EFB questionnaire flagged difficulties in obtaining timely and complete information from the government, especially on the details of budgetary measures and their expected impact. Some were also hampered by uncertainty about the interpretation of the EU fiscal rules and inputs necessary for the calculations, such as the exact deviations allowed under the various clauses. In many countries, including the ones not covered by the EFB questionnaire, the role of IFIs was de facto limited because they did not identify (or no longer identified) a risk of deviation.

4. ASSESSMENT OF THE FISCAL STANCE IN 2017

At the end of 2016, the Commission assessed the economic recovery as fragile and uncertain and called for a fiscal expansion in 2017 of up to 0.5 % of GDP for the euro area as a whole. Other international institutions had a less pessimistic assessment of risks to the macroeconomic outlook. Of note, until the summer of 2016, there was a consensus between the Commission and the Council on a broadly neutral fiscal stance for 2017; while the Commission reviewed its position in November 2016, the Council did not.

The observed fiscal stance in 2017 was a marginal fiscal contraction of 0.1 % of GDP — the first after two consecutive years of mild expansion — implemented in a macroeconomic environment that turned out much better than expected (102)*.*

Looking back at the information available in real time, some limited fiscal support to the economy may have been justified; however, the expansion of up to 0.5 % of GDP advocated by the Commission was not warranted. An expansion of more than 0.2 % of GDP would have implied either a deviation from the requirements of the Stability and Growth Pact (SGP) in all euro area countries, or a more targeted but major deviation from the medium-term budgetary objective in Germany and the Netherlands. Given the economic outlook at the time, a call for a more limited expansion would have been more appropriate and consistent with the EU fiscal rules.

Based on the latest information available, the need for fiscal support to the euro area economy in 2017 was not at all obvious given the observed strength of the economic expansion. In fact, economic activity proved very robust. In spite of the marginal fiscal contraction, available output gap estimates narrowed significantly in the course of the year. Moreover, a deterioration of the underlying fiscal positions was unwarranted at a time when many euro area countries still needed to reduce their debt and rebuild fiscal buffers.

In its 2018 June Report, the EFB discussed how fiscal policy decisions are surrounded by a high degree of uncertainty about the current economic situation (103)*. The Commission Communication of end 2016 illustrates the risks of a more 'activist' decision maker towards running false positives, namely calling to implement a fiscal stimulus in what turned out to be normal economic times. It also illustrates the tendency of underestimating good economic conditions as they occur and the difficulty of making timely fiscal decisions.*

In hindsight, the observed marginally restrictive fiscal stance in the euro area was appropriate in 2017. The fiscal stimulus recommended by the Commission proved unnecessary while the Council's view was vindicated. Compared to 2016, the country composition improved in 2017: most of the countries with high debt improved their underlying fiscal position, although not always as much as required, while most of the countries with available fiscal space had a neutral or slightly expansionary fiscal stance. The notable exceptions were (i) Italy, which ran a fiscal expansion despite its high indebtedness; and (ii) Germany, which built up additional fiscal space. Moreover, the two countries that were still subject to an excessive deficit procedure (EDP), namely France and Spain, only met their nominal targets without providing the required structural effort.

(102) This report does not cover the fiscal stance in 2018 and 2019. The EFB published its forward-looking assessment of the fiscal stance appropriate for the euro area in 2018 on 20 June 2017 (EFB 2017a) and did the same for 2019 on 18 June 2018 (EFB 2018).

(103) see Box 1 on 'The real-time assessment of the cycle as risk management', EFB (2018).

4.1. PROJECTIONS AND OUTTURNS

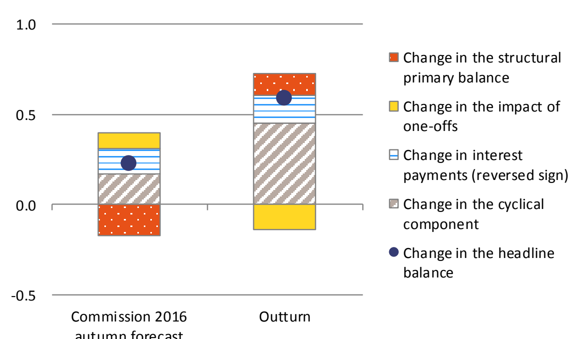
In the autumn of 2016, economic activity in the euro area was expected to continue on an upward trend in 2017. While the central scenario for economic growth was broadly unchanged compared to the spring 2016 scenario, the Commission updated its assessment of risks, highlighting in particular new downside risks of both a political and economic nature. Based on the Commission 2016 autumn forecast (Table 4.1), growth was expected to decelerate somewhat from the previous year. Although narrowing, the Commission's estimate of the output gap was still somewhat negative, and labour market indicators were also interpreted as indicating persisting slack in the economy. Inflation (as measured by the harmonised index of consumer prices, HICP) was expected to pick up but to remain below the ECB's reference of below but close to 2 %.

Monetary policy was very accommodative and was expected to remain so. The observed gradual increase in credit growth in 2016 suggested that the transmission of monetary policy had become more efficient, putting bank lending back on a positive trend that was expected to continue in 2017.

The fiscal outlook in the Commission 2016 autumn forecast pointed to a somewhat expansionary fiscal stance. While the headline deficit was expected to decline to 1.5 % of GDP in the euro area as a whole, the structural primary balance was estimated to deteriorate somewhat (Graph 4.1). The Commission's assessment of sustainability suggested limited risks in the short term, with narrow sovereign bond yield spreads (on average) indicating reduced tensions on financial markets. At the same time, both the Commission's assessment of adjustment needs for debt to reach the 60 %-of-GDP threshold and its debt sustainability analysis pointed to high risks in the medium term for several Member States. The IMF's debt sustainability analysis in 2016 and 2017 also concluded that public debt in certain countries was subject to significant risks.

Moving fast-forward, the latest data indicate a sizeable positive growth surprise in 2017. While the inflation forecast for the euro area largely materialised, real GDP growth was nearly 1 percentage point higher than expected in the autumn of 2016. As a result, available output gap estimates narrowed faster and unemployment fell more markedly than anticipated.

Graph 4.1: **Change in the general government budget balance in 2017, projections and outturn, % of GDP**



Note: A decrease in interest payments is shown as an improvement in the headline balance.
Source: European Commission, own calculations.

On the fiscal side, the government deficit and debt ratios at the aggregate level came in below forecasts, as a result of both better-than-expected economic conditions and statistical revisions of GDP and public finances data

Table 4.1: **Main macroeconomic and budgetary variables in the euro area and its largest Member States, projections and outturn**

	Real GDP growth (yoy % change)				Inflation (yoy % change)				Output gap (% of potential GDP)				Unemployment rate (% of labour force)			
	Autumn 2016		Spring 2018		Autumn 2016		Spring 2018		Autumn 2016		Spring 2018		Autumn 2016		Spring 2018	
	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017
EA-19	1.7	1.5	1.8	2.4	0.3	1.4	0.2	1.5	-1.0	-0.7	-1.3	-0.5	10.2	9.7	10.0	9.1
DE	1.9	1.5	1.9	2.2	0.4	1.5	0.4	1.7	0.0	-0.3	-0.2	0.0	4.4	4.3	4.1	3.8
FR	1.3	1.4	1.2	1.8	0.3	1.3	0.3	1.2	-1.4	-1.2	-1.3	-0.7	10.0	9.9	10.1	9.4
IT	0.7	0.9	0.9	1.5	0.0	1.2	-0.1	1.3	-1.6	-0.8	-2.4	-1.2	11.5	11.4	11.7	11.2
ES	3.2	2.3	3.3	3.1	-0.4	1.6	-0.3	2.0	-1.5	0.0	-2.2	-0.2	19.7	18.0	19.6	17.2

	Headline balance (% of GDP)				Structural balance (% of potential GDP)				Structural primary balance (% of potential GDP)				General government debt (% of GDP)			
	Autumn 2016		Spring 2018		Autumn 2016		Spring 2018		Autumn 2016		Spring 2018		Autumn 2016		Spring 2018	
	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017
EA-19	-1.8	-1.5	-1.5	-0.9	-1.2	-1.3	-0.8	-0.6	1.0	0.8	1.3	1.4	91.6	90.6	91.1	88.8
DE	0.6	0.4	1.0	1.3	0.6	0.4	1.1	1.5	2.0	1.7	2.2	2.5	68.1	65.7	68.2	64.1
FR	-3.3	-2.9	-3.4	-2.6	-2.5	-2.3	-2.6	-2.1	-0.6	-0.5	-0.7	-0.3	96.4	96.8	96.6	97.0
IT	-2.4	-2.4	-2.5	-2.3	-1.6	-2.2	-1.4	-1.7	2.4	1.6	2.5	2.1	133.0	133.1	132.0	131.8
ES	-4.6	-3.8	-4.5	-3.1	-3.8	-3.8	-3.3	-3.0	-1.0	-1.2	-0.5	-0.4	99.5	99.9	99.0	98.3

Source: European Commission.

of previous years (Table 4.1). Based on the latest Commission estimates, most of the improvement was cyclical, with a contribution from reduced interest payments and, for the first time since 2014, a slight improvement in the structural primary balance (Graph 4.1).

4.2. ASSESSMENT OF THE FISCAL STANCE IN 2017

4.2.1. Policy guidance issued in 2016 and early 2017

The Commission gave guidance on the aggregate fiscal stance in 2017 on two occasions: in summer 2016, after the euro area Member States submitted their stability programmes, and in autumn 2016, after they submitted their draft budgetary plans (DBPs). The Council, in turn, issued statements based on the Commission's analysis and, in early 2017, adopted a recommendation for the euro area as a whole.

Summer 2016: Consensus on a broadly neutral fiscal stance

On 11 July 2016, the Commission's Directorate-General for Economic and Financial Affairs presented the Eurogroup with a note on the fiscal stance and the policy mix in the euro area [104]. This analysis concluded that in 2017, for the euro area as a whole, the broadly neutral fiscal stance emerging from the stability programmes was appropriate. With GDP growth gaining strength even without fiscal support and with countries needing to rebuild fiscal buffers, it argued that a broadly neutral fiscal stance would balance the two considerations of short-term stabilisation of the economy and long-term sustainability of public finances. It also indicated, however, that the geographical distribution of the fiscal stance emerging from the stability programmes was sub-optimal: some countries that were required to consolidate did not plan to do it adequately, while others with available fiscal space — i.e. outperforming their medium-term budgetary objective (MTO) — were not planning to use it sufficiently. Finally, it advised Member States to improve the quality of their public finances, favouring growth-friendly revenues and expenditure.

On the same day, the Eurogroup summing-up letter noted that there was '*general agreement that the broadly neutral euro area stance in 2017 strikes an appropriate balance between sustainability and stabilisation concerns, including in the aftermath of the UK referendum*' [105]. It invited governments to address the country-specific challenges in their DBPs. It added that the discussion mentioned the importance of safeguarding both fiscal sustainability and competitiveness and stressed the need for Member States to continue with their efforts to make their budgets as growth-friendly as possible.

Autumn 2016: Commission Communication on a '*positive fiscal stance*'

On 16 November 2016, based on its assessment of the DBPs, the Commission presented its guidance for the fiscal stance in 2017 [106]. This included a Commission Communication entitled 'Towards a positive fiscal stance for the euro area' [107] and a draft Council Recommendation on the economic policy of the euro area [108]. The Commission argued that, despite significant progress in economic activity and employment, the recovery in the euro area remained fragile and subject to uncertainty. In particular, persistently low investment and high unemployment were weighing on the potential output that the economy could deliver. The Commission therefore concluded that, to overcome the risk of a '*low-growth, low-inflation*' trap, the economy needed support from fiscal policy on top of the ECB's very accommodative monetary policy.

By calling for a '*positive fiscal stance*', the Commission Communication delivered two messages: one on the direction of the fiscal stance and one on its composition. The first message was that the aggregate fiscal stance in the euro area should be expansionary in 2017. More precisely, the Commission argued that an aggregate fiscal expansion of up to 0.5 % of GDP, and at least 0.3 % of GDP, would be desirable to support the recovery. It also envisaged a more ambitious fiscal expansion, by 0.8 % of GDP, to fully close the output gap in 2017; however, the Commission considered that such a stance might be '*overly expansionary, since it [might] fuel undesirable overheating in some Member States and would be at odds with the goal of preserving the sustainability of public finances*'.

As a second message, the Commission Communication also called for a more growth-friendly composition of fiscal policies. In particular, it recommended shifts in taxation and refocusing expenditure towards items that would strengthen potential growth, such as public investment. The importance of improving the composition and quality of public finances also meant that, where no fiscal space was available, a more

[104] The note was subsequently published on 2 September 2016, along with the assessment of the stability and convergence programmes; see European Commission (2016).

[105] http://www.consilium.europa.eu/media/23665/11-eurogroup-summing-up-letter.pdf

[106] http://europa.eu/rapid/press-release_IP-16-3664_en.htm

[107] http://data.consilium.europa.eu/doc/document/ST-14630-2016-INIT/en/pdf

[108] http://data.consilium.europa.eu/doc/document/ST-15070-2016-INIT/en/pdf

'positive' fiscal stance could be achieved without deteriorating the budgetary position.

At the same time, the Commission Communication acknowledged some obstacles. Most prominently, in the absence of a centralised fiscal stabilisation function, the fiscal stance in the euro area is simply the aggregation of national fiscal stances, and the use of available fiscal space depends on the good will of national governments, as the SGP cannot impose it. In addition, the Commission noted that compliance with the CSRs in 2017 — without using the available fiscal space — would lead to a slightly restrictive fiscal stance; the only way to deliver the recommended fiscal expansion therefore was to make full use of the flexibility within the fiscal rules. The Commission Communication did not clarify or quantify, however, what this meant for individual Member States. Finally, the Commission stated that the fiscal stimulus would need to be accompanied by structural reforms to strengthen both the economy and public finances.

The draft Council Recommendation on the economic policy of the euro area prepared by the Commission closely reflected the Commission Communication. The draft background recitals — the descriptive introductory part to the legal text — used the same quantification, namely a fiscal expansion of up to 0.5 % of GDP, presented as '*a prudent and pragmatic target, within a range of possible targets which has 0.3 % as a lower bound and 0.8 % as an upper bound*'. The draft fiscal recommendation itself, however, only referred to the central target of '*up to 0.5 % of GDP*'. At country level, it stressed the need to differentiate the fiscal effort across Member States '*by better taking into account their respective position with regard to the requirements under the Stability and Growth Pact, the situation of the euro area aggregate and spillovers across euro area countries*'. In particular, it called on Member States with available fiscal space to use it '*to support domestic demand and quality investments, including cross-border ones, as part of the Investment Plan for Europe*'. The other countries were asked to comply with their fiscal requirements, although countries under the preventive arm and not yet at their MTO were only asked to be '*broadly compliant*' with the requirements of the SGP.

The Council's prudent reaction to the Commission Communication

On 5 December 2016, the Eurogroup issued a statement on the DBPs for 2017 ([109]). It noted that the euro area was set to enter its fifth year of economic recovery, which nevertheless remained fragile. Unlike in July, it did not express agreement with the Commission's conclusions but only '*took note of the Commission Communication and analysis of the fiscal stance calling for a positive fiscal stance*'. It also recalled that, in July 2016, the euro area finance ministers had '*concluded, on the basis of Commission analysis, that the broadly neutral aggregate fiscal stance in 2017 [stroke] an appropriate balance*'. The Eurogroup underlined '*the importance to strike an appropriate balance between the need to ensure sustainability and the need to support investment to strengthen the fragile recovery thereby contributing to a more balanced policy mix*'. It also stressed the importance of a growth-friendly composition of budgetary measures and the considerable differences in fiscal space and budgetary consolidation needs across Member States.

The Council's wording left some room for ambiguity. While some read the Eurogroup's statement as implicitly supporting the Communication, many saw it as distancing itself from the Commission's views and prudently reiterating the call for a neutral fiscal stance that had been expressed in July 2016 ([110]).

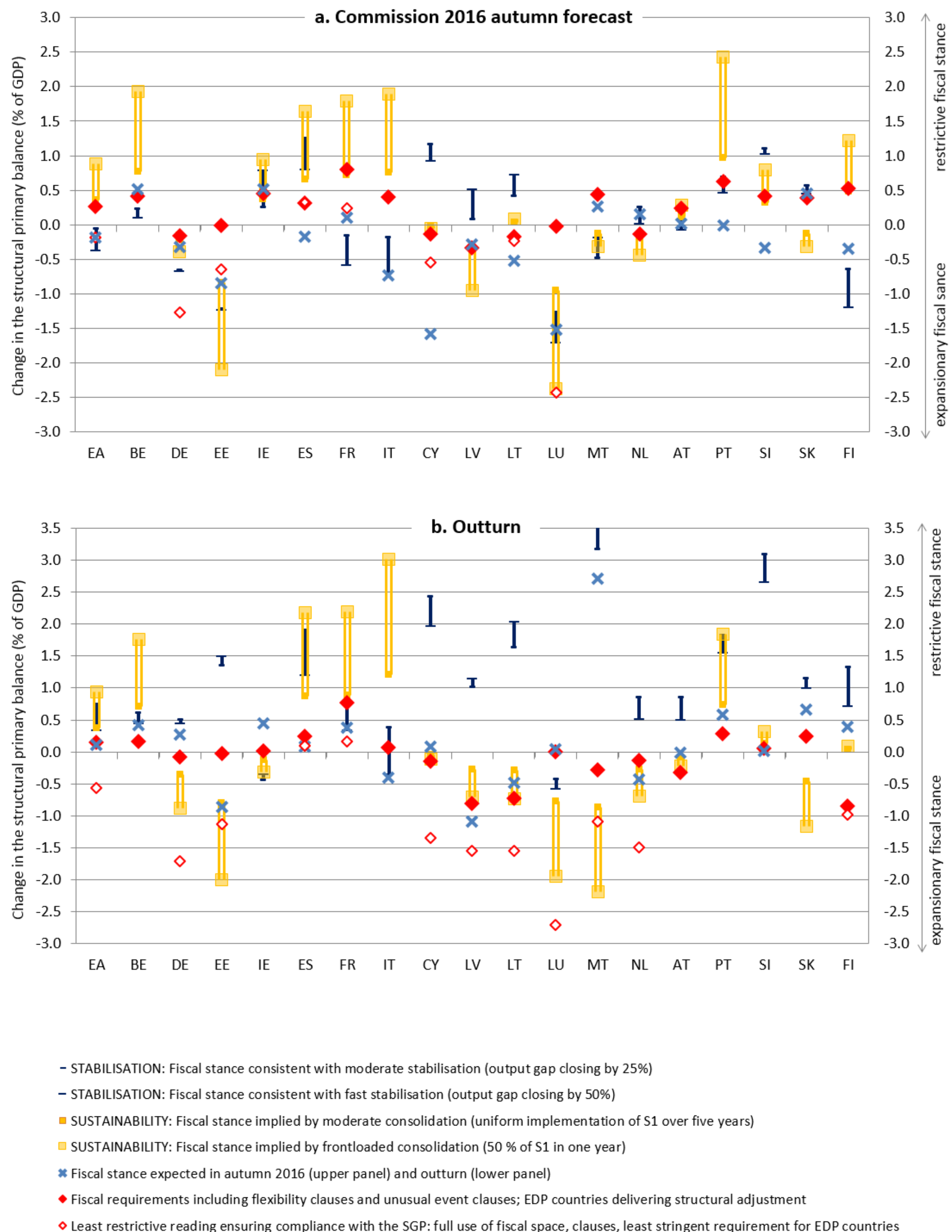
The tensions between the Commission's and the Council's assessments remained in the final version of the Council Recommendation on the economic policy of the euro area, as adopted by the ECOFIN Council on 27 January 2017 and endorsed by the European Council on 21 March 2017 ([111]). Unlike the Commission draft, the background recitals did not include the range of 0.3 to 0.8 % of GDP, and while they still referred to the Commission's call for a fiscal expansion of 0.5 % of GDP, they did not present it as 'a prudent and pragmatic target'. Instead, they recalled the Eurogroup's conclusions of July and December 2016 and gave more prominence in the text to debt sustainability concerns and compliance with fiscal rules. The fiscal recommendation was to '*aim for an appropriate balance in fiscal policies between the need to ensure sustainability and the need to support investment to strengthen the recovery, thereby contributing to an appropriate aggregate fiscal stance*', without spelling out what fiscal stance would be appropriate. The message addressed to Member States with fiscal space was less prescriptive than in the Commission draft, only inviting them '*to continue to prioritise investments to boost potential growth while preserving the long-term sustainability of public finances*'. Finally, while inviting countries to make '*the best use of the flexibility embedded within the existing rules*', it called for full respect rather than broad compliance with the SGP.

([109]) http://www.consilium.europa.eu/en/press/press-releases/2016/12/05/eurogroup-statement-dbp/

([110]) The press conference that followed the Eurogroup meeting seemed to confirm that the Council maintained its conclusion of July 2016. See the video of questions and answers, starting at 1:50: https://tvnewsroom.consilium.europa.eu/permalink/187443.

([111]) http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32017H0324(01)

Graph 4.2: **Analysis of the fiscal stance in 2017**



Notes: (1) The ranges for stabilisation are computed using a uniform fiscal multiplier of 0.8. (2) S1 measures the total cumulative adjustment needed in 2017-2021 to bring the debt-to-GDP ratio to 60 % by 2031. Uniform implementation over 5 years means that one fifth of S1 is implemented in 2017. (3) The fiscal requirements (red diamonds) are recalculated in terms of change in the structural primary balance, as they are actually formulated in terms of change in the structural balance.
Source: European Commission, own calculations.

4.2.2. *Ex post* assessment

The EFB's assessment of the fiscal stance follows an economic reasoning: it considers the need for discretionary fiscal stabilisation subject to the sustainability constraints of public finances ([112]). Alternative fiscal stances, along with the fiscal requirements under the SGP, are reported in Graph 4.2, based on both the expectations of autumn 2016 (upper panel) and the outturn observed in spring 2018 (lower panel).

There is no single optimal target for how fast economic activity should return to its potential level or for debt dynamics that would be relevant for all countries. To account for differences across countries and over time, Graph 4.2 shows possible ranges for the fiscal stance. Starting with the stabilisation objective, a range of stylised policies is considered when the output gap has not closed yet, namely a moderate to fast stabilisation — i.e. closing the output gap by 25 % to 50 % within the reference year ([113]) ([114]).

Similarly, for sustainability constraints, the fiscal adjustment can be implemented at a constant pace over several years or frontloaded; when sustainability is already ensured, no consolidation is assumed to be needed ([115]). To provide more background on whether sustainability is ensured or at risk in the various Member States, Graph 4.3 shows the assessment of risks according to four different indicators used by the European Commission as measured in autumn 2016: (i) the S1 indicator, (ii) a debt sustainability analysis, (iii) the distance to the MTO and (iv) the primary gap, which is an indicator similar to the debt rule ([116]). The graph also reports the values for the euro area as a whole — although in the absence of a central fiscal capacity issuing common debt, the analysis of sustainability for the euro area as a whole remains a theoretical aggregation of national situations.

([112]) For further details on the EFB's approach, see Boxes 4.1, 4.2 and 4.3 on 'Assessing the appropriate fiscal stance', 'Assessing the cyclical position of the economy' and 'Assessing the sustainability of public finances' in last year's annual report (EFB, 2017b).

([113]) In this chapter, the fiscal stance needed to achieve a certain change in the output gap is calculated using a fiscal multiplier of 0.8. This is an average value that seems reasonable given the constraints on monetary policy and assuming a balanced composition between revenue and expenditure measures.

([114]) Outside these indicative standardised ranges, the relevant target can also be a neutral fiscal stance — i.e. no discretionary fiscal stabilisation — e.g. when the output gap has just closed or changed sign, or when the stabilisation provided by automatic fiscal stabilisers is sufficient. For the sake of readability, this is not reported in the graph.

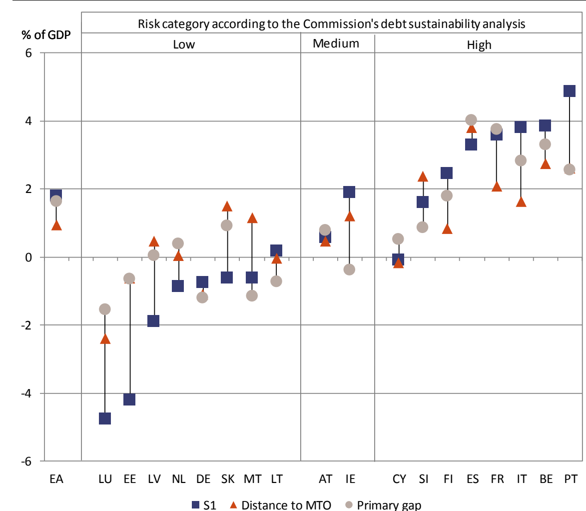
([115]) For instance, a negative value of the S1 indicator in a given country does not imply that its structural primary position *should* deteriorate so that its debt ratio increases to 60 % of GDP; it only means that some leeway is available for fiscal stabilisation if needed.

([116]) The primary gap measures the distance between the current primary balance and the primary balance consistent with a reduction of the excess of debt over 60 % of GDP at an annual pace of 5 %.

Would the EFB have supported the Commission Communication at the time?

In the autumn of 2016, the Commission's growth forecast lay within the range of prevailing expectations (Graph 4.4). Compared to other analysts, however, its assessment of risks to the central scenario tended to focus more on the downside. The Commission's assessment was possibly also downplaying sustainability risks in some countries, especially as there were signs of renewed tensions on government bond spreads for some countries, especially Portugal and Italy, for which several sustainability indicators pointed to risks (Graph 4.3).

Graph 4.3: **Sustainability indicators in autumn 2016, % of GDP**



Notes: (1) This graph shows three quantitative indicators (S1, the distance to MTO and the primary gap) plus the risk classification resulting from the Commission's debt sustainability analysis (DSA), except for the euro area as a whole for which the Commission does not publish a DSA. (2) The graph shows the euro area on the left, followed by Member States grouped by risk category according to the DSA and ranked by increasing levels of S1. (3) S1 measures the total cumulative adjustment, in terms of structural primary balance, needed in 2017-2021 to bring the debt-to-GDP ratio to 60 % by 2031. (4) A negative distance from the MTO means that the Member State is above its MTO. (5) The primary gap measures the distance between the current primary balance and the primary balance consistent with a reduction of the excess of debt over 60 % of GDP at an annual pace of 5 %.
Source: European Commission, own calculations.

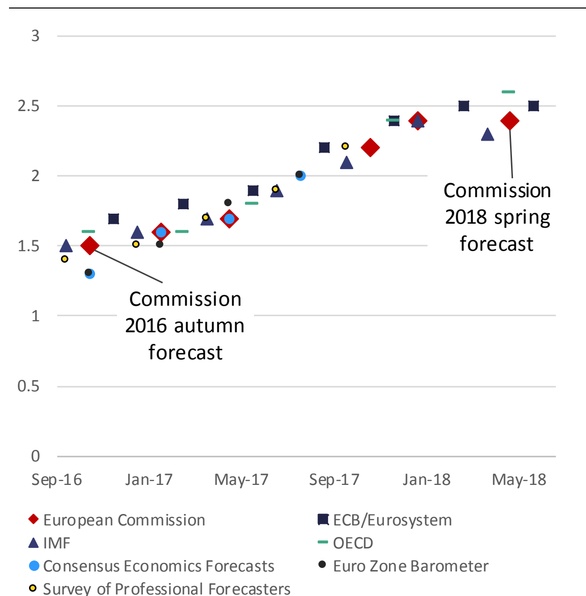
Based on the information available at the time, the EFB could have shared much of the Commission's views. In particular, it would have agreed that (i) although real GDP had surpassed its pre-crisis level, the euro area economy did not yet seem back on solid ground, especially in light of low inflation despite very low policy rates; (ii) withdrawing all fiscal support to the recovery in that context could have been premature; (iii) there were still sustainability issues, especially in some

countries; (iv) national fiscal stances should be differentiated across countries, depending on specific situations and needs; and (v) supporting the recovery could be provided by a growth-friendly composition of fiscal policies, including by using fiscal space where available to boost public investment and in a budgetary-neutral manner where no fiscal space was available.

However, even based on real-time data, the size of the expansion recommended by the Commission in the autumn of 2016 was not appropriate for two reasons.

First, while real-time assessments are always surrounded by uncertainty, it is still possible to engage in a risk management exercise that exploits past differences between estimates available in real time and *ex post* ([117]). The fact that the Commission recommended a sizeable fiscal expansion when output gap estimates for the euro area were in the range -1 % to -0.5 % of GDP indicates

Graph 4.4: **Real GDP growth in the euro area in 2017, projections and outturns**



Note: The ECB/Eurosystem staff and the OECD both report working day-adjusted growth rates, while the Commission and the IMF report unadjusted numbers. The other sources do not tell whether they adjust growth rates for working days.
Source: European Commission, ECB, IMF, OECD, Consensus Economics, MJEconomics.

a fairly 'activist' stance. According to Commission staff's own analysis, a fiscal expansion of that magnitude meant that full priority was given to supporting economic growth (European Commission, 2016b). Specifically, it reveals a preference for avoiding the risk of failing to intervene if needed, at the cost of recommending fiscal expansions that may not be needed. The Council, by contrast, revealed a more prudent stance, with a preference for avoiding the risk of false alerts. In 2017, the more prudent stance of the Council seemed more appropriate.

Moreover, the euro area Member States could not have delivered an expansion of 0.5 % of GDP within the boundaries of the SGP. Based on the deviations that had already been allowed under the flexibility clauses in the autumn of 2016, only an expansion of 0.2 % of GDP was possible in 2017 (Graph 4.5). This would have corresponded to the least restrictive reading of the SGP still ensuring compliance, i.e. assuming a full use of the available fiscal space and of the allowed deviations granted under the flexibility clauses, and implementing the least stringent requirement under the corrective arm.

Stretching the reading of the SGP further and assuming that the unusual event clauses invoked by some Member States were going to be granted *ex post* in the spring of 2018, the expansion could have been slightly larger, but still remaining below 0.3 % of GDP.

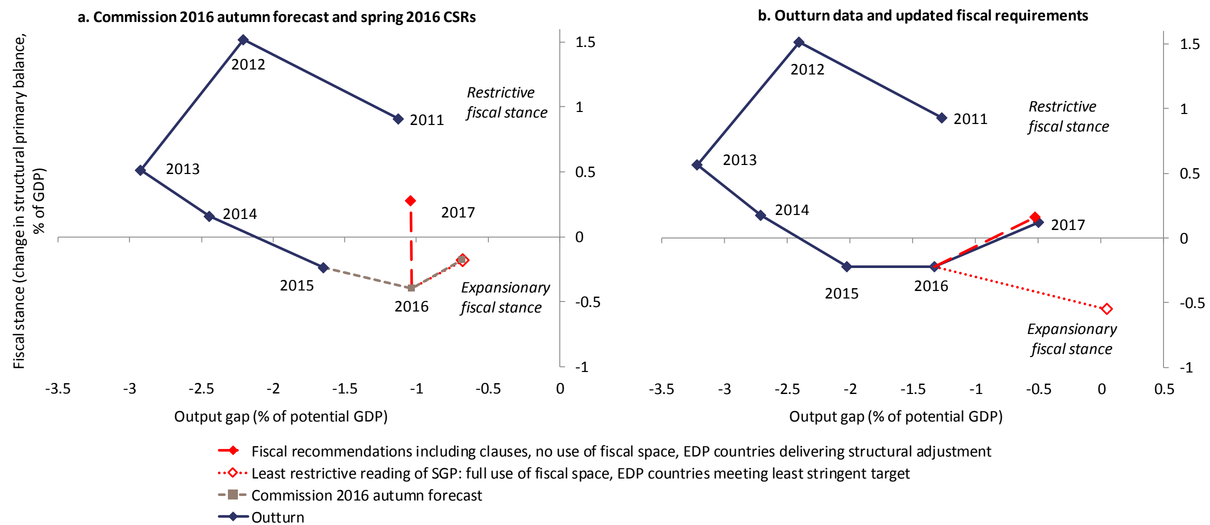
To get to a fiscal expansion of 0.5 % of GDP, deviations from the fiscal rules would have been necessary. If the expansion had originated only in countries with fiscal space, it would have brought them well below their MTO. For instance, Germany alone would have had to implement a major fiscal expansion of 2 % of GDP and deviate from its MTO by 0.9 percentage points of GDP. If both Germany and the Netherlands had been involved, they would have had to deviate from their respective MTOs by 0.7 percentage points of GDP. Alternatively, all the countries under the preventive arm would have needed to deviate from their MTO or the adjustment path (including flexibility) by more than 0.25 percentage points; or there would have been a general deviation from the fiscal requirements of more than 0.2 percentage points in all euro area countries, including in the countries in EDP.

Overall, the expansion recommended by the Commission does not appear to have been a '*prudent target*'. It is a clear sign of inside lags of fiscal policy, that is, the time it takes for policymakers to form views on the economic situation and make a decision. While recommending a fiscal expansion would have been more relevant at an earlier stage of the recovery, at this advanced stage it would have been more consistent to recommend again, as in previous years, a broadly neutral fiscal stance.

It was not the first time that the Commission recommended fiscal policies involving a breach of the SGP. The European economic recovery plan of 2008-2009 was a clear precedent. In the face of a very sharp and deep economic downturn, the Commission and the Council agreed to implement significant fiscal expansions, only weakly differentiated between

([117]) See Box 1 in the EFB's 2018 June Report (EFB, 2018).

Graph 4.5: **The fiscal stance in the euro area**



Note: The impact of alternative implementations of the SGP in 2017 is computed assuming a uniform fiscal multiplier of 0.8.
Source: European Commission, own calculations.

countries, which were in conflict with the letter of the SGP ([118]). However, 2017 is a very different case: the economy was perceived as fragile but recovering, and the Council was not convinced of the need to overstretch the SGP.

Based on the latest information available, was the fiscal stance observed in 2017 appropriate?

There is widespread consensus to acknowledge that the euro area economy was very strong in 2017, for the first time in a decade. The expansion was broad-based across sectors and countries, and robust, gaining strength during the year. Investment picked up, economic sentiment was high and unemployment fell. Surveys suggest that the remaining weaknesses on the labour market were of a different nature from previous years, becoming increasingly linked to difficulties hiring qualified workers rather than uncertainty about the economic outlook.

Given the observed strength of the economy, the observed marginally restrictive fiscal stance — an improvement of the structural primary balance by 0.1 % of GDP — was appropriate at the aggregate level. A neutral to slightly restrictive fiscal stance was enough not to hamper the robust economic growth. Moreover, avoiding a further deterioration of the underlying fiscal positions was crucial at a time when many euro area countries still needed to reduce their debt and rebuild fiscal buffers.

At the euro area level, the observed fiscal stance stood close to the aggregation of country-specific fiscal requirements. As a number of countries were still either subject to an EDP or on the adjustment path towards their MTO, delivering the structural effort required in these countries without any use of fiscal space would have led to a slightly restrictive fiscal stance at the aggregate level (Graph 4.5) ([119]). In autumn 2016, the euro area fiscal stance was expected to come close to the least restrictive interpretation of fiscal requirements, i.e. assuming a full use of fiscal space where available and with countries in EDP meeting only their least stringent requirement. The observed aggregate fiscal stance, by contrast, ended up close to a more restrictive reading assuming full compliance with structural requirements and no use of fiscal space.

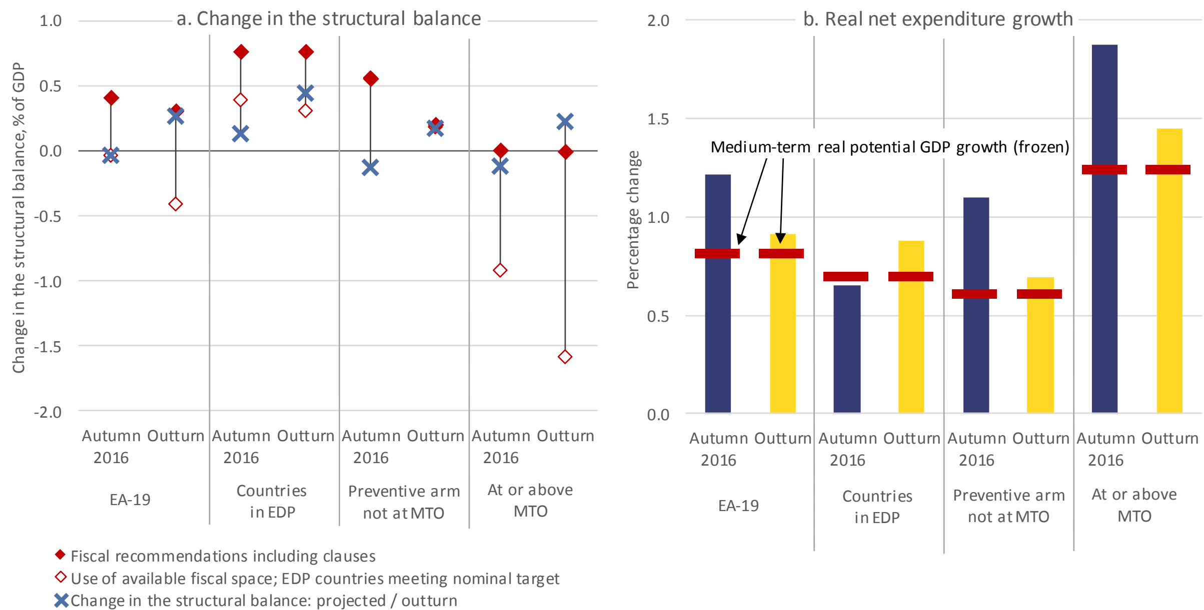
The country composition was generally more appropriate than expected, with some exceptions. Graph 4.2 shows how the observed fiscal stance of individual countries and of the euro area as a whole (the blue crosses) compared with different readings of the SGP (the red and white diamonds) ([120])([121]). Graph 4.6a

([118]) See the Commission Communication 'A European economic recovery plan', COM(2008) 800 of 26 November 2008, http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:52008DC0800, and the Presidency Conclusions of the Brussels European Council of 11 and 12 December 2008, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/104692.pdf

([119]) The final requirements used for the *ex post* assessment in spring 2018 (right panel of Graph 4.5) were, on aggregate, slightly lower than in autumn 2016 (left panel) as several countries benefited from additional clauses or more favourable initial positions.

([120]) In the CSRs, the fiscal requirements are expressed as change in the structural balance. In Graph 4.2, to ensure comparability with the other indicators, the requirements are recalculated in terms of change in the structural primary balance, i.e. excluding interest payments, which on average declined by 0.2 % of GDP in the euro area in 2017. The change in the structural primary balance is therefore slightly more negative (or less positive) than the corresponding change in the structural balance, by 0 to 0.5 % of GDP depending on the country.

Graph 4.6: **Change in the structural balance and real net expenditure growth in 2017 by group of countries, projections and outturn**



(1) Countries are grouped according to their situation at the beginning of 2017. Countries in EDP: ES and FR. In the preventive arm not at MTO: BE, IE, IT, LV, MT, AT, PT, SI, SK and FI. At or above MTO: DE, EE, CY, LT, LU and NL. (2) In line with practice for the expenditure benchmark, medium-term potential growth is frozen at its spring 2016 value.
Source: European Commission, own calculations.

applies the same presentation to three groups of countries at the aggregate level for each group ([122]). In the first group, made up of the two countries in the corrective arm of the SGP, structural positions improved by a larger extent than initially expected, but they still fell short of the structural requirements. This is confirmed by the fact that, in 2017, net expenditure in these countries grew faster than the economy over the medium term (Graph 4.6b). The second group, countries in the preventive arm of the Pact that were not yet at their MTO, complied on average with structural requirements. They also contained net expenditure growth compared to the expectations of autumn 2016. However, within this group, Italy stood out as the only country with a deteriorating structural fiscal position (Graph 4.2). Finally, in the last group, several countries standing at or above their MTO used some of their available fiscal space; however, this was outweighed by a slight fiscal contraction in Germany.

Overall, in most cases, fiscal consolidation took place where required without being an obstacle to solid economic growth. This was in particular the case in the high-debt countries, with the notable exception of Italy.

Conversely, most of the countries with available fiscal space made at least partial use of it, with the exception of Germany. Compared to a slightly tighter fiscal contraction corresponding to full compliance with the SGP, only a marginally restrictive fiscal stance was achieved because (i) the countries in EDP — Spain and France — met their nominal rather than structural target, (ii) Italy did not deliver the effort required, and (iii) some fiscal space was used where available.

([121]) Of note, the adjustment requirements were reduced for some Member States between the country-specific recommendations of spring 2016 and the *ex post* assessment of spring 2018 because they benefited from the unusual-event clause. Moreover, some countries were found to have more available space than expected in spring 2016, as their structural balances of 2016 were revised upwards.

([122]) In Graph 4.6, the fiscal requirements are expressed in terms of change in the structural balance as in the country-specific recommendations.

5. REVIEW OF THE FLEXIBILITY CLAUSES OF THE STABILITY AND GROWTH PACT

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 (SGP). The Communication was intended to strengthen the economic rationale of the EU fiscal rules by (i) introducing and codifying a more detailed modulation of the budgetary adjustment under the preventive arm of the SGP according to the prevailing macroeconomic conditions and risks to the sustainability of public finances; and (ii) allowing temporary deviations from the required fiscal adjustment in order to account for major structural reforms and increases in government investment expenditure. It was launched during an economic recovery that had turned out much more protracted and weaker than expected, while successive reforms of the SGP had formally tightened both rules and monitoring.

Although the stated objective of the Communication was sound, it came on top of a series of earlier adaptations which had already affected the credibility of the SGP and its implementation. As a result, the Commission Communication gave rise to extensive discussions with the Member States in the competent Council committees on how to exactly interpret and implement flexibility within the existing rules. The discussions finally led to a commonly agreed position in November 2015, subsequently endorsed by the ECOFIN Council in February 2016.

This chapter presents an independent assessment of the implementation of the flexibility provisions agreed in 2015 and applied since then. The assessment takes into account budgetary outcomes as well as the interaction with the unusual event clause, an element of flexibility introduced with the 2011 reform of the SGP that accounts for the budgetary impact of events outside the control of government. The analysis is centred on the economic design of the clauses and their implementation by the Commission and the Council. The assessment of the long-term economic impact of structural reforms and public investment underpinning the flexibility clauses is outside the scope of our analysis.

Our independent assessment supports four main conclusions:

(i) Flexibility for cyclical conditions resulted in a very limited modulation of fiscal efforts across both countries and time; in the vast majority of cases, the modulation amounted to one decimal point of GDP. In its own assessment, the Commission considers the design of the matrix a success, in that recommendations were mostly kept close to the benchmark adjustment of 0.5 % per year on average. However, this conclusion contrasts with the stated objective of ensuring a better modulation of fiscal adjustment. The few more significant modulations of the required fiscal adjustment could have been achieved with a much more surgical interpretation of flexibility.

(ii) Although economic conditions improved markedly after 2015, flexibility was exclusively used to lower fiscal requirements after the initial requirement was set in the spring of each year. This asymmetry is due to two interlinked elements: first, the modulation is more refined for bad economic times; second, there is a tendency to underestimate good economic times when they occur.

(iii) Very few countries have taken advantage of the flexibility for structural reforms and government investment expenditure. For the few countries that did, the Commission assessment of whether reforms had actually been implemented was not always conclusive.

(iv) The recourse to flexibility had no visible impact on compliance with the rules. In 2015-2017, compliance was mixed at best. Some Member States even failed to meet the much reduced adjustment requirements.

Overall, the sense emerging from our independent assessment is that the flexibility provisions agreed in 2015 have not lived up to expectations. Relatively little has been achieved in practice compared to the scope of the interpretative add-on, at the price of further increasing the degree of judgement when assessing compliance with rules and ultimately affecting both transparency and predictability. Furthermore, the cumulative effect of different forms of flexibility, coupled with the usual margin of broad compliance applied in the final assessment of compliance, have lengthened the period of convergence towards the medium-term budgetary objective far beyond what could be considered reasonable, especially for high-debt countries.

In sum, our analysis supports a more critical assessment of the flexibility within the existing rules. In a special report published in July 2018, the European Court of Auditors was critical about the implementation of the flexibility clauses too. However, contrary to the European Court of Auditors, the EFB is of the view that improvements to the existing legal framework, although possible, would not be a game changer. Recent attempts to simplify the SGP have not been successful. As indicated in Chapter 2 of this report, they essentially amounted to introducing additional elements to an already complex system without amending or clearing up the existing legal provisions. Consequently, the overall diagnosis presented in last year's report still holds: a major overhaul of the EU fiscal rules is required to make them simpler and stronger, including effective elements of flexibility. Chapter 6 details the main planks and features of such an overhaul of the SGP.

5.1. BACKGROUND

In January 2015, the Commission provided new guidance on the best possible use of the flexibility embedded within the existing EU fiscal rules ([123]). The declared purpose of the Communication was two-fold: (i) to better adapt fiscal adjustments to the economic cycle without neglecting fiscal consolidation needs; and (ii) to accommodate temporary deviations from the medium-term budgetary objective (MTO), or the adjustment path towards it, for the budgetary costs implied by structural reforms and higher investment expenditure. A concise summary of the flexibility provisions covered by the Commission Communication is provided in Box 5.1. Following lengthy discussions in the competent Council committees about how to interpret the relevant provisions of the Stability and Growth Pact (SGP), a common position was eventually agreed by the Commission and the Economic and Financial Committee at the end of 2015 and endorsed by the ECOFIN Council shortly afterwards ([124]).

The Commission Communication does not cover all types of flexibility provisions under the preventive arm of the SGP. On top of the flexibility for cyclical conditions, structural reforms and investment, the preventive arm also includes provisions for systemic pension reforms and unusual events which have also been applied in the past several years ([125]). For instance, the Commission activated the unusual event clause for several countries to accommodate the budgetary costs arising from the exceptional inflow of refugees and security threats in the wake of terrorist attacks. In addition, Italy was granted an allowance for expenditure to protect the territory against seismic risks.

There is an additional element of flexibility which has never been activated since its introduction with the six-pack reform of the SGP in 2011, although conditions would have been met: an escape clause in the event of a severe economic downturn in the euro area or the EU as a whole ([126]). A severe economic downturn is defined as negative real growth of GDP or as an accumulated loss of output during a protracted period of very low real growth of GDP relative to its potential. If activated, the clause allows for a temporary deviation from the required fiscal adjustment on a country-by-country basis provided it does not endanger fiscal sustainability in the medium term.

Table 5.1: **Flexibility provisions under the preventive arm of the Stability and Growth Pact**

Covered by Commission Communication of 2015	cyclical conditions + sustainability risks: *matrix of adjustement requirements*
	structural reform clause
	investment clause
other flexibility provisions	systemic pension reform clause
	unusual event clause
	severe economic downturn

Source: European Commission.

Table 5.2 presents an overview of the allowances granted under different flexibility provisions in 2015-2017. The allowed deviations granted under the unusual event clause were quite significant and, in total, actually exceeded those granted under the investment and structural reform clauses. The clause on government investment generated very limited interest among the Member States. No new requests for flexibility were submitted for 2018.

On 23 May 2018, responding to the common position agreed with the Council at the end of 2015, the Commission published a review assessing the implementation of the flexibility clauses ([127]). The review focuses on the effectiveness of the flexibility for cyclical conditions and the implementation of the structural reform and investment clauses. It does not cover the use of the unusual event clause. The overall conclusion of the Commission assessment was favourable.

Table 5.2: **Temporary deviations granted in 2015-2017 under different clauses, % of GDP**

	2015			2016			2017		
	struct. reforms	invest.	unsual events	struct. reforms	invest.	unsual events	struct. reforms	invest.	unsual events
BE	-	-	0.03	-	-	0.13	-	-	0.02
IT	-	-	0.03	0.50	0.21	0.12	-	-	0.39
LV	0.80	-	-	0.60	-	-	0.70	-	-
LT	-	-	-	0.1	-	-	0.50	-	-
HU	-	-	0.04	-	-	0.08	-	-	0.25
AT	-	-	0.09	-	-	0.38	-	-	0.41
SI	-	-	-	-	-	0.07	-	-	-
FI	-	-	0.05	-	-	0.17	0.50	-	0.22

Notes: Temporary deviations granted to Latvia and Lithuania include allowances for systemic pension reforms. Latvia implemented a systemic pension reform as from 2013. The budgetary costs of the pension reform amounted to 0.5 % of GDP in 2013-2014, 0.8 % of GDP in 2015, 0.6 % in 2016-2017 and 0.3 % of GDP in 2018. Lithuania applied for a systemic pension reform clause in 2016 in relation to changes to its pension system initiated in 2012. The granted deviation amounted to 0.1 % of GDP. For countries at, or close to the MTO, the granted deviations include carryovers from previous year allowances (see Box 5.1).
Source: European Commission.

([123]) COM(2015)12 final.
([124]) http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf
([125]) See Articles 5(1) and 6(3) of Council Regulation (EC) No 1466/97.
([126]) See Article 5(1) of Council Regulation (EC) No 1466/97.
([127]) https://ec.europa.eu/info/sites/info/files/economy-finance/com_2018_335_en.pdf

Box 5.1: **The commonly agreed position on flexibility within the Stability and Growth Pact (SGP)**

On 13 January 2015, the Commission issued a Communication providing guidance on the best possible use of the flexibility embedded within the existing EU fiscal rules ([1]). Member States discussed the guidance and reached a common position with the Commission at the end of 2015, which the ECOFIN Council endorsed on 12 February 2016 ([2]). The commonly agreed position clarifies three specific aspects: (i) cyclical conditions; (ii) structural reforms; and (iii) government investment.

Cyclical conditions. The required annual structural adjustment to the MTO is modulated around the benchmark of 0.5 % of GDP, according to prevailing cyclical conditions and government debt. The adjustments are detailed in what is usually referred to as the 'matrix of requirements':

		Required annual fiscal adjustment (pp of GDP)	
	Condition	Debt ≤ 60% and low/medium sustainability risks	Debt > 60% or high sustainability risks
Exceptionally bad times	Real growth <0 or output gap < -4	No adjustment needed	
Very bad times	-4 ≤ output gap <-3	0	0.25
Bad times	-3 ≤ output gap <-1.5	0 if growth below potential, 0.25 if growth above potential	0.25 if growth below potential, 0.5 if growth above potential
Normal times	-1.5≤output gap <1.5	0.5	> 0.5
Good times	Output gap ≥1.5	>0.5 if growth below potential, ≥0.75 if growth above potential	≥0.75 if growth below potential, ≥1 if growth above potential

Fiscal requirements for a given year are initially set in the spring of the preceding year. For the sake of predictability, fiscal requirements are kept unchanged over the entire surveillance cycle, unless: (i) a country experiences bad or very bad economic conditions (i.e. the output gap falls below -3 % of GDP) or (ii) a Member State is assessed to have achieved, or have come close to, the MTO.

Structural reform and investment clauses. Flexibility aims to accommodate temporary and limited deviations from the MTO, or the adjustment path towards it, to account for the budgetary impact of major structural reforms or specific government investment that can raise growth potential and improve fiscal sustainability in the future.

Eligibility. The flexibility clauses are subject to eligibility conditions. They are meant to ensure that sustainability is not at risk in the medium term and is strengthened in the longer term. The Member State must (i) remain in the preventive arm of the SGP, (ii) respect the minimum benchmark ([3]); and (iii) achieve its MTO within 4 years ([4]). To be eligible, structural reforms must also be (i) major and with positive long-term effects on growth and the sustainability of public finances, and (ii) either already fully implemented or part of a dedicated structural reform plan described in sufficient detail in the national reform programme or in the corrective action plan. As for the investment clause, (i) the expenditure under consideration must be on projects that are co-funded by the EU under certain programmes, (ii) co-financed expenditure should not replace nationally financed expenditure, so that total public investment does not decline, and (iii) the country must be in bad economic times ([5]).

Member States that intend to request flexibility under the structural reform or investment clauses have to supply relevant information in their stability or convergence programme (SCP) in the spring. The deviation allowed under

([1]) COM(2015)12 final.
([2]) http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf
([3]) The level of the structural balance safeguarding against the risk of breaching the 3 % of GDP deficit reference value under normal cyclical fluctuations.
([4]) This is expected to be guaranteed if the difference between the initial structural balance and the MTO does not exceed 1.5 % of GDP.
([5]) Economic unfavourable times are characterised by negative GDP growth or a negative output gap exceeding 1.5% of GDP

(Continued on the next page)

Box (continued)

each clause may not exceed 0.5 % of GDP. If both clauses are granted, the cumulated deviation may not exceed 0.75 % of GDP. Eligibility is assessed *ex ante* by the Commission in its assessment of the SCP or the draft budgetary plan if the request is submitted in autumn. As a safeguard, some criteria are assessed again *ex post*. These include the actual implementation of structural reforms and the actual level of and change in investment expenditure. By contrast, the expected short-term costs implied by the structural reforms and the expected impact on potential growth and sustainability are not checked *ex post*.

Temporary deviation. The granted flexibility applies for 3 years and, in the event of successive requests, each incremental amount is carried over for 3 years. Allowed deviations apply to either the change or level of the structural balance, whichever leads to the least stringent requirement. A deviation in terms of change affects the adjustment path towards the MTO and applies to countries that are still relatively far from their MTO. By contrast, when the structural balance stands in the vicinity of the MTO, the deviation is in level and refers directly to the distance from the MTO. Three broad cases are possible:

- a Member State which is not at the MTO and would not reach it before the end of the 3 years of application of the flexibility clause is allowed, in the year the clause applies, to deviate from its adjustment path towards the MTO by an amount equal to the granted temporary deviation. In the following years, the country is required to adjust towards the MTO at the normal pace, as defined in the 'matrix of adjustment requirements';
- a Member State which is at the MTO can deviate from the MTO for 3 years by an amount equal to the granted temporary deviation;
- a combination of the two previous cases applies to a Member State which is not at the MTO, but would reach it before the end of the 3-year period.

In all cases, in the fourth year of the adjustment period covered by the clause, the deviation no longer applies and the Member State is then required to adjust according to the matrix (for a detailed outline of all the different possible trajectories, see Annex 13 of the *Vade Mecum on the SGP* – 2018 edition).

On 12 July 2018, the European Court of Auditors issued a special report on the implementation of the preventive arm of the SGP in 2011-2016, including the flexibility clauses ([128]). In clear contrast to the Commission's own assessment, the ECA is fairly critical of the design and implementation of the flexibility provisions and recommends several changes within the existing legal framework. These include addressing the cumulative effect of the permitted deviation, including the so-called 'margin of broad compliance'; increasing the adjustment requirements for Member States with a debt ratio above 60 % of GDP; limiting the structural reform clause to directly identified budget costs; discontinuing the use of the investment clause in its current form; and approving the unusual event clause only for expenditure directly linked to the event.

5.2. ASSESSMENT OF THE FLEXIBILITY CLAUSES

The EFB has carried out its own independent assessment of the flexibility provisions of the SGP covering the period 2015-2017. The focus is on the economic design of the clauses and their implementation. The assessment of the long-term economic impact of structural reforms and public investment covered by the flexibility clauses is outside the scope of the present analysis.

5.2.1. Timing and process of granting flexibility

The commonly agreed position of the Commission and the Council includes detailed provisions on how to implement the flexibility clauses. As a rule, a Member State requests flexibility in the spring of the previous year, when submitting its stability or convergence programme (SCP). The Commission and the Council are then expected to assess the Member State's eligibility and, if the required conditions are met, grant the requested flexibility in the relevant country specific recommendations (CSR). All this is meant to happen in the spring of the year before the clauses are expected to be used. A request can also be submitted later in the year (by 15 October) with the draft budgetary plan (DBP) ([129]). In that case, flexibility is supposed to be granted via an update of the CSR in the autumn of the same year.

In practice, however, the Council adopted most of the requests for flexibility well after the Commission's endorsement, typically in the spring of the year the

([128]) European Court of Auditors (2018).

([129]) Non-euro area countries need to submit an ad-hoc request, as they are not required to submit a DBP.

margins were used ([130]). Although the Commission's assessment of compliance takes into account allowances under the flexibility clauses only after the request is formally agreed by the Council, the preliminary endorsement by the Commission in spring or autumn of the preceding year gives rise to expectations by the Member State concerned which are difficult to reverse. In other words, the assessment of the DBP, including requests for flexibility, affects the preparation and implementation of the budget before the Council has the possibility to assess and grant the flexibility requested.

The assessment of eligibility, especially the assessment of the long-term impact of structural reforms or the growth-enhancing nature of public investment, involves a considerable degree of economic judgement. With the exception of pension reforms introducing a multi-pillar system with a mandatory fully-funded pillar, which envisage a specific role for Eurostat in assessing eligibility, the Commission analysis is almost entirely based on input provided by the Member States ([131])([132]). The Commission assessment is limited to a plausibility analysis (see Annex 14 of the *Vade Mecum on the SGP* — 2018 edition) which remains largely of a qualitative nature, based on elements of judgement on the plausibility of the reform's estimated effects.

So far, the Commission has always assessed requests for flexibility as plausible, confirming the analysis and the quantification provided by Member States. In only few cases were the allowances approved by the Council lower than those requested by Member States. This was (i) to ensure the total allowance stays within the limit of 0.75 % of GDP (i.e. in the case of Italy in 2016) or (ii) to respect the safety margin with respect to the 3 % of GDP deficit reference value (i.e. in the case of Lithuania and Latvia in 2017). With the exception of Finland (see Section 5.2.4), the Commission has always confirmed, in the final assessment, the initial amount of flexibility requested.

([130]) For example, in autumn 2016, Finland requested flexibility under the structural reform and investment clauses. In its assessment of the DBP of Finland, the Commission provided a full assessment of the eligibility conditions and concluded that '*reforms presented appear to be major and to have plausible positive direct long-term budgetary effects*'. However, only in spring 2017, in the context of the CSR for 2018, the Council made its own assessment and, based on the latest Commission forecast, granted the flexibility '*provided that it adequately implements the agreed reforms, which will be monitored under the European Semester*'. A similar approach was followed in the case of Lithuania under the structural reform clause and of Italy under the structural reform and investment clauses.

([131]) Article 5(1) and 9(1) of Regulation (EC) No 1466/97.

([132]) As per the Code of Conduct, a Member State's request for flexibility should also be supported by an independent evaluation, including on the estimated short- and medium-term budgetary impact and on the timetable for the implementation of the reforms.

5.2.2. Accounting for cyclical conditions and sustainability risks: the matrix of adjustment requirements

The Commission's review of flexibility extensively examines whether the modulation of the annual fiscal adjustment for cyclical conditions has (i) promoted counter-cyclical fiscal policies, (ii) contributed to the achievement of the MTO, and (iii) ensured a reduction in government debt at a satisfactory pace. It concludes that the current design of the matrix ensured an effective modulation of the required fiscal effort while supporting, if recommendations had been followed, the achievement of the MTO and the reduction of public debt. On the other hand, the report acknowledges that the actual budgetary adjustment made by the Member States fell short of the required fiscal efforts.

The EFB's assessment is less favourable. While the design of the matrix may have been successful in keeping the average fiscal adjustment around the benchmark requirement of 0.5 % of GDP, modulation for cyclical conditions appears minimal. According to the Commission's own analysis for 2000-2017, in most cases (i.e. in over three out of four), modulating the required annual fiscal adjustments ultimately amounted to choosing between a fiscal effort of 0.5 % or 0.6 % of GDP: a rather marginal degree of modulation for a fairly involved flexibility provision. More importantly, the design of the matrix reveals some shortcomings:

(i) The modulation of the fiscal adjustment requirement is not symmetric: it is much more differentiated for negative economic conditions than for good economic times (see Box 5.1).

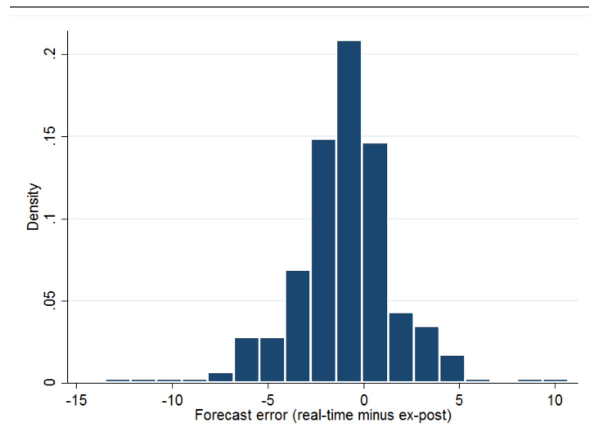
(ii) The Commission forecasts tend to underestimate good times when they occur. Graph 5.1 shows the distribution of the one-year-ahead forecast error of the output gap of all EU countries in 2003-2016. The distribution exhibits a bias towards a negative assessment of cyclical conditions in real time ([133]). In combination with the asymmetric design of the matrix, this forecast bias translates into a downward bias of the recommended adjustment: modulations will prevalently reduce the adjustment requirement compared to the benchmark of 0.5 % of GDP per year.

(iii) Provisions for reviewing fiscal requirements, known as the unfreezing principle, further add to the downward bias. Adjustment requirements are initially set in spring $t\text{-}1$ for year t on the basis of the one-year-ahead forecast of the output gap. They can be reviewed in year $t+1$, at

([133]) This pattern is consistent with the findings of Jonung and Larch (2006) and Frankel and Schreger (2013). Both papers find a tendency to overestimate future growth which translates into an overly pessimistic assessment of cyclical conditions in real time.

the latest, if conditions change but only in one direction, to reduce the adjustment requirement (see Box 5.1). In 2015-2017, the output gap for year *t* (as estimated in spring *t+1*) turned out to be more positive than initially expected (i.e. in spring *t-1*) in around three quarters of the cases. Because of the built-in asymmetry of the unfreezing principle, the revisions of the output gap did not result in higher requirements. In only one case, i.e. Italy in 2015, the adjustment requirement was lowered from 0.5 % of GDP to 0.25 % of GDP, to take into account the worsening economic conditions.

Graph 5.1: **Distribution of the forecast error of output gap estimates 2003-2016; EU countries**



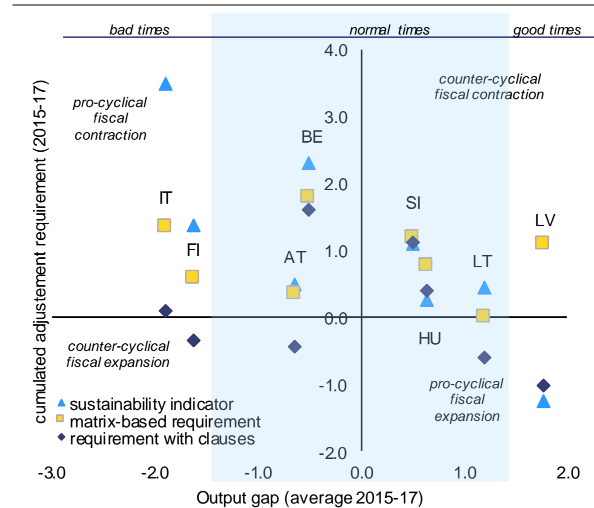
Note: Real time = output gap estimates from the Commission autumn forecast in year t-1 for year t; ex-post = estimate of the same year t from the Commission 2017 autumn forecast, for EU countries between 2003 and 2016.
Source: European Commission, own calculations.

It should also be pointed out that the Commission autonomously deviated from the matrix in six cases, softening the matrix-based requirements: Romania in 2015, Slovenia in 2017, Italy and Slovenia in 2018 and Spain and Slovenia in 2019. Except for Romania in 2015, when the departure was made to incentivise the absorption of EU funds, the reduction of the fiscal adjustment was motivated by the uncertainty surrounding output gap estimates. Adjustment requirements were set following an *ad hoc* judgemental analysis or by applying a new 'margin of discretion' in the cases of Italy and Slovenia in 2018 (See Section 2.2.2).

Graph 5.2 shows the cumulated adjustment requirement of countries benefiting from flexibility and unusual event clauses in 2015-2017, including for systemic pension reforms. It sets them out against the requirements dictated by sustainability considerations and those derived from the matrix of adjustment requirements.

In countries which exhibited a significant amount of economy slack, i.e. an average output gap of less than -1.5 % of potential GDP, the recourse to flexibility and unusual event clauses averted, on the face of it, a pro-cyclical fiscal contraction (the dark blue diamonds are below the yellow squares). However, it also implied a major departure from the adjustment requirements suggested by the sustainability needs of the countries concerned (the light blue triangles). In some countries with a positive output gap, flexibility clauses entailed a pro-cyclical fiscal expansion. In sum, the flexibility and unusual event clauses granted in 2015-2017 have not necessarily improved the balance between fiscal stabilisation and the sustainability of public finances.

Graph 5.2: **Fiscal requirements and cyclical conditions in 2015-2017**



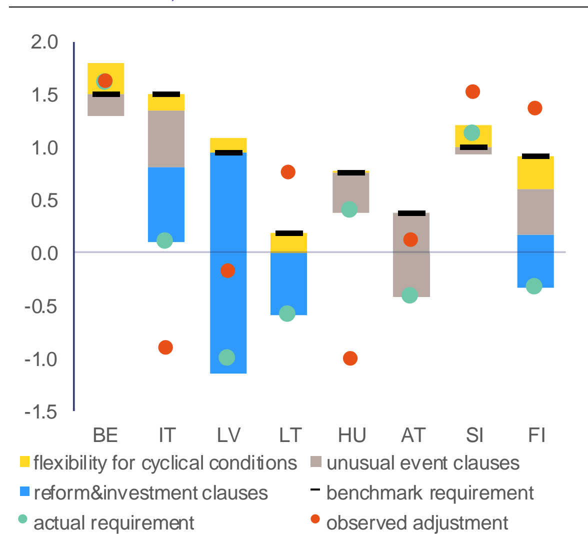
Notes: The output gap in 2015-2017 is an average of output gap estimates of each year t from the Commission spring forecast of year t+1. The sustainability indicator refers to the structural adjustment in 2015-2017 necessary to reach a 60 % government debt-to-GDP ratio in 15 years' time; it is calculated from the medium-term sustainability risk indicator (S1), as estimated by the Commission and reported in its Debt Sustainability Monitor.
Source: European Commission, own calculations.

Turning to budgetary outcomes, in terms of Member States' compliance with their MTO or adjustment towards it, the first 3 years of application of the flexibility clauses provide a rather mixed picture. Graph 5.3 compares the cumulated adjustment requirement of the countries that were granted allowances with the actual improvement of the structural budget balance in 2015-2017. It shows the transition from the benchmark requirement of 0.5 % of GDP per year as defined in EU law to the final recommended adjustment, taking into account the different types of flexibility. Although the flexibility provisions, including the unusual event clauses, reduced the required fiscal adjustment by a sizeable amount, some Member States nevertheless failed to observe the more comfortable adjustment path. Italy and Hungary clearly fell short of the required fiscal effort. The case of Italy stands out: while it was granted reductions under the structural reform, the investment and the unusual event clauses, which lowered the required cumulative fiscal adjustments from 1.5 % of GDP to 0.1 % of

GDP, the structural balance deteriorated by 0.9 % of GDP in 2015-2017.

A priori, flexibility provisions cannot be responsible for lack of compliance with EU fiscal rules. However, the outcome documented above should trigger a debate on whether the design of the framework offers adequate incentives and actually strengthens ownership to comply with the EU fiscal rules, especially as greater ownership was one of the main motivations for clarifying flexibility within the existing rules in 2015.

Graph 5.3: **Cumulative fiscal adjustment in 2015-2017: from benchmark to actual adjustment, % of GDP**



Notes: Benchmark requirement = adjustment of 0.5 % of GDP per year (until the MTO is achieved). Flexibility for cyclical conditions = modulation of adjustment as per the 'matrix of adjustment requirements' around the benchmark requirement.
Source: European Commission.

Table 5.3 summarises the track record of the Member States that were granted flexibility. For the two Baltic countries, and to a lesser extent for Finland, the structural budget balance turned out consistently higher than required. Italy, by contrast, has constantly fallen short of the required adjustment even after the application of flexibility and unusual event clauses. In 2017, the structural budget balance even fell below the minimum benchmark, i.e. the structural position that is meant to provide a sufficient safety margin against the risk of breaching the 3 % of GDP deficit reference value of the Treaty. However, the recurring failure to comply with fiscal targets did not lead to a formal breach of EU fiscal rules because of the margin of broad compliance that comes on top of the deviations granted under the different flexibility provisions: a deviation from the required adjustment including flexibility is only considered significant if it exceeds 0.5 % of GDP in a single year, or cumulatively over 2 consecutive years (see Section 2.2.2).

In sum, the different forms of flexibility, coupled with the margin of broad compliance when assessing estimated changes of the structural budget balance, have considerably lengthened the period of convergence towards the MTO. For the countries not yet at their MTO, the average annual adjustment in 2015-2017 turned out to be around 0.4 % of GDP and it almost halved in countries with a debt-to-GDP ratio above 60 %.

Table 5.3: **Structural balance: targets and outcomes 2015-2018 (Latvia, Lithuania, Italy and Finland)**

	Structural balance *(% of potential GDP)*	Latvia	Lithuania	Italy	Finland
	2014 outturn	-1.6	-1.2	-0.9	-1.6
2015	required without clauses	-1.2	-1.3	-0.9	-1.3
2015	required with clauses	-2.0	-1.3	-0.9	-1.4
	2015 outturn	-1.9	-0.4	-1.0	-1.6
2016	required without clauses	-1.0	-0.6	-0.5	-0.6
2016	required with clauses	-1.6	-1.3	-1.3	-0.8
	2016 outturn	-0.8	-0.2	-1.7	-0.9
2017	required without clauses	-0.3	-0.3	-0.8	-0.7
2017	required with clauses	-1.7	-1.7	-1.2	-1.5
	2017 outturn	-1.2	-0.6	-1.7	-0.1
2018	required without clauses	-0.8	-0.6	-1.1	0.4
2018	required with clauses	-1.5	-1.2	-1.4	-0.3
	p.m. MTO =	*-1.0*	*-1.0*	*0.0*	*-0.5*

Note: (1) For each given year, the table reports i) the level of the structural balance of the previous year; ii) the structural budget balance required before the application of clauses and iii) the structural budget balance required once all the clauses are considered. Cases where the structural balance turned out lower than required (i.e. after the application of flexibility and unusual event clauses) are highlighted in red. (2) For Italy, the required level of the structural balance (with clauses) in 2018 takes into account the 'margin of discretion' (see Section 2.2.1)
Source: European Commission.

5.2.3. The structural reform clause

Since 2015, only four Member States have made use of flexibility under the structural reform clause: Italy, Latvia, Lithuania and Finland. Excluding systemic pension reforms, for which provisions had already been specified before 2015, the reform clause was activated to support government reforms in a wide range of areas (see Table 5.4)([134]). The Commission's review of the flexibility clauses noted that less than a quarter of all eligible Member States applied for and benefited from a temporary deviation from the adjustment path on account of structural reforms. The fairly limited demand most likely reflects political costs of structural reforms which are typically perceived to be significantly higher than the budgetary benefits obtained from the flexibility granted under the SGP.

According to the commonly agreed position of the Commission and the Council of November 2015, to be eligible, structural reforms must be major and with

([134]) Systemic pension reforms that introduce a multi-pillar system are a special case and require a specific assessment by Eurostat; see Article 5(1) of Council Regulation (EC) No 1466/97.

positive long-term effects on growth and the sustainability of public finances. In line with the *Code of Conduct on the SGP*, Member States have to provide the Commission with an in-depth and transparent documentation, including a quantitative analysis of the short-term budgetary costs of the prospective reform, complemented by an independent evaluation.

It is admittedly difficult to assess the impact of structural reforms on potential output and the long-term sustainability of public finances. The difficulty lies at the heart of the more fundamental problem in economic science, namely establishing convincing and conclusive counterfactuals. Even complex economic models used to simulate policy measures cannot capture all aspects of structural reforms. As a result, the Commission did not carry out its own assessment of the Member States' reform proposals. The Commission assessment has always been limited to a plausibility check of the government's own analysis, even when, as in the case of Italy, the analysis lacked an independent evaluation. On the other hand, the Council always endorsed the Commission's conclusions.

The Commission and Council's commonly agreed position of December 2015 also states that the Council will grant the temporary deviation only after the Commission confirms the full implementation of the agreed reforms. The *Code of Conduct on the SGP* further clarifies that '*in case a Member State fails to implement or reverses the agreed reforms, the temporary deviation from the MTO, or from the adjustment path towards it, will be considered as not warranted'*. While assessing the economic impact of structural reforms is difficult, it is a more factual and straightforward exercise to monitor their implementation, i.e. assess whether a government (i) has adopted all the relevant legal and implementing acts and (ii) is ensuring the necessary administrative follow-through. The European Semester process is in fact the established framework for carrying out a detailed assessment of all structural reforms implemented by Member States, including those relating to flexibility clauses under the SGP.

In actual practice, however, the Commission's assessment was not always conclusive or raised doubts about the full implementation of the reforms. When assessing the flexibility granted to Italy in 2016 and to Finland in 2017 under the structural reform clause, the Commission did not discuss whether the conditions for granting the flexibility had actually been met. The Commission also did not refer to the relevant part of the respective Country Reports published under the European Semester, while the 2017 budget for Italy contained provisions that partially reversed some reforms. In the case of Latvia, the Commission noted that the implementation of the healthcare reform broadly followed the announced plan. In the case of Lithuania, the Commission assessment of the draft budgetary plan of 2018 considered that *'measures related to the pension reform have been implemented from the start of 2017, while the labour market and associated reform measures entered into force in July 2017'*. However, in spring 2018, the Commission argued that the pension reform might not be sufficient to address the falling adequacy of pensions in the future.

Table 5.4 provides a summary of the Commission's assessment of the structural reforms in relation to the flexibility clauses for Italy, Latvia, Lithuania and Finland, as per the 2017 and 2018 Country Reports published as part of the European Semester. The picture that emerges is mixed at best. In none of the cases does the Commission assessment indicate full implementation.

Table 5.4: **Major structural reforms: assessment of progress**

Country	Granted deviation	Main area of intervention	Country Report ex-post assessment
Italy	2015 Stability Programme (SP) 0.4% in 2016	(i) Public administration	limited progress (2017) some progress (2018)
		(ii) Product and service markets	limited progress (2017) some progress (2018)
		(iii) Labour market	some progress (2017) limited progress (2018)
		(iv) Civil justice	some progress (2017) limited progress (2018)
		(v) Education	-
		(vi) A tax shift	some progress (2017) limited progress (2018)
		(vii) Spending review	substantial progress (2017)
	2016 SP 0.1% in 2016	(viii) Bank insolvency procedure	some progress (2017) limited progress (2018)
Latvia	2017 SP 0.1% in 2017	(ii) Healthcare reform	limited progress (2017) some progress (2018)
Lithuania	2017 SP 0.5% in 2017	(ii) Labour market	some progress (2017; 2018)
		(iii) Additional pension reforms	some progress (2018)
Finland	2017 SP 0.5% in 2017	(i) Pension reform	-
		(ii) Health and social services	some progress (2017) limited progress (2018)

Note: The different categories of progress (no progress; limited progress; some progress; substantial progress; full implementation) are those used under the European Semester (for more details, see Annex A Overview Table of Country Reports). 'Some progress' refers to a situation in which national parliaments or governments have taken a formal decision, but implementing acts are missing.
Source: European Commission.

Finally, when different forms of flexibility are at play, even the assessment of the numerical budgetary conditions becomes blurry. In 2017, as noted in Section 2.2.2, Italy benefited from all current and past deviations granted, including for structural reform and investment expenditure, although the structural balance fell below the minimum benchmark that ensures a safety margin against the risk of breaching the 3 % of GDP deficit reference value.

5.2.4. The investment clause

The Commission's own review of flexibility within the SGP highlights that, in 2015-2017, the eligibility conditions for the investment clause turned out to be more restrictive than for the structural reform clause. The investment clause requires a country to be in bad economic times, as measured by an estimated output gap below -1.5 % of GDP. As the recovery in the euro

area improved, very few countries were estimated to have such a large negative output gap. Italy and Finland were the only two countries that applied for and were granted flexibility under the investment clause. In the case of Finland, the Council granted the request after applying constrained judgement (see Section 2.2.2), that is, after picking an output gap estimate different from the one derived from the commonly agreed methodology.

The key condition to be met *ex post* to effectively benefit from flexibility under the investment clause is that government investment does not decrease in absolute terms. This condition intends to ensure that the flexibility is effectively used to increase government investment expenditure and to avoid that nationally financed investment is simply substituted with co-financed expenditure. As explained in Box 5.1, the clause only applies to government investment expenditure co-funded by the EU under certain programmes, i.e. the Structural and Investment Fund, the Trans-European-Network or Connecting Europe Facility, the European Fund for Strategic Investments.

In the case of Italy, total government investment declined in 2016. The Commission acknowledged that this was due to a sharp fall in government investment involving EU co-funding, which mainly resulted from the transition to the new code of public procurement and concessions and the start of the new programming period for EU funds. However, the domestic public investment net of the co-funded part did increase, although marginally. It concluded that there was no substitution between co-financed and nationally financed investment. In the case of Finland, by contrast, outturn data for 2017 displayed a decline in public investment compared to the previous year, while investment linked to EU funds was estimated to have remained stable. Therefore, the fall in overall investment was considered an indication that the 'non-substitution' condition had not been met, and the Commission did not confirm the allowance in its final assessment.

5.2.5. The unusual event clause

Since the six-pack reform of the SGP in 2011, temporary deviations from the adjustment towards the MTO may be allowed in case of unusual events that are outside government control and have a major impact on the financial position of the general government. The overarching condition is that fiscal sustainability in the medium term is not endangered ([135]). Although the unusual event clause had initially been intended for events such as natural disasters, it was first activated in spring 2016 (ex-post for 2015) to provide for the budgetary costs associated with the exceptional inflows of refugees. In 2016, the Commission further clarified that the clause could be applied to costs linked to security measures following the terrorist attacks in 2015 and 2016. In 2017, the clause was used to grant a temporary deviation to Italy for government expenditure related to seismic events in 2016.

In 2016 the Commission laid out principles for applying the unusual event clause ([136]): (i) budgetary costs should be directly linked to the unusual event; (ii) deviations are allowed on a temporary basis only, in principle not exceeding 2 years; (iii) allowances should only reflect the additional costs compared with the previous year; (iv) the additional expenditure can only be confirmed in the final assessment.

In practice, however, the Commission has not strictly followed those principles. Firstly, as explained in Section 2.2.2, by applying to the unusual event clause the provisions agreed for the structural reform and public investment clause, the Commission made each allowance granted under the unusual event clause *de facto* applicable for 3 years, i.e. each temporary deviation is carried forward to the 2 subsequent years as the permissible distance to the MTO. Such a generalised extension is debatable, as unusual events and the ensuing budgetary costs are meant to be exceptional and temporary. Moreover, the extension to 3 years has not been codified in the *Code of Conduct of the SGP*.

Secondly, the Commission granted a deviation under the unusual event clause to Austria in 2015 and 2016, even though the country remained at or above its MTO. This practice is at odds with the fact that the unusual event clause is granted in the final assessment, taking into account an observed deviation from the MTO or the adjustment path towards it. Article 5(1) of Regulation (EC) 1466/97 states that in case of an unusual event, a temporary deviation '*from the adjustment path towards the MTO may be allowed*'; it is silent about a possible deviation from the MTO or about cases where no deviation is observed.

Finally, as indicated in Section 2.2.2, in one case in 2017, the Commission did not follow the principle of considering only increments on the previous year. Moreover, in the same case, the Commission and the Council granted an allowance for costs that were not directly related to an unusual event but to a preventive investment plan.

([135]) See Articles 5(1) and 6(3) of the Council Regulation (EC) No 1466/97.

([136]) See Section 2 of the Commission Communication COM(2015) 800 final, 16 November 2015, on '2016 Draft Budgetary Plans: an Overall Assessment'. https://eur-lex.europa.eu/resource.html?uri=cellar:5d0db65c-8d14-11e5-b8b7-01aa75ed71a1.0002.02/DOC_1&format=PDF

6. FUTURE EVOLUTION OF THE EU'S FISCAL FRAMEWORK

Since its inception in 1997, the Stability and Growth Pact (SGP) has attracted criticism from many quarters for a variety of reasons, and it has been reformed and reinterpreted several times. The rules were first considered to be too simple and rigid, imposing excessive uniformity on the EU Member States. As a result, rules were first reformed in 2005 by introducing country-specific elements and breaking down government budgets into a cyclical and structural component. When the global financial and economic crisis hit the EU in 2008, the SGP was found to be incomplete and too difficult to enforce. The scope of surveillance was broadened and surveillance was tightened. New instruments of enforcement were added and the Commission's role strengthened.

However, the markedly tougher set of EU fiscal rules entered into force during a very slow economic recovery in the course of which Member States with high government debt and a backlog of structural reforms recorded anaemic real growth and inflation. The tension between stronger rules and weak economic momentum was addressed by exploring new forms of flexibility within the existing rules and by applying more economic judgement in assessing compliance. Against the backdrop of growing divisions in the Council over how to implement the Pact, the Commission, based on its own public statements, played a progressively more prominent and more political role.

The outcome of the successive reforms and re-interpretations of the Pact is a system that many observers and stakeholders find unsatisfactory. From a simple multilateral framework, primarily focused on the long-term sustainability of public finances, the Pact today is an extremely complex set of rules, in which fiscal surveillance is increasingly granular and governance is more bilateral. Due to its increased complexity, the Pact is considered to lack transparency and predictability, raising doubts about its consistent implementation. This is evidenced by the increasing drive towards codifying all possible aspects of how to interpret and implement the rules and procedures of the SGP, and the tendency to cement precedents of interpretations of the rules on the grounds of equal treatment.

The current system of EU fiscal rules has reached its limits, and new attempts to fix the many issues in isolation without taking into account the more general architecture of the rules would make things only worse. A general overhaul of the SGP is necessary, to simplify the framework and to make the rules more effective. Following an abridged review of previous reform attempts and an assessment of the current set of rules against established criteria of good practice, this section details a concrete proposal for a simplified and stronger EU fiscal framework. The proposal follows up on the ideas outlined in last year's report and takes into account additional insights gained from the implementation of the 2017 EU surveillance cycle.

The reform proposal detailed in this chapter takes the Treaty as given but requires important changes in secondary EU legislation and in the intergovernmental Fiscal Compact. The key features of the reform proposal are:

- *i.* *A medium-term debt ceiling at 60 % of GDP.*
- *ii.* *For Member States with debt above 60 % of GDP, one operational target formulated as a ceiling on the growth rate of primary expenditure, net of discretionary revenue measures, which ensures the required reduction of the debt ratio over the medium term.*
- *iii.* *A strengthened system of sanctions.*
- *iv.* *Escape clauses for exceptional circumstances, to be triggered parsimoniously and on the basis of independent economic judgement.*
- *v.* *A streamlined surveillance cycle with fewer steps. Adjustments and corrections in fiscal requirements would not be made every year in light of minor deviations, but over the medium term or in the event of major deviations from the ultimate objective.*

Simpler rules and procedures are necessary but will not be enough to ensure effectiveness. One of the main predicaments of the current EU fiscal framework is the increasingly blurred distinction between the analytical assessment underpinning the application of the rules and the final decision of the policy-makers. As long as concerns about the impartiality of the assessment are not addressed, any attempt to simplify the rules would be short-lived. The quest or drive towards refinements and codification would continue. One way to enhance trust among Member States and between the Commission and the Council is to clearly separate the role of the assessor from that of the decision maker(s). Since trust is the flipside of reputation, the governance of the SGP needs to be adapted, either by assigning the task of the assessment to an independent entity, or by endowing the assessor with the necessary independence.

6.1. SIMPLIFYING AND STRENGHTENING THE SGP

Since its early days in 1997, the SGP has undergone numerous reforms, which have gradually increased its complexity. The nature of these reforms was incremental and evolutionary, with the aim of correcting perceived flaws in the fiscal architecture of the EU without altering its overall design, which is anchored in the Treaties and therefore difficult to amend. These changes in the Pact are reflected in its legal basis, which today encompasses a fairly wide web of sources, spanning from the Treaty on the Functioning of the European Union (TFEU), numerous elements of secondary legislation and various agreements on many operational aspects between the Commission and the Council, such as the Code of Conduct. The many reforms often reflected conflicting objectives, sometimes moving towards a stricter framework and sometimes toward a more flexible one. The result is an extremely complex set of rules, methods and processes which are sometimes difficult to follow even for practitioners.

The reforms of the SGP have given rise to a framework that presents internal inconsistencies. The most prominent inconsistency stems from the fundamental difference between the two arms of the SGP: the preventive arm assesses fiscal compliance using structural measures of fiscal effort, while the corrective arm essentially looks at developments in the headline balance. This has enabled Member States under the corrective arm to pursue less demanding fiscal adjustments than countries under the preventive arm, even if the Treaties clearly intended otherwise. Another significant inconsistency stems from the presence of multiple fiscal requirements. For instance, there is a distinction between the fiscal requirements necessary to comply with the medium-term objective (MTO) and those necessary to comply with the debt rule: in the present environment of low nominal GDP growth, the latter was considered to be excessively demanding for high debt countries, leading to a reduced role for the debt rule.

The complexity of the current framework also weighs on its predictability. For instance, fiscal targets are determined (and sometimes revised) based on the output gap, an indicator that is notoriously volatile: while this should ensure a more counter-cyclical orientation of fiscal policy, it also reduces its predictability. Compliance is assessed using more than one indicator; some are unobservable and subject to considerable estimation errors, such as the structural balance. Other indicators are more observable but are also frequently affected by factors which are outside the control of the government, such as the debt reduction benchmark and the headline budget balance in the corrective arm, which can be affected by cyclical developments.

Last but not least, complexity has introduced a significant degree of discretion in the implementation of EU fiscal rules. For instance, the measurement uncertainty of some indicators is compensated by employing an overall assessment, which may conclude that ultimately no indicator provides the right measure. Furthermore, providing flexibility frequently depends on complex evaluations of economic impact of structural reforms and progress in their implementation, both of which are very difficult to assess. While discretion is not a problem per se, under the current governance framework sound economic judgement is often crowded out by other considerations ([137]).

Some attempts have been made in recent years to simplify the SGP within the existing legal architecture of the rules. In particular, the Council adopted in November 2016 two new opinions to give more prominence to the expenditure benchmark as an indicator of compliance with fiscal targets, both under the preventive and the corrective arms of the Pact. Although well intentioned, these steps have not materially reduced the complexity of the EU fiscal framework, because the rules themselves have not been altered.

As a result, the recent discussion among policymakers about the future of EU fiscal governance reflects a change of attitude. It focuses on a reform of the Pact that is more revolutionary than evolutionary, with the ultimate objective of a simpler and more effective framework. In 2016, the Dutch EU Presidency proposed a two-pronged reform of the SGP that involved: (i) moving towards a single indicator for assessing compliance with the rules, to be applied consistently in both the preventive and corrective arms of the Pact; (ii) strengthening the medium-term orientation of government budgeting to improve the overall quality of public finances ([138]). In its May 2017 Reflection Paper on EMU deepening, the Commission also called for a review of EU fiscal rules as part of the

([137]) As Wieser (2018) notes, *'[t]he present rules-based system of the Stability and Growth Pact (SGP) has become nearly unmanageable due to its complexity, and the constant addition of exceptions, escape clauses, and other factors. […] The set-up of rules and procedures forces the Commission into actions designed for grief: fiscal adjustment paths are designed on the basis of forecasts of potential output growth, and thus deviations occur with remorseless logic. The choice is thus of proposing sanctions on the basis of shaky forecasts, or of not proposing sanctions despite the rules requiring them. If the Commission does not wish to sanction such deviations, it again and again has to devise a new rule that explains why fiscal reality is in conformity with rules.'*

([138]) See Dutch Council Presidency (2016).

overall process of completing the economic and monetary union ([139]).

A simplification of EU fiscal rules is also an essential component of the overall process of EMU deepening. In the ongoing policy debate, for instance, the establishment of a central stabilisation function has been proposed. To ensure the credibility and public acceptance of such instrument, and to avoid that any possible fiscal risk sharing weakens the incentives for budgetary discipline, it is envisaged that access to this instrument should be subject to strict *ex ante* conditionality, in the form of full compliance with the SGP. For the reasons highlighted above, however, assessing compliance with the current rules is not a straightforward exercise, and a streamlined fiscal framework is necessary to ensure the smooth functioning of any future stabilisation function.

6.2. PREVIOUS REFORMS OF THE EU FISCAL FRAMEWORK

As mentioned earlier, the successive reforms of the EU fiscal architecture have often reflected competing objectives. For instance, the first major update of the rules occurred in 2005 to make them more flexible and country-specific. The second major update of the framework, which occurred after the European debt crisis with the two-pack and six-pack reforms, aimed instead to significantly strengthen the rules. This was because insufficient enforcement was perceived as the main culprit of the crisis. Afterwards, the introduction of flexibility in 2015 was meant to create more leeway for Member States, as the normalisation of the economy took much longer than expected and the preceding reforms were perceived as too stringent.

Over the course of the last 20 years, the various reforms of the SGP have reflected a gradual change of views over the underlying purpose of fiscal rules. This change of views occurred along three separate dimensions. The first dimension concerns the purpose of fiscal rules and their underlying economic rationale. The second dimension concerns the implementation of the rules, and in particular compliance. The third dimension involves the governance of the overall framework, and which institutions are in charge of enforcing the rules.

6.2.1. The economics of the rules: the role of debt sustainability and economic stabilisation

When the SGP was created in 1997, the rules were almost exclusively concerned with debt sustainability. The Pact aimed at enforcing the Maastricht reference values: a gross debt ratio of 60 % of GDP and a deficit ceiling of 3 % of GDP. The debt reference value aimed for consistency with average debt levels observed at the time, while the 3 % of GDP deficit ceiling would have ensured the stability of the debt ratio under the assumption of a nominal growth of 5 % per year.

The economic motivation underpinning the rules was the need to correct for the well-known problem of the deficit bias, according to which governments tend to accumulate excessive debt. The economic literature cites numerous reasons for this bias: information problems, impatience, exploitation of future generations, electoral competition, common-pool problems and time-inconsistent preferences ([140]). A monetary union further exacerbates the deficit bias because the cost of increased government borrowing from one Member State in the form of higher interest rates is dispersed across the whole union ([141]). Additionally, fiscal rules are necessary to ensure the proper functioning of EMU by preventing negative financial spillovers that may arise from the unravelling of unsustainable fiscal imbalances. Finally, fiscal rules also help safeguard the independence of monetary policy by reducing the incentives for monetary financing.

The strict focus on simplicity and debt sustainability in the original rules drew increasing criticism for lacking adequate economic rationale. In particular, the 3 % of GDP reference value for budget deficits was too rigid for Member States that regard it as a target rather than a ceiling, leading to pro-cyclical policies. Successive reforms of the rules therefore aimed at gradually increasing the weight attributed to economic stabilisation. In the first reform of 2005, the focus of fiscal rules moved from nominal to structural balances, and the MTO under the preventive arm of the Pact became country-specific. The six-pack reform of 2011 introduced the expenditure benchmark in the preventive arm as a complementary indicator to the structural balance: an overall assessment determines compliance with the fiscal requirements based on all information available. While the six-pack reform also reinforced the focus on debt sustainability with the operationalisation of the debt rule, this was mitigated in subsequent years by the increasing consideration given to relevant factors, which could justify lack of compliance with the debt rule during adverse economic circumstances.

Further focus on economic stabilisation came in 2015 when, based on a Commission communication, the Council agreed to an interpretation of the existing rules offering greater flexibility to Member States. The commonly agreed position on flexibility introduced a

([139]) European Commission (2017).

([140]) Calmfors and Wren-Lewis (2011).

([141]) Beetsma and Bovenberg (1999).

modulation of fiscal requirements based on economic circumstances and risks to debt sustainability (see Box 5.1) ([142]). Moreover, Member States were granted the possibility to request a reduction in their fiscal requirements in exchange for additional structural reforms and investments, provided that these had a positive impact on public finances in the long run.

As a result of this long reform process, the SGP moved from a simple but excessively rigid framework that was almost exclusively focused on debt sustainability towards a flexible but overly complicated set of rules, which attempts to account for all possible economic circumstances, involving layers of judgement where the separation between economic analysis and broader political considerations is no longer clear.

6.2.2. The implementation of the rules: from loose coordination to granular surveillance

While successive iterations of the rules have always stressed the Treaty-based requirement of coordinating Member States' economic policies, the manner in which coordination is achieved has changed substantially. In its inception, the SGP was implemented on the expectation that Member States would be committed to following the rules and readily respond to peer pressure.

The limits of peer pressure first appeared in November 2003, when the ECOFIN Council took the controversial decision to put the excessive deficit procedure for France and Germany in abeyance, although they had not taken effective action to correct an excessive deficit. This decision was later challenged by the Commission at the European Court of Justice. The initial reaction to this crisis was to assume that compliance would improve by making the rules more flexible and country-specific, giving way to the 2005 reforms. It was only after the 2010 European debt crisis that more fundamental problems in the EU fiscal architecture became apparent. An inadequate enforcement of the rules before the Great Recession left several Member States with fragile fiscal positions, unable to cope with the shocks of the financial crisis. At the same time, important links between macroeconomic and fiscal imbalances had been neglected.

The need to strengthen the enforcement of the SGP led to substantial reforms. In 2010, the European Semester was introduced to reinforce policy coordination throughout the year. The adoption of the six-pack and two-pack reforms in 2011 and 2013 introduced the significant deviation procedure and established a graduated system of financial sanctions for non-compliance with the rules. Furthermore, euro area Member States were required to submit their draft budgets to the Commission for evaluation, before adoption by national parliaments. These innovations were based on the conclusion that more flexible rules were not enough to strengthen the commitment of Member States, and that tighter monitoring and enforcement were necessary.

A fundamental change that emerged from these reforms is that today the rules aim at providing an extremely granular guidance to national fiscal policies. In the spring of each year, Member States under the preventive arm receive recommendations containing detailed fiscal targets, which are defined on the basis of the economic and fiscal position of each country. For instance, under the current matrix of adjustment requirements, a high-debt Member State facing an output gap between -3 % and -1.5 % of GDP is required to implement an adjustment of 0.25 % of GDP if growth is below its potential or an adjustment of 0.5 % of GDP otherwise. Member States can then negotiate reductions in their fiscal requirements based on the flexibility provisions, in exchange for specific types of investment and structural reforms.

More recent experiences have shown that tighter monitoring and the prospect of sanctions do not necessarily improve enforcement if the Commission and the Council retain a wide margin of discretion in deciding on the size of sanctions.

A final and major change in governance occurred in 2011, when surveillance at EU level was complemented by the establishment of independent fiscal institutions at national level, in order to make the budgetary process more transparent and strengthen the accountability of policy-makers (see Section 3).

6.2.3. The governance of the rules: from multilateral to bilateral, with an enhanced role for the Commission

The successive reforms of EU fiscal rules have also affected the overall governance framework. In its early years, the SGP made a clear separation between the technical assessment of Member State policies, which rested in the hands of the Commission, and the political responsibility to enforce the rules, which was assigned to the Council. Every decision under the SGP had to be explicitly adopted by the Council. The events of 2003 were emblematic of the division between technical assessment and politics, when the Council rejected the Commission's assessment and followed a more political course.

Following the two-pack and six-pack reforms, more responsibility was shifted to the Commission, and the

([142]) European Council (2015).

discretionary power of the Council to waive financial sanctions was significantly reduced with the introduction of the reverse qualified majority voting rule. The Commission was tasked with assessing Member States' draft budgets, and with possibly requesting the submission of a revised budget: such an assessment is an autonomous legal act of the Commission which is merely discussed by the Council and does not require any adoption. Finally, with the introduction of flexibility clauses, there has been a further increase in the discretion to be exercised by the Commission, which was given the complicated and sensitive task of assessing the eligibility conditions that Member States' investment and reform plans have to fulfil before there can be any reduction in their fiscal requirements. Because of these changes, the implementation of the rules has increasingly become a bilateral exercise between the Commission and the Member State concerned, where the peer pressure of the Council was replaced by a more top-down pressure from the Commission, which could rely on its enhanced powers to apply sanctions.

At the same time, the Commission's role has gradually been transformed as a result of greater political integration among Member States. From the simple 'guardian of the Treaties', the Commission has increasingly been given the role of the EU executive. The Commission has also become more political where, as described by President Juncker, *'a political Commission is one that listens to the European Parliament, listens to all Member States, and listens to the people'* ([143]). Today, the roles of the technical assessor and the political enforcer of the rules are more blurred, as the Commission is asked to undertake both.

6.3. DESIRABLE FEATURES OF A NEW SGP

There is broad agreement that fiscal policy should be conducted with a medium-term view and a counter-cyclical orientation and that fiscal rules are necessary to compensate for the government's deficit bias. In their seminal contribution, Kopits and Symansky look into how fiscal rules should be designed to ensure sound budgetary policies ([144]). They identify eight characteristics for a model fiscal rule: it should be (i) well defined, (ii) transparent, (iii) adequate to achieve the intended goal, (iv) internally consistent, (v) simple, (vi) sufficiently flexible to accommodate exogenous shocks, (vii) enforceable and (viii) conducive to efficient policies. The following paragraphs briefly assess the SGP against these characteristics and highlight elements that can be improved.

([143]) Juncker (2016).
([144]) Kopits and Symansky (1998).

Definition of the rules

The most important requirement of a fiscal framework is for the rules to be well specified. The numerical objectives of the rules, the indicators of compliance and the conditions to grant flexibility should be well defined *ex ante*. Over time, the SGP has benefited from clarifications of definitions, as an increasing number of Treaty provisions have been operationalised, such as the debt rule, the adjustment path towards the medium-term budgetary objective and the provisions on sanctions. Nonetheless, there are a number of areas where rules remain open to interpretation, and indeed recent reforms of the Pact have taken the form of agreements between the Commission and the Council on how to implement existing provisions, such as the commonly agreed position on flexibility.

A reformed EU fiscal framework should retain the current good level of definition of the rules, in terms of numerical targets and indicators, while at the same time clarifying the definition of flexibility provisions and escape clauses.

Transparency

The assessments underpinning the enforcement of fiscal rules should be transparent and replicable. The rules should also foster transparency in the conduct of fiscal policies by preventing creative accounting and relying on unbiased macroeconomic and fiscal assumptions. Over the years, the SGP has significantly strengthened transparency by making all Commission and Council surveillance documents public, requiring independent evaluations of forecasts and strengthening accounting rules. The distinction between Commission recommendations and staff working documents has also increased transparency by separating legal decisions from the underlying economic assessment. Furthermore, the creation of independent fiscal institutions at national level has been an important step forward in increasing transparency and government accountability vis-à-vis the national public.

On the other hand, the introduction of multiple indicators of compliance, which frequently point to divergent assessments, has led to an increase in discretion. This is particularly evident in the preventive arm of the SGP, where fiscal performance is assessed simultaneously using the structural balance and the expenditure benchmark. The two indicators often point to conflicting evidence, particularly because their numerical definitions are different. The conflicting information from these two indicators is then evaluated as part of an overall assessment, which invariably relies on elements of discretion and judgement. In particular, even when both indicators point to a breach of the rules

the assessment may conclude that both measurements are incorrect and should not lead to the opening of a significant deviation procedure. Furthermore, the rules provide that fiscal requirements may be revised *ex post*, which decreases the predictability of the framework.

To strengthen transparency, a reformed EU rulebook should be based on a single indicator of compliance. While no indicator is perfect, avoiding a multitude of measures of fiscal effort makes the assessment more predictable and prevents 'cherry-picking'. Moreover, to strengthen predictability and the medium-term orientation of the framework, fiscal requirements should be less volatile from one year to the next. Finally, the role of independent fiscal institutions should be strengthened, to enhance ownership by the public and strengthen government accountability.

Simplicity

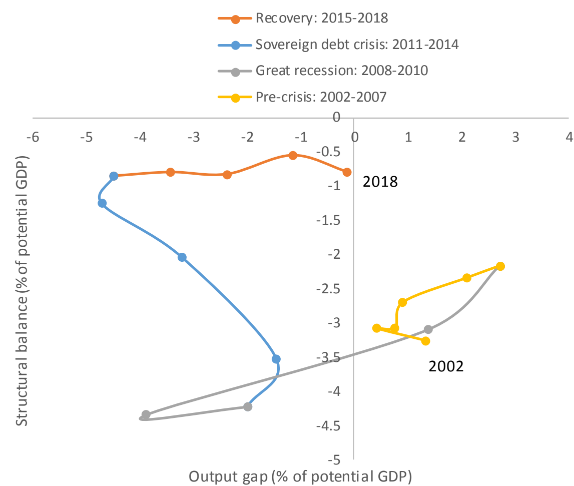
Simpler and more understandable rules are easier to enforce. While initially conceived as a simple framework, the SGP has become increasingly complex because of the need to allow for a growing number of contingencies. Furthermore, there are now two separate anchors, the deficit and the debt, which lead to divergent requirements. Finally, the structural budget balance, the key measurement underpinning the rules, is difficult to understand for both political leaders and the general public. In this respect, the expenditure benchmark introduced in 2011 is much more intuitive, because fiscal recommendations are formulated as limits on net expenditure growth and are much easier to communicate to the public. However, using two indicators in parallel has increased complexity when they do not support the same conclusion. A simplified framework should therefore be based on the expenditure rule only.

Flexibility

An essential feature of a fiscal framework is to strike a good balance between debt sustainability and economic stabilisation, encouraging a counter-cyclical fiscal stance. During good economic times, when the government budget constraint is less binding, fiscal rules must be sufficiently enforceable to correct for the deficit bias of government, and encourage the build-up of adequate fiscal buffers. During bad economic times, when government budgets are more constrained by revenue shortfalls, fiscal rules must be sufficiently flexible to allow for the operation of automatic stabilisers and, in particularly bad times, for discretionary fiscal stimulus.

Until recently, EU fiscal governance has not been conducive to a counter-cyclical fiscal stance. During the pre-crisis period, Member States maintained large structural deficits instead of taking advantage of good economic times to adjust towards their MTOs, and some were even under the excessive deficit procedure in 2007, at the peak of the business cycle. In November 2008, in the context of the economic and financial crisis, the European economic recovery plan advocated a coordinated fiscal stimulus of 1.2 % of GDP, deviating temporarily from the SGP. Under the Plan, Member States would commit to reverse any budgetary deterioration and return to their MTO: in particular, for Member States under an EDP, the plan stressed that '*corrective action [would] have to be taken in time frames consistent with the recovery of the economy*' ([145]). Sizeable fiscal consolidation occurred during the sovereign debt crisis between 2011 and 2014, while the euro area experienced two further years of recession. This abrupt pro-cyclical tightening contributed to further deterioration in the economy while debt ratios continued to increase. In the recovery phase from 2014 onwards, when market pressure ended and the flexibility provisions were introduced in the rules, the euro area fiscal stance gradually became more balanced (Graph 6.1).

Graph 6.1: **Fiscal stance in the euro area**



Source: European Commission.

While the SGP has now achieved a high level of flexibility, this has come at the cost of excessive complexity and reduced transparency, as argued earlier. In addition, the provision of flexibility is often asymmetric, as it comes in the form of waivers when the economy deteriorates. A reformed EU fiscal framework could solve the trade-off between simplicity and flexibility by combining simpler rules with escape clauses, provided that these are well defined, parsimoniously used and triggered on the basis of an independent analytical assessment.

([145]) European Commission (2008).

Adequacy

Fiscal rules should be adequate to achieve the intended objective. Under the preventive arm of the SGP, the rules appear more than adequate, as compliance with the medium-term budgetary objective tends to be more stringent than what is required to comply with the debt rule under normal economic conditions. On the other hand, the adequacy of the corrective arm is doubtful. The 3 % of GDP reference value for the deficit, in particular, was predicated on the assumption of a 5 % average nominal growth, which is no longer plausible in the present economic environment. At the same time, reliance on nominal deficit targets has encouraged Member States to rely on cyclical budgetary windfalls to achieve compliance with the rules, instead of implementing structural measures, a behaviour referred to by the Commission as 'nominal strategy'.

Another important requirement for ensuring the adequacy of fiscal rules is to avoid loopholes, which allow the government to deviate systematically from fiscal requirements. A fiscal framework typically involves a target, which provides *ex ante* guidance for fiscal policy, and a threshold of deviation, which can be used *ex post* to trigger a correction mechanism, such as a sanction. Fiscal rules must therefore account for the possibility that the government engages in strategic behaviour, planning to deviate repeatedly from fiscal targets by effectively considering the threshold of deviation as the actual target to reach. Such was the case in the early years of the SGP, when Member States notoriously disregarded the requirement to achieve their medium-term objective and only considered the 3 % of GDP reference value for the deficit, which effectively became the new operational target. Even after the recent reforms of the Pact, Member States in the preventive arm can still plan to deviate systematically from their fiscal requirements without incurring a significant deviation procedure ([146]).

A reformed EU fiscal framework should therefore contain a mechanism to avoid the possibility of cumulating persistent deviations from fiscal targets. Several existing national fiscal frameworks, such as the debt brakes of Germany and Switzerland, contain compensation accounts where slippages from fiscal requirements are debited and overachievements are credited: governments are required to compensate outstanding balances on the account by aiming for more stringent fiscal targets in the future. A similar mechanism should be present in a redesigned SGP.

([146]) European Fiscal Board (2017b).

Enforceability

To be enforceable, fiscal rules should rely on operational targets that are directly controllable by the government, fiscal requirements that can reasonably be achieved and a credible system of sanctions.

The SGP relies on the structural balance as the main operational indicator. While such an indicator is widely popular in economics, it has also come under significant criticism for not correctly identifying discretionary policy. The structural balance attempts to derive the underlying budgetary position of the government based on the estimated elasticities of revenue and expenditure to the economic cycle. Although conceptually convincing, it is a problematic indicator due to at least two important limitations. First, the assessment of the economic cycle is based on real-time estimates of potential output that tend to be highly uncertain. Second, actual elasticities of revenue and expenditure may depart significantly from their estimated values in a given year, leading to incorrectly classifying cyclical windfalls and shortfalls as discretionary fiscal actions. The expenditure benchmark is less affected by these two problems. On the one hand, the real-time assessment of potential output is replaced by a more stable 10-year average of potential growth; on the other hand, the yield of discretionary revenue measures is estimated directly, by evaluating the budgetary impact of individual tax measures.

Enforcing fiscal rules at EU level also requires a transparent and credible system of sanctions for non-compliance. In the current system of fiscal rules, there are two separate sanction regimes. The first regime is part of the SGP and provides for an escalating system of financial sanctions in case of non-compliance with the rules. Discretion remains however in the hands of the Commission to reduce or cancel the sanctions. Such discretion was for instance exercised in 2016, when the Commission decided to cancel a fine for non-compliance with an excessive deficit procedure in Spain and Portugal.

A second system of sanctions is provided for in the Common Provisions Regulation for Structural Funds, Regulation (EU) 1303/2013. Following non-compliance with an excessive deficit procedure, the Commission is obliged to propose the suspension of ESI funds for the Member State concerned, following a dialogue with the European Parliament. Implementation delays and procedural hurdles have however impeded in some cases the full deployment of this type of sanction. Its effectiveness is further limited by the fact that not every Member State receives significant amounts of ESI funds, while the amount of funds suspended is subject

to important reductions in relation to economic and social conditions.

Finally, an excessive modulation of fiscal requirements should be avoided, because it may lead to fiscal targets which are too stringent and which rely on very uncertain measurements of the cycle. By the same token, interference with national fiscal policies should be avoided when debt sustainability is unquestionable.

Consistency

Rules must be internally consistent. As mentioned earlier, this is not always the case in the SGP. For instance, the MTO provided for under the preventive arm is not consistent with the debt rule for high-debt countries. At the same time, the various operational indicators used are based on different numerical definitions, and often provide a divergent assessment of compliance. A reformed EU fiscal framework should assure consistency by relying on a single set of requirements which are directly derived from the underlying medium-term fiscal anchor, and a single indicator of compliance.

Efficiency

Compliance with fiscal rules should not generate distortions in the economy, and the SGP is mostly faring well in this respect. For instance, reliance on cyclically-adjusted indicators fosters the adoption of structural fiscal measures rather than one-offs. Moreover, under the preventive arm, the expenditure benchmark prevents a country from being penalised for undertaking large investment projects, by smoothing out their costs over time. Finally, with the adoption of flexibility clauses, the rules provide incentives to implement structural reforms and undertake productive investment. A reformed EU fiscal framework should preserve the efficiency-enhancing features of the SGP, ensuring that the rules do not dis-incentivise investment or structural reforms.

6.4. PROPOSAL FOR A SIMPLER AND MORE EFFECTIVE FISCAL FRAMEWORK

Based on the earlier considerations, this section outlines a proposal for a reformed SGP. The proposal has three objectives: first, to put debt reduction at the centre of the rules; second, to strengthen the transparency and predictability of economic governance in the EU; third, to radically simplify the existing framework. The proposal is based on the following elements:

i. A medium-term debt ceiling at 60 % of GDP. The structural MTO will therefore no longer guide fiscal policy in the medium term.

ii. One operational rule: a ceiling on the growth rate of primary expenditure net of discretionary revenue measures. The assessment of compliance will therefore no longer be based on multiple indicators simultaneously, thus reducing the scope for discretion.

iii. A more effective system of sanctions, which will apply to both the preventive and the corrective arms of the Pact.

iv. A streamlined surveillance cycle with fewer steps. In particular, fiscal targets will be fixed for 3 years to strengthen the medium-term orientation of fiscal policies. Furthermore, a compensation account will track deviations from fiscal requirements, avoiding the need for a continuous monitoring of budgetary implementation.

v. Escape clauses, triggered on the basis of independent judgement, will provide additional flexibility during exceptional circumstances. These escape clauses will replace the complex system of waivers and flexibility within the current rules.

vi. A clearer separation between analytical assessment and enforcement of the rules, including the introduction of the comply-or-explain principle.

Table 6.1 makes a comparison between the existing rules and this reform proposal. While the reform outlined in this section could be adopted without changes to the Treaty, substantial modifications in secondary legislation would however be required. Similar proposals have recently been published, focussing on debt reduction via an expenditure rule (see Bénassy-Quéré et al. (2018), Heinemann (2018), Darvas et al. (2018), Feld et al. (2018)). More generally, Eyraud et al. (2018) suggest that fiscal frameworks should ideally be based on a debt anchor combined with a small number of operational rules, while flexibility can be allowed by combining expenditure rules with escape clauses.

Table 6.1: **Comparing the proposed fiscal framework and the current one**

	SIMPLIFIED STABILITY AND GROWTH PACT	CURRENT STABILITY AND GROWTH PACT		
	DEBT ANCHOR	DEFICIT ANCHOR & DEBT ANCHOR		
		PREVENTIVE ARM	CORRECTIVE ARM	
ANCHOR & OBJECTIVE	**Debt below 60% of GDP, or converging towards it**	**Medium-term budgetary objective (MTO) in structural terms**	**Deficit below 3% of GDP**	**Debt below 60% of GDP, or converging towards it**
FISCAL REQUIREMENTS	ANNUAL CEILING ON NET EXPENDITURE GROWTH: • The ceiling ensures that the debt ratio would reach 60% of GDP in, say, 15 years • The ceiling is fixed for 3 years	ANNUAL STRUCTURAL ADJUSTMENT: • 0.5% adjustment as a benchmark • Higher/lower effort based on economic cycle and debt ratio	ANNUAL STRUCTURAL ADJUSTMENT: • Minimum 0.5% adjustment	ANNUAL ADJUSTMENT: • Minimum adjustment ensuring a 5% reduction of debt above 60% of GDP
ASSESSMENT OF COMPLIANCE	ONE INDICATOR OF COMPLIANCE • Net expenditure growth	TWO INDICATORS OF COMPLIANCE: • Structural balance • Expenditure benchmark	THREE INDICATORS OF COMPLIANCE: • Nominal deficit • Structural deficit • Net expenditure growth	THREE INDICATORS OF COMPLIANCE: • Backward-looking debt benchmark • Forward-looking debt benchmark • Cyclically-adjusted debt benchmark
	NON-COMPLIANCE OCCURS IF: • Deviations exceed 1% of GDP (for Member States under the preventive arm) • Net expenditure growth is above the ceiling in a given year (for Member States under the corrective arm)	NON-COMPLIANCE OCCURS IF: • One or both indicators point to a breach larger than 0.5%, in one year or cumulatively over two years • An 'overall assessment' confirms the existence of a breach	NON-COMPLIANCE OCCURS IF: • All indicators fall short of target	NON-COMPLIANCE OCCURS IF: • All three indicators point to a breach
	FLEXIBILITY AND WAIVERS: • Severe economic downturn • 'Unusual events' outside the control of the Member State • Pension reforms	FLEXIBILITY AND WAIVERS: • In 'bad times', fiscal requirements are lowered *ex-post* • Implementation of structural reforms • Implementation of investments • 'Unusual events' outside the control of the Member State • Severe economic downturn in the euro area or the EU as a whole • 'Margin of discretion' in the overall assessment • 'Constrained judgement' in the plausibility assessment of output gap estimates	FLEXIBILITY AND WAIVERS: • In practice, meeting only the nominal target is sufficient (i.e. the 'nominal strategy') • Severe economic downturn in the euro area or the EU as a whole	FLEXIBILITY AND WAIVERS: • Compliance with the required adjustment towards the MTO • Developments in the medium-term debt position (e.g. stock-flow adjustments) • Presence of unfavourable economic conditions • Implementation of structural reforms • Other 'relevant factors'
SANCTIONS	FOR EURO AREA COUNTRIES • No access to central stabilisation function • Suspension of EU funds • Fine	FOR EURO AREA COUNTRIES: • Interest-bearing deposit when a significant deviation occurs	FOR EURO AREA COUNTRIES: • Non-interest bearing deposit when opening an EDP • Suspention of ESI funds • Fine, in case of non-effective action	
ASSESSMENT CYCLE	3-YEAR ASSESSMENT CYCLE, WITH ANNUAL SURVEILLANCE: • Spring T-1: ceiling on net expenditure growth fixed for next 3 years • Autumn T-1: assessment of draft budget • Spring T+1: final assessment of compliance and upgrading of compensation account	ANNUAL ASSESSMENT CYCLE, WITH IN-YEAR SURVEILLANCE: • Spring T-1: required adjustment is defined (for Member States in the corrective arm, requirements are defined in the EDP) • Autumn T-1: assessment of budgetary plans and possible reduction of requirements • Spring T: assessment of implementation, possible SGP steps and autonomous Commission recommendations • Autumn T: assessment of implementation, possible SGP steps and autonomous Commission recommendations • Spring T+1: final assessment of compliance and possible reduction of requirements		
GOVERNANCE	INDEPENDENT BODY: • Assesses eligibility for waivers and escape clauses EUROPEAN COMMISSION: • Proposes waivers and escape clauses • Explains difference of views with the independent assessor • Drafts policy recommendations ECOFIN COUNCIL: • Amends and adopts Commission recommendations • Explains difference of views with Commission	EUROPEAN COMMISSION: • Proposes waivers and escape clauses • Drafts policy recommendations ECOFIN COUNCIL: • Amends and adopts Commission recommendations		

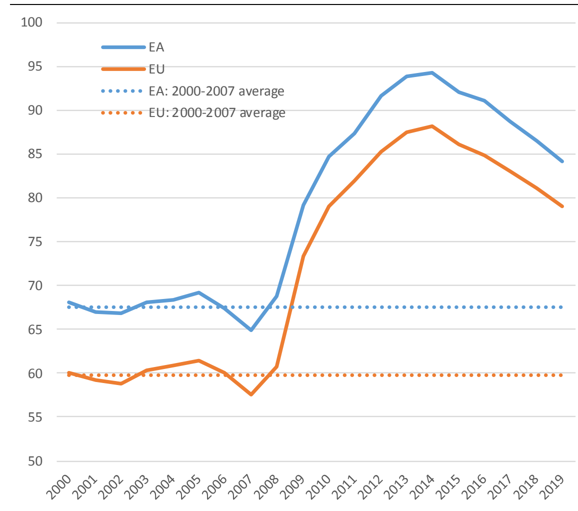
Source: European Fiscal Board.

6.4.1. A medium-term debt ceiling at 60 % of GDP

The debt-to-GDP ratio should be the anchor of the new simplified fiscal framework. This choice ensures that long-term debt sustainability in the Member States remains the ultimate objective of the rules. At the same time a debt anchor helps to provide an overall signal, for both the government and the public, of the amount of fiscal space that is available over the medium term, with higher debt ratios associated to more stringent budgetary conditions.

The ceiling for the debt ratio should remain at 60 % of GDP. Although not underpinned by solid theoretical considerations, this value is now broadly accepted by the public, and maintaining it will avoid the need for changes to the Treaty. The Maastricht Treaty first introduced the 60 % of GDP reference value for the debt ratio in 1992, based on the consideration that such a value was consistent with the average debt ratio in the Union at the time. The experience of the following years showed that this value was still in line with average debts in the euro area and the EU for the years up to the financial crisis (Graph 6.2). Finally, the focus should remain on the stock of gross government debt, given the difficulties in estimating non-financial government assets.

Graph 6.2: Average debt ratio in the euro area and the EU, % of GDP



Source: European Commission.

6.4.2. A ceiling on net expenditure growth as the operational target

To achieve the objective of the framework, as defined by the fiscal anchor, an operational rule is needed to guide fiscal policies. For Member States whose debt is already below 60 % of GDP, the only requirement is to ensure that their budget deficit remains below the 3 % reference value, in line with Treaty requirements. For Member States with debt above 60 % of GDP, fiscal requirements will take the form of a ceiling on the growth rate of primary expenditure at current prices, net of discretionary revenue measures. For high-debt Member States, fiscal requirements will be determined with the same operational rule in both the preventive and the corrective arms of the Pact. If a Member State with debt above 60 % of GDP is placed under the excessive deficit procedure, the deadline to correct the excessive deficit will be established based on the nominal budgetary developments implied by the ceiling on net expenditure growth. The only difference between the corrective and the preventive arms of the SGP will consist in the degree of surveillance and sanctions for non-compliance.

The ceiling on net expenditure growth is computed on the basis of:

i. An underlying macroeconomic scenario, including assumptions about real GDP growth, inflation, interest rates, as well as the size of the existing stock of gross government debt. Such a scenario should assume that output is at its potential rate, to ensure that fiscal targets are not affected by short-term cyclical developments.

ii. A time-frame for adjustment of, say, 15 years, indicating the speed at which government debt should converge towards the 60 % of GDP ceiling. The ceiling on net expenditure growth is computed in a given year t to ensure that gross debt reaches 60 % of GDP in year $t + 15$, based on the underlying macroeconomic scenario.

The ceiling on net expenditure growth would be fixed for a three-year period, in order to provide a medium-term orientation to fiscal policies. In year t, the ceiling is computed to ensure a 60 % debt-to-GDP ratio in $t + 15$. The ceiling is then recalculated in year $t + 3$, on the basis of the realised stock of debt and an updated macroeconomic scenario, so as to ensure that the 60 % debt-to-GDP ratio is reached again in 15 years' time. As a rule, this ceiling would not be modulated over the cycle: maintaining a steady rate of expenditure growth provides already a sufficient level of short-term stabilisation. Box 6.3 provides an analytical derivation of the expenditure rule.

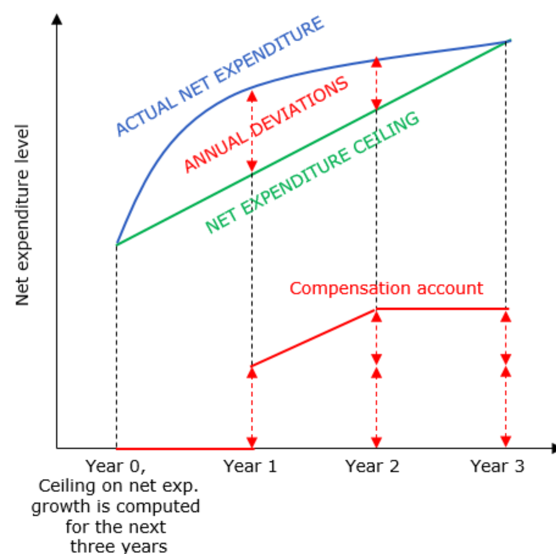
6.4.3. Assessing compliance with the expenditure rule

Compliance with the expenditure rule, under both the preventive and the corrective arm, is assessed with a single indicator of net expenditure. In line with the current methodology used in the expenditure benchmark of the SGP, net expenditure is defined as

overall government expenditure net of interest payments, cyclical unemployment benefits, EU-funded investments and discretionary revenue measures, with gross fixed capital formation smoothed over four years. When assessing compliance with the rule, this single indicator will not be complemented by any other information. There will not be an overall assessment under the preventive arm nor a 'careful analysis' under the corrective arm.

Under the preventive arm, a cumulative deviation from the expenditure ceiling in excess of 1 % of GDP will be considered *prima facie* evidence of non-compliance with the rules. Deviations from the ceiling for net expenditure will be recorded in a compensation account: when net expenditure is above the ceiling in a given year, the difference will be credited into the account; when it is below the ceiling, the shortfall will be debited in the account and will compensate for past excesses (Graph 6.3). Whenever the compensation account exceeds a positive balance of 1 % of GDP, this will be considered *prima facie* evidence of non-compliance with the rules. This mechanism will ensure that any deviation of primary expenditure from the ceiling will have to be corrected in future years, or compensated with additional revenue measures. For Member States under the corrective arm, there should be no compensation account, and any deviation from the net expenditure ceiling should be considered *prima facie* evidence of non-compliance.

Graph 6.3: **The compensation account**



Source: European Fiscal Board.

6.4.4. Sanctions

To increase the effectiveness of the system of sanctions, the current EU fiscal framework should be reformed along three directions: (i) there should be no discretion in setting the amount of the financial sanctions when a Member State is non-compliant with the rules; (ii) macroeconomic conditionality in the EU budget, linking the disbursement of EU funds to compliance with EU fiscal rules, should be strengthened and extended beyond the ESI funds; and (iii) access to a future central stabilisation mechanism, such as the one proposed in the June 2018 Report of the EFB, should be conditional to compliance with the expenditure rule. Alternative systems of market-based discipline may also be worth considering ([147]).

The current system of sanctions requires that a Member State sets aside funds equal to 0.2 % of GDP in an interest-bearing deposit if it failed to take effective action in the context of an SDP ([148]). Under the corrective arm of the SGP, failure to take effective action leads to a fine equal to 0.2 % of GDP as a rule. However, in exceptional circumstances or following a reasoned request by the Member State, the Commission may decide to reduce or cancel the fine. This discretion was exercised in full in 2016 when the Commission decided to set the fine to zero in the case of Spain and Portugal, setting a precedent for future penalties. By removing this discretion, the system is likely to gain credibility. The proposed change can also clarify the role of the respective institutions while reinforcing Commission impartiality.

The cases of Spain and Portugal in 2016 suggest that economic conditionality may be more effective in strengthening compliance with fiscal rule. To this end, the macroeconomic conditionality in the EU budget should be strengthened in three ways. First, in line with the conditionality already foreseen in the Common Provision Regulation for ESI funds, Member States that are in breach of the rules should face a suspension of a pre-determined amount of EU funds. Member States could establish *ex ante*, in the preparation of the multiannual financial framework, the amount of EU funds that could be withheld from the Member States as soon as the Council issues a decision establishing non-compliance with the rules. Second, the suspension should involve any type of funds, not just those related to structural investments. Third, conditionality should

([147]) For instance, Bénassy-Quéré at al. (2018) propose that borrowing in excess of spending targets should be financed by junior bonds with (i) one-limb collective action clauses, (ii) a fixed maturity which will be automatically extended in case of an ESM programme, (iii) no benefit from existing regulatory privileges (e.g. zero risk-weighting) and a large exposure limit. See also Bini Smaghi and Marcussen (2018) and Tabellini (2018).

([148]) In addition, if the Council establishes the existence of an excessive deficit, the deposit is converted into a non-interest bearing deposit.

be applied equally for non-compliance under both the preventive and corrective arms.

If a central fiscal capacity is established in the euro area, such a mechanism should help to strengthen EU fiscal rules by requiring compliance with the expenditure ceiling to access the mechanism ([149]). In particular, access to the fund should be denied when, in one of the previous years, the Member State is in breach of the expenditure rule beyond what is allowed by the compensation account, and the possible triggering of escape clauses (see next section).

6.4.5. Escape clauses

To provide additional flexibility in the framework, beyond the counter-cyclical effect of the expenditure rule, a general escape clause should replace the existing system of waivers and derogations under the current rules as assessed in Chapter 5. Such an escape clause will be triggered only in exceptional circumstances and will cover events that are outside of the control of the Member State. The clause can be triggered at the request of the Member State concerned, or directly by the Commission and the Council, subject to an independent verification that the eligibility criteria are satisfied. In that case, the Member State will be allowed to deviate from its fiscal targets and, for Member States under the preventive arm, the deviation will not be recorded in the compensation account.

To avert the opportunistic use of escape clauses, an independent body will assess whether the conditions for triggering the clause apply, and will provide advice to the Commission and the Council (see Section 6.4.6).

A deviation from the net expenditures ceiling will be allowed in two circumstances:

i. In case of adverse economic events. If a Member State is experiencing a recession or a severe economic downturn, a deviation can be allowed, to provide extra room for fiscal stabilisation. This request will need to be examined by an independent body (see Section 6.4.6), which will assess (i) whether the Member State has been hit by a significantly large adverse economic shock (e.g. a recession or a large negative output gap); (ii) whether, and to what extent, fiscal policy would be able to offset the shock; and (iii) whether a deviation from the SGP would imperil debt sustainability in the Member State concerned. Based on a Commission proposal, the Council will decide whether to grant a temporary deviation from the rules to the Member State concerned, after taking into account the independent assessment. In case the Council or the Commission decide to reject the assessment of the independent body, they will motivate the rejection.

ii. In case of expenditure which is non-discretionary despite being non-cyclical, in the spirit of the current unusual event clause of the SGP. The request will need to be examined by an independent body, which will assess whether: (i) the deviation is due to an event that is outside of the control of the government; (ii) it is temporary; (iii) the deviation does not imperil debt sustainability in the Member State concerned. The Commission and the Council will decide whether to credit the deviation in the compensation account or not, after taking into account the independent assessment. In case they decide to deviate from this assessment, they will motivate the deviation.

Finally, the particular consideration that the SGP gives to pension reforms should be maintained in the reformed rules. A Member State implementing a pension reform introducing a multi-pillar system, including a fully-funded pillar, should be able to obtain a deviation from its fiscal targets, for an amount limited to the increased short-term costs related to the establishment of the fully-funded pillar.

6.4.6. Governance

Simplification of the rules could remain fruitless, maybe even counterproductive, if not accompanied by a change in governance acknowledging the need for some discretion, and for how and by whom it should be exercised. Simpler rules look temptingly easy to understand and implement compared to the current rules of the SGP, but they are not sufficient to make a reform successful. The reason for the current complexity is that the economic reality itself is complex and that, over time, the Pact has evolved to reflect it more accurately and leave some room to adapt to unforeseen conditions. While justifiable to enhance the economic rationale, predefining complex rules as a framework for exercising discretion in implementing fiscal surveillance has not proven ideal. Experience shows that a complete contract covering all possible situations is neither possible nor, most likely, desirable.

([149]) In May 2018, the Commission adopted a number of legal proposals preparing the ground for a central stabilisation function as part of the 2021-2027 multiannual financial framework (MFF). The proposal aims at establishing a European Investment Stabilisation Function (EISF), to be used in the event of large asymmetric shocks and subject to compliance with the SGP. For further discussion on the role of fiscal rules in accessing a central stabilisation function, see European Fiscal Board (2018).

Still, reverting to a simple Pact could mean losing what has been learnt from experience over time (Bini Smaghi, 2018). It would also leave a crucial question unanswered: some discretion in the implementation of fiscal rules is inevitable, so if this is not provided for by the Pact itself, then who would be in charge of accounting for the economic environment?

The question of who should exercise discretion is closely linked to how the Commission has evolved as an institution. In the 2017 edition of its annual report, the EFB discussed how the Commission was caught between two roles. On the one hand, its original role is, by design, that of an impartial guardian of the EU Treaties. On the other hand, the Commission also has an executive and political role that, in the EU integration process, has become more prominent.

To clarify the perspectives of fiscal surveillance based on economic analysis and of the policy decisions which draw on it while adding broader considerations, the analytical and political perspectives should be made more clearly identifiable. Fiscal surveillance should be grounded in solid and consistent economic analysis, leading to impartial advice. Country-specific recommendations and corrective procedures will also draw on elements of discretion decided at the political level – the Commission, the ECOFIN Council and the Eurogroup.

Several options could be envisaged to safeguard the impartiality of the analytical assessment underpinning the Commission's proposals. One option could be to maintain this task within the Commission, by ring fencing an assessor that would enjoy full independence. Another option could be to outsource the analytical assessment to one or several external bodies, provided that this is consistent with the Treaties. This would require establishing or strengthening an independent institution at the central level outside the Commission, or independent institutions at the national level. The independent assessor(s) would feed analytical input into the surveillance process and ultimately into the decisions. In parallel, there would still be a role for an independent watchdog to assess the implementation of the fiscal framework and the consistency of the decisions taken, without being directly involved in the decision-making process.

Each option raises in turn fundamental questions about the division of labour, which this report does not intend to solve but only to highlight. First, what should be the relationship between the independent analytical assessor(s) and the Commission in its role of making proposals? Where would the analytical assessment end and the broader policy considerations begin? Should the comply-or-explain principle apply for the Commission vis-à-vis independent assessor(s) in the same way as it is meant to apply for national governments vis-à-vis their respective IFIs?

Second, if the option were more decentralised surveillance, how would coordination and consistency be ensured? Would the coordinator have a mandate to cross-check the assessments?

Third, the role of IFIs in this context deserves a specific discussion. Should they be endowed with a surveillance role? IFIs can and should play a stronger role in the fiscal surveillance framework, but this needs to be assessed carefully. The risk is to create a cacophony of voices, for lack of a coordinated and clear allocation of tasks, potentially triggering conflicts between the EU and the national level. Moreover, in the short to medium term, it is not clear whether all IFIs would be sufficiently independent and staffed for this role. Finally, the crux of the matter is that IFIs may enjoy independence only as long as they have the role of a watchdog, with the important task of enhancing transparency on budgetary matters and thus putting pressure on governments. To what extent would this independence be preserved if IFIs were given a more direct role in the decision-making process? Political pressure would be bound to arise, reviving the issue of the confusion of roles.

6.4.7. A simpler surveillance cycle

The Council will issue country-specific recommendations to each Member State in the spring of a given year, containing a ceiling on net-expenditure growth. The ceiling should be fixed for 3 years, and will form the basis for medium-term government plans. These fiscal requirements will be set in the same manner for each Member State, irrespective of whether they are in the preventive or the corrective arm of the SGP. Member States will detail in their stability and convergence programmes all the budgetary measures they intend to take to ensure compliance with the expenditure ceiling over the 3-year period and, in the autumn of each year, Member States will publish their draft budgets, which will be assessed by the Commission. If a budget is deemed to be non-compliant with the rules on the basis of Commission projections, the Commission may request the Member State to submit a revised budget including additional measures.

A final assessment will be carried out on the basis of notified data. If a deviation from the net expenditure ceiling is observed, an independent assessment will be carried out to determine whether the Member State can avail itself of the escape clause. If the escape clause is not triggered, the Commission and the Council will decide whether to impose sanctions on the Member

State concerned, taking into account the independent assessment. In line with current practice, if a Member State's budget deficit exceeds the 3 % of GDP reference value and the breach is not exceptional and temporary, an excessive deficit procedure will be launched. The procedure may not be launched if the Member State with an excessive deficit is complying with the expenditure ceiling, or has a debt ratio projected to stay below 60 % of GDP.

6.4.8. Numerical examples

Box 6.1 simulates the functioning of the proposed expenditure rule for high-debt Member States in the euro area, while Box 6.2 presents a sensitivity analysis for the euro area as a whole. These simulations broadly illustrate the fiscal requirements stemming from the proposed rule ([150]), based on a set of macroeconomic assumptions. Three fundamental results emerge.

First, fiscal policy under the expenditure rule would be more counter-cyclical than what is currently foreseen by the debt rule in the SGP. The simulations indicate that the proposed expenditure rule tends to achieve equivalent (or faster) rates of debt reduction than the debt rule in the SGP, while at the same time allowing for a more stable path for net expenditure growth. This leads to a fiscal stance that is more counter-cyclical, because Member States are not required to compensate revenue shortfalls when the economy is below its potential. Furthermore, Box 6.2 shows that the expenditure ceiling remains roughly unchanged even in the case of a significant recession, allowing Member States to rely on extra debt for shock absorption. In the practical implementation of the rule, as outlined in earlier sections, further flexibility during economic downturns would be made available by the use of escape clauses.

A second important result is that, for all Member States considered with the exception of Cyprus, the expenditure rule implies a tightening of the fiscal stance over the medium term. This is because the ceiling for net expenditure growth is not just linked to potential growth, but also to the level of outstanding public debt: the higher the debt ratio, the lower expenditure growth needs to be compared to potential growth, while extra revenues are used for debt reduction. This contrasts with the expenditure benchmark currently foreseen in the preventive arm of the SGP where, for Member States that are at their MTO, net expenditure growth is linked exclusively to potential growth, irrespective of the level of debt.

([150]) The simulations ignore the presence of the compensation account.

Finally, the proposed rule requires Member States to maintain moderate levels of primary surpluses, with the exception of Portugal and Italy. Under available estimates for potential growth and interest rates, based on methodologies and assumptions agreed with Member States ([151]), the two countries would be required to maintain higher primary surpluses to compensate for adverse structural developments. Nevertheless, under the proposed expenditure rule, the required adjustment is distributed over a 15-year horizon, implying a lower annual fiscal effort than what is foreseen under the current rules.

([151]) Potential growth rates are estimated with a production function approach, endorsed by the ECOFIN Council. Long-term real interest rates are assumed to linearly converge to 3 %, as agreed by Member States within the Ageing Working Group of the Economic Policy Committee, and in line with average real market rates observed in the euro area since 1970.

Box 6.1: Simulating the expenditure rule for high debt countries

The SGP currently requires Member States to reduce any amount of debt in excess of the reference value of 60 % of GDP by an average annual rate of 5 %. Since this rule is defined in nominal terms, it has a tendency to promote pro-cyclical policies. In good economic times, Member States may rely on high growth and inflation to achieve the required debt reduction, without the need for any additional consolidation. During a downturn, on the other hand, the debt rule requires Member States to tighten fiscal policy in order to compensate for the adverse impact of low inflation and growth on debt dynamics.

Under the expenditure rule proposed in this chapter, Member States must ensure that the growth rate of primary expenditures at current prices, net of discretionary revenue measures, does not exceed a predetermined ceiling. This ceiling is computed to ensure that, if net expenditure grows consistently at this pace, the gross debt-to-GDP ratio reaches the 60 % reference value after 15 years, provided that the economy is growing at its potential rate and inflation is at 2%. The net expenditure ceiling is recomputed every 3 years; at the same time, the 15-year horizon to bring the debt ratio to 60 % is extended by 3 years. The target is therefore reached asymptotically, as under the existing debt rule.

Over the medium term, the reduction in the debt ratio implied by the proposed expenditure rule is equivalent to or slightly faster than the one implied by the existing debt rule in the SGP. In the short term, however, the expenditure rule is significantly less pro-cyclical than the debt rule, and is therefore less demanding for Member States facing adverse economic circumstances. There are two reasons for this. First, while the debt rule imposes a reduction in the debt ratio already in the short term, the expenditure rule may allow a short-term debt increase during adverse economic circumstances, as long as this is offset by a faster debt reduction in the subsequent years. Second, while the expenditure rule (counterfactually) assumes that the economy is at its potential, the debt rule only caters for a limited cyclical correction ([1]).

The charts below provide a simulation of how the expenditure rule would operate in Member States that currently have a debt ratio above 80 % of GDP (excluding Greece), and shows a comparison with the debt rule in the current framework ([2]). In all cases, the expenditure rule implies a more stable path for net expenditure growth than what is implied by the debt rule in the SGP. With the exception of Cyprus, the expenditure rule requires an increase in primary surpluses over the medium-term, as the current rates of debt reduction are insufficient to reach the 60 % reference value.

For Spain and Italy, which are still experiencing a subdued inflation environment, compliance with the expenditure rule over the next 2 years would require a structural consolidation which is 0.7 percentage points lower than what is necessary under the debt rule. This lower initial effort is compensated by higher primary surpluses in the medium term, so that the overall debt reduction achieved in 15 years is equivalent to that of the debt rule in the SGP.

For France and Portugal, the two rules imply a similar adjustment path in the short term. In the case of France, this is due to an economic outlook close to potential, while for Portugal, this is the consequence of a relatively high starting level for the primary surplus, which reduces the need for further adjustment under the debt rule. Over the medium term, Portugal maintains nonetheless a tighter budgetary position compared to the debt rule, because fixing expenditure growth prevents a significant relaxation of the budget.

Finally, in the case of Belgium and Cyprus, the expenditure rule is more stringent than the debt rule in the short term. For Cyprus, this is because the economy is expected to be considerably above potential: while the debt rule allows a major budgetary relaxation of 1.6 % of GDP in the next 2 years, the expenditure rule requires that cyclical windfalls be used for consolidation. In the case of Belgium, while the initial level of debt is comparable to Spain, the economic outlook and the initial budgetary position are considerably better. The debt rule thus allows for completely back-loading fiscal consolidation, while the expenditure rule requires a small upfront adjustment. Over the medium term, in both countries, the expenditure rule is also more stringent than the debt rule, because the stability of the expenditure ceiling prevents a significant relaxation of the fiscal stance and allows for a greater debt reduction.

([1]) The debt rule allows only a backward-looking cyclical correction. Furthermore, the rule does not correct for the possibility that inflation may be below target. See European Commission (2018c).

([2]) The charts consider only the 'forward-looking' debt criterion. See European Commission (2018c).

(Continued on the next page)

Box (continued)

Graph 1a: **Simulating the impact of the proposed expenditure rule, against the debt rule in the SGP**

Note: The adjustment path under the expenditure rule is computed assuming that the economy is growing at its potential rate and that inflation is at 2%. The adjustment path under the debt rule is computed based on actual projections for GDP and inflation. Implicit interest rates are computed assuming that long-term nominal rates converge to 5% over ten years, and interest expenditures increase in line with the expected roll-over schedule of debt. 'Net expenditure growth' refers to the growth rate of primary expenditures at current prices, net of discretionary revenue measures and cyclical unemployment benefits.

Box 6.2: **Sensitivity analysis for the euro area as a whole**

The expenditure rule proposed in this section prescribes a fixed ceiling for the growth rate of primary expenditure at current prices, net of discretionary revenue measures. The calculation of this ceiling is based on assumptions for potential growth and interest rates, and on the initial levels of debt and primary balance. The impact on debt dynamics also depends on actual economic developments. This box applies the proposed expenditure rule to the euro area as a whole under six different scenarios.

Scenario 1 considers the impact of a different time horizon to meet the reference value of 60 % of GDP for the debt ratio. It compares a horizon of 20 years to the 15-year horizon proposed in this section. When applied directly to the euro area as a whole, the expenditure rule behaves roughly in the same manner whether the horizon for adjustment is 15 or 20 years, due to the rolling window. For individual Member States with a high debt, however, the difference between the two time horizons would be more significant.

Scenario 2 considers the impact of a 1-year recession of 4 % of GDP followed by an economic recovery over 5 years, as opposed to the baseline assumption of real GDP growing in line with potential. Compared to the baseline scenario, the cumulative fiscal effort implied by the expenditure rule in the 3 years after the recession is only 0.2 % of GDP higher, bringing the debt ratio 9 % of GDP higher after the third year. After 15 years, the debt ratio is still 4 percentage points higher than in the baseline scenario. The rule therefore exhibits a high degree of counter-cyclicality, and allows the government to stabilise public expenditure while letting the debt ratio absorb the shock of lower revenues.

Scenario 3 considers the impact of a permanent growth shock. When potential growth is permanently lower by 1 percentage point, the expenditure rule leads to an immediate reduction in the allowed growth rate of nominal expenditure of approximately 1.2 percentage points, to prevent a deterioration in the budget deficit. Over 15 years, the rule implies a cumulative fiscal effort higher by approximately 0.8 % of GDP and a final debt ratio higher by approximately 3 % of GDP. Therefore, under the proposed rule, even a large error in the estimation of potential output would not materially endanger debt sustainability over the medium term.

Scenario 4 considers the impact of a permanent increase of interest rates by 1 percentage point. Over 15 years, the overall fiscal impact is equivalent to that of the permanent growth shock: compared to the baseline scenario, the cumulative fiscal effort increases by 0.8 % of GDP and the final debt ratio by 3 % of GDP. The growth ceiling of primary expenditure is however largely unaffected, as the amount of additional interest expenditure that needs to be offset is small compared to total expenditure. Once again, a large error in the estimation of interest rates would not endanger debt sustainability under the expenditure rule.

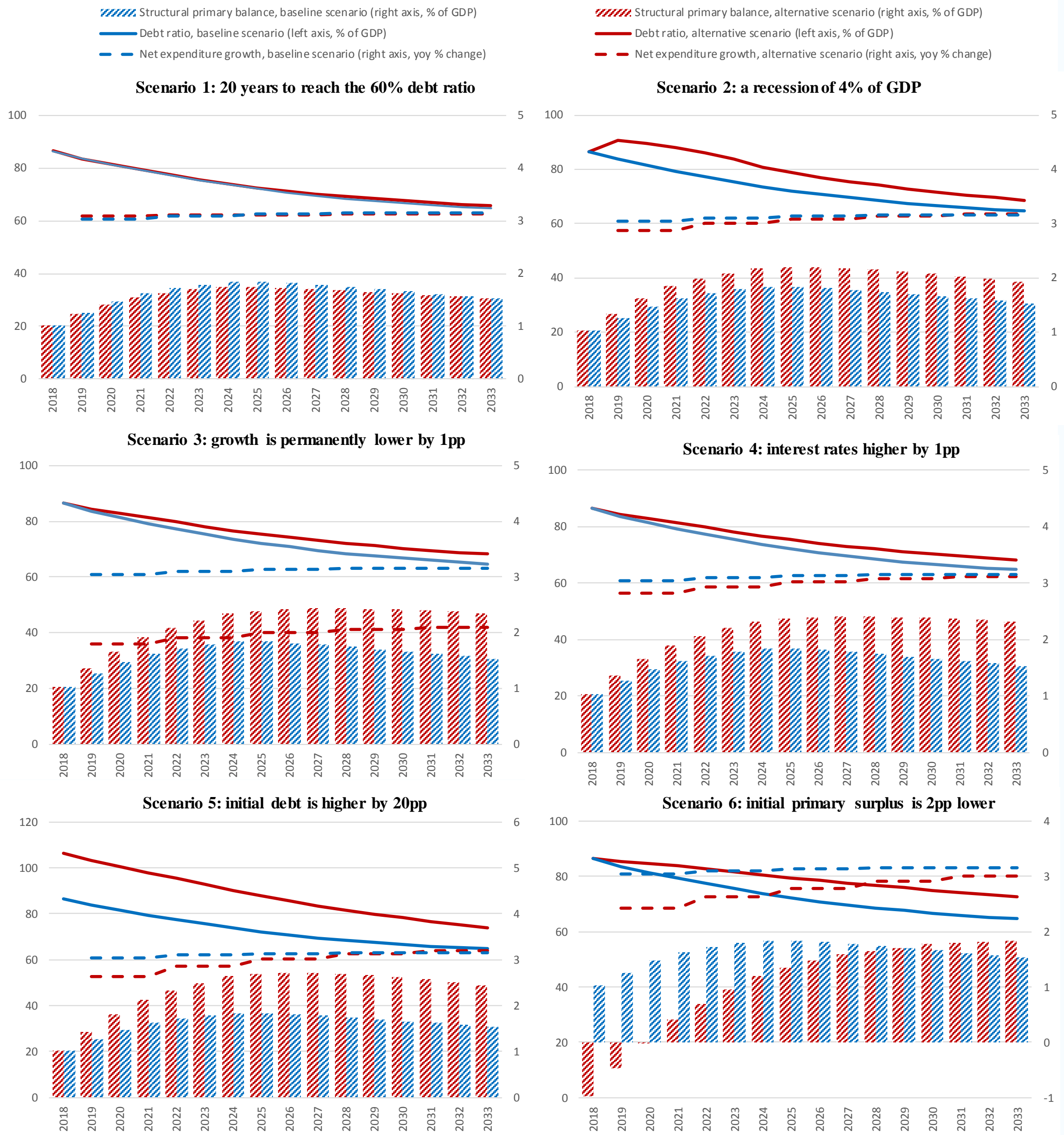
Scenario 5 considers the case of an initial debt ratio higher by 20 % of GDP. Over 15 years, this implies a cumulated fiscal effort higher by approximately 0.9 % of GDP compared to the baseline scenario, and this higher adjustment is concentrated mostly in the first 5 years. After 15 years, the resulting debt ratio is higher by approximately 9 % of GDP. For high debt countries, the expenditure rule therefore strikes a fair balance between the extra debt to be corrected and the additional fiscal effort needed.

Finally, Scenario 6 consider the case of a starting level of primary budget surplus which is lower by 2 % of GDP than in the baseline scenario. While over 15 years this increases the cumulative fiscal effort by 2.3 % of GDP, the final debt ratio still remains higher by 8 % of GDP. The rule may therefore be somewhat lenient for Member States starting with a worse fiscal position. This could be avoided by phasing in the new expenditure rule with a transition period requiring countries to first reduce their primary deficit more rapidly.

(Continued on the next page)

Box (continued)

Graph 1a: **Sensitivity of the proposed expenditure rule to alternative assumptions, for the euro area**



Note: In the baseline scenario, the adjustment path under the expenditure rule is computed assuming that the economy is growing at its potential rate and that inflation is at 2%. Implicit interest rates are a weighted average of the implicit interest rate for each Member State, using debt weights. 'Net expenditure growth' refers to the growth rate of primary expenditure at current prices, net of discretionary revenue measures and cyclical unemployment benefit expenditures.

Box 6.3: **Technical appendix**

This box presents a simplified analytical representation of the expenditure rule. The ratio of gross government debt to GDP in year t, d_t, evolves according to the standard dynamic formula:

$$d_{t+1} = d_t \left(\frac{i_{t+1} - y_{t+1}}{1 + y_{t+1}} + 1 \right) - (r_{t+1} - e_{t+1})$$

where i_t is the nominal interest rate, y_t is the growth rate of nominal GDP, r_t and e_t are respectively the ratios of government revenues and primary expenditures to GDP. The revenue ratio can be decomposed as:

$$r_{t+1} = r_t \frac{1 + \epsilon_{t+1}^R y_{t+1}}{1 + y_{t+1}} + drm_{t+1}$$

where $\epsilon_t^R = {}^{\frac{\Delta R_t}{R_{t-1}}}\!/_{y_t}$ is the elasticity of revenues to GDP and drm_t is the impact of additional discretionary revenue measures as a share of GDP. The primary expenditure ratio is:

$$e_{t+1} = e_t \frac{1 + g_{t+1}^e}{1 + y_{t+1}}$$

where $g_t^e = \frac{\Delta E_t}{E_{t-1}}$ is the growth rate of primary expenditures. Replacing the above formulas into the debt dynamics yields:

$$d_{t+1} = d_t \left(\frac{i_{t+1} - y_{t+1}}{1 + y_{t+1}} + 1 \right) - r_t \frac{1 + \epsilon_{t+1}^R y_{t+1}}{1 + y_{t+1}} + e_t \frac{1 + g_{t+1}^{NE}}{1 + y_{t+1}}$$

where $g_t^{NE} = \frac{\Delta E_t - DRM_t}{E_{t-1}}$ is the growth rate of the level of primary expenditures at current prices, E_t, net of discretionary revenue measures, DRM_t.

We assume a convergence period of 15 years. Based on the outstanding level of debt, d_0, and on a macroeconomic scenario covering the next 15 years, $\{\epsilon_t^R, i_t, y_t\}_{t=1}^{15}$, it is possible to derive the constant growth rate $\bar{g}^{NE}$ that leads to $d_{15} = 60\%$.

Assuming that $\epsilon_t^R = 1$ and that the government makes all the necessary fiscal adjustments on the expenditure side (i.e. $drm_t = 0$), the ratio of government revenues to GDP remains constant over time, $r_t = \bar{r}$. Further assuming that growth is constant at its potential level $\bar{y}$ and the interest rate is constant at its long-run level $\bar{\imath}$, the equation of the debt dynamics can be simplified into:

$$d_{t+1} = d_t \alpha - \bar{r} + e_t \gamma$$

where $\alpha = \left(\frac{\bar{\imath} - \bar{y}}{1 + \bar{y}} + 1 \right)$ is the 'snow-ball' effect and $\gamma = \frac{1 + g^e}{1 + \bar{y}}$ is the growth of net primary expenditures as a share of GDP, which we also assume to be constant. The solution for debt is:

$$d_{15} = d_0 \alpha^{15} - \bar{r} \sum_{i=0}^{15-1} \alpha^i + e_0 \sum_{i=1}^{15} \gamma^i \alpha^{15-i}$$

and the ceiling on net expenditure growth $\bar{g}^{NE}$ that Member States must respect is derived from the unique positive root of the following equation:

$$\sum_{i=1}^{15} \gamma^i \alpha^{15-i} - \frac{0.6 - d_0 \alpha^{15} + \bar{r} \sum_{i=0}^{15-1} \alpha^i}{e_0} = 0$$

Under the expenditure rule proposed in this chapter, the ceiling on net expenditure growth $\bar{g}^{NE}$ is computed from a modified expenditure aggregate where EU funded expenditures and cyclical unemployment benefit expenditures are excluded, and the level of gross fixed capital formation is smoothed over four years. This is in line with the methodology underlying the expenditure benchmark in the Stability and Growth Pact, and allows to correctly derive discretionary expenditures, while avoiding that Member States are penalised for undertaking new investments.

GLOSSARY

Automatic fiscal stabilisers: Features of the tax and spending regime of a government budget which react automatically to the economic cycle and reduce its fluctuations. As a result, the government budget balance in per cent of GDP tends to improve in years of high economic growth and deteriorate during economic slowdowns.

Budget semi-elasticity: The change of the *budget balance-to-GDP ratio* to a cyclical change of GDP. The estimates of the budget semi-elasticity used for EU fiscal surveillance purposes are derived from an agreed methodology developed by the OECD. The average semi-elasticity for the EU as a whole is 0.5.

Constrained judgement: A two-step approach that allows the Commission — under specific circumstances — to depart from the *output gap* estimates of the commonly agreed method in its assessment of the cyclical position of a Member State. The plausibility of the commonly agreed method is first checked against the indications of an alternative tool. If the difference between the two exceeds a given threshold, the Commission may apply a constrained degree of discretion in choosing the appropriate output gap estimate for surveillance purposes.

Corrective arm of the Stability and Growth Pact: The part of the *Stability and Growth Pact* that deals with preventing the risk of and/or correcting an excessive budgetary imbalance. Under the SGP an excessive budgetary imbalance is (i) a government deficit exceeding 3 % of GDP and (ii) government debt in excess of 60 % of GDP that is not approaching 60 % at a satisfactory pace (see also *debt reduction benchmark*).

Country-specific recommendations (CSRs): Policy guidance tailored to each EU Member State based on the provisions of the SGP and the MIP. The recommendations are put forward by the European Commission in May of each year, then discussed among Member States in the Council, endorsed by EU leaders at a summit in June, and formally adopted by the finance ministers in July.

Debt reduction benchmark: The reduction of a country's government debt above 60 % of GDP by 1/20th per year on average. This is the criterion used to assess whether excessive government debt is sufficiently diminishing and approaching 60 % of GDP at a satisfactory pace. The pace of reduction is assessed over both the past 3 years and the next 3 years, and after correcting for the cycle. Compliance in at least one of the three cases is sufficient to ensure compliance with the debt criterion (see *corrective arm of the SGP*).

Discretionary fiscal policy: A government decision that leads to a change in government spending or revenue above and beyond the effect of existing fiscal policies. Its effect is usually measured as the change in the budget balance net of the effect of *automatic fiscal stabilisers*, one-off measures and interest payments (see also *structural balance* and *structural primary balance*).

Draft budgetary plans (DBPs): Governments submit DBPs to the Commission and the Council to ensure the coordination of fiscal policies among Member States who have the euro as their currency and because the EU Treaty recognises economic policy as "a matter of common concern". They submit their DBPs for the following year between 1 and 15 October. The requirement was introduced in 2013 with the *two-pack* reform of the Stability and Growth Pact.

European Semester: A framework for the coordination of economic policies across the European Union. It is organised around an annual timeline that allows EU countries to discuss their economic and budgetary plans and monitor progress at specific dates throughout the year.

Excessive deficit procedure (EDP): A procedure under the corrective arm of the SGP to correct an excessive deficit, i.e. a deficit that lastingly exceeds the 3 % of GDP Treaty threshold by a margin, or a debt ratio that is not diminishing sufficiently.

Expenditure benchmark: One of the two pillars used to assess compliance with the *preventive arm of the Stability and Growth Pact*, along with the change in the *structural balance*. It specifies a maximum growth rate for public expenditure (i) corrected for certain non-discretionary items, such as interest expenditure, (ii) including a smoothed measure of public investment, and (iii) adjusted for discretionary revenue measures. The growth rate may not exceed *potential GDP* growth over the medium term and is further constrained for Member States that have not yet achieved their *medium-term budgetary objective*.

Fiscal Compact: The fiscal chapter of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (*TSCG*), an intergovernmental treaty, aiming to reinforce fiscal discipline in the euro area. The *TSCG* was signed on 2 March 2012 by all Member States of the European

Union, except the Czech Republic, the United Kingdom, and Croatia, which joined the EU only in 2013. Out of the 25 contracting parties to the TSCG, 22 are formally bound by the Fiscal Compact: the 19 euro area Member States plus Bulgaria, Denmark and Romania. They are required to have enacted laws requiring their national budgets to be in balance or in surplus. These laws must also provide for a self-correcting mechanism to prevent their breach.

Fiscal stance: A measure of the direction and extent of *discretionary fiscal policy*. In this report, it is defined as the annual change in the *structural primary balance*. When the change is positive, the fiscal stance is said to be restrictive. When it is negative, the fiscal stance is said to be expansionary.

Five Presidents' Report: A report on 'Completing Europe's Economic and Monetary Union', prepared by the President of the European Commission in close cooperation with the President of the Euro Summit, the President of the Eurogroup, the President of the European Central Bank, and the President of the European Parliament. Published on 22 June 2015, the report defines a roadmap towards the completion of the Economic and Monetary Union.

Flexibility clauses: Provisions under the preventive arm of the SGP allowing for a temporary and limited deviation from the *MTO*, or the adjustment path towards it. Flexibility clauses can be granted, subject to pre-defined eligibility conditions, to accommodate the budgetary impact of major structural reforms or government investment.

Macroeconomic imbalance procedure (MIP): The macroeconomic imbalance procedure aims to identify, prevent and address the emergence of potentially harmful macroeconomic imbalances that could adversely affect economic stability in a particular EU Member States, the euro area, or the EU as a whole. It was introduced in 2011 after the financial crisis showed that macroeconomic imbalances in one country — such as a large current account deficit or a real estate bubble — can affect others.

Margin of broad compliance: The margin of error the Commission applies in the assessment of compliance with the preventive arm of the SGP. A Member State is considered to be broadly compliant if the observed deviation from its MTO, or from the recommended adjustment towards it, does not exceed 0.5 % of GDP in a single year, or cumulatively over 2 consecutive years. The margin of broad compliance is motivated by the measurement uncertainty surrounding real time estimates of the *structural budget balance*.

Margin of discretion: A new element of discretion the Commission intends to use in the 2018 surveillance cycle when assessing compliance with the preventive arm of the SGP. Allowing for a margin of discretion means that a Member State may be found compliant even if the established indicators — the change in the structural budget balance and the expenditure benchmark — point to a significant deviation from the MTO or the adjustment path towards it.

Matrix of adjustment requirements: A double-entry table detailing the structural adjustment required under the *preventive arm of the Stability and Growth Pact* since 2015. It modulates the benchmark annual adjustment of 0.5 % of GDP depending on (i) cyclical conditions, as indicated by the level of the *output gap* and whether GDP growth is above or below potential, and (ii) the level of government debt and sustainability risks as measured by the *S1 indicator*.

Medium-term budgetary objective (MTO): According to the *Stability and Growth Pact*, EU Member States are required to specify a medium-term objective for their budgetary position in the *stability and convergence programmes*. The MTO is country-specific, in order to take into account the diversity of economic and budgetary developments and the diversity of fiscal risks to the sustainability of public finances. It is defined in structural terms (see *structural balance*).

Minimum benchmark: The lowest value of the structural balance that provides a sufficient margin against the risk of breaching the Treaty threshold of 3 % of GDP for the deficit during normal cyclical fluctuations. For each Member State, the Commission provides an annual update of the *minimum benchmark*, by taking into account past output volatility and the budgetary responses to output fluctuations. A Member State with a greater output volatility and a larger budgetary semi-elasticity will need a more demanding structural balance in order to ensure compliance with the threshold of 3 % of GDP.

Output gap: The difference between actual output and estimated potential output at any particular point in time. A business cycle typically includes a period of positive output gaps and a period of negative output gaps. When the output gap is closed, the economy is in line with its potential level (see *potential GDP*). A standard business cycle usually lasts up to 8 years, suggesting that the output gap is normally expected to close roughly every 4 years.

Overall assessment: The analysis of the information conveyed by the two indicators used to assess compliance with the *preventive arm of the SGP*, namely the change in the *structural balance* and the *expenditure*

benchmark. An overall assessment is conducted whenever at least one of the two indicators does not point to compliance with the requirements. It is meant to clarify (i) whether and how specific factors may affect one or both indicators, and (ii) if the two indicators do not support the same conclusions, which indicator would provide a more accurate assessment in the given context.

Potential GDP (or potential output): The level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, constraints on capacity begin to show and inflationary pressures build. If output falls below potential, resources are lying idle and inflationary pressures abate (see also *production function approach* and *output gap*).

Preventive arm of the Stability and Growth Pact: The part of the *Stability and Growth Pact* that aims to prevent gross policy errors and excessive deficits. Under the preventive arm, Member States are required to progress towards their *medium-term budgetary objective* at a sufficient pace and maintain it after it is reached.

Production function approach: A method of estimating an economy's sustainable level of output, compatible with stable inflation based on available labour inputs, the capital stock and their level of efficiency. *Potential output* is used to estimate the *output gap*, a key input in estimating the *structural balance*.

S0 indicator: A composite indicator published by the European Commission to evaluate the extent to which there might be a risk of fiscal stress in the short term, stemming from the fiscal, macro-financial or competitiveness sides of the economy. A set of 25 fiscal and financial-competitiveness variables proven to perform well in detecting fiscal stress in the past is used to construct the indicator.

S1 indicator: A medium-term sustainability indicator published by the European Commission. It indicates the additional adjustment, in terms of change in the *structural primary balance*, required over 5 years to bring the general government debt-to-GDP ratio to 60 % in 15 years' time, including financing for any future additional expenditure arising from an ageing population.

S2 indicator: The European Commission's long-term sustainability indicator. It shows the upfront adjustment to the current *structural primary balance* required to stabilise the debt-to-GDP ratio over an infinite horizon, including financing for any additional expenditure arising from an ageing population.

Safety margin: The difference between the 3 %-of-GDP threshold of the deficit and the *minimum benchmark*.

Significant deviation procedure (SDP): A procedure under the preventive arm of the SGP to correct a significant deviation from the MTO or the adjustment path towards it.

Six-pack: A set of European legislative measures — five regulations and one directive — to reform the *Stability and Growth Pact*. The six-pack entered into force on 13 December 2011. It aims to strengthen the procedures for reducing public deficits and debts and to address macroeconomic imbalances.

Stabilisation: Economic policy intervention to bring actual output closer to *potential output*. In the Economic and Monetary Union, in normal economic times, this is expected to be achieved through the ECB's monetary policy (for common shocks) and national *automatic fiscal stabilisers* (for country-specific shocks). When this is not sufficient, *discretionary fiscal policy* can also play a role.

Stability and convergence programmes (SCPs): Every year in April, EU Member States are required to set out their fiscal plans for the next 3 years and to submit them for assessment to the European Commission and the Council. This exercise is based on the economic governance rules under the *Stability and Growth Pact*. Euro area countries submit stability programmes; non-euro area countries convergence programmes.

Stability and Growth Pact (SGP): A set of rules designed to ensure that countries in the European Union pursue sound public finances and coordinate their fiscal policies. The SGP is based on an agreement reached by the EU Member States in 1997 to enforce the deficit and debt limits established by the Maastricht Treaty.

Structural (budget) balance: The actual budget balance corrected for the impact of the economic cycle and net of one-off and other temporary measures. The structural balance gives a measure of the underlying trend in the budget balance and of the overall orientation of fiscal policy (see also *fiscal stance*).

Structural primary (budget) balance: The *structural (budget) balance* net of interest payments (see also *fiscal stance*).

Sustainability of public finances: The ability of a government to service its debt. From a purely theoretical point of view, this basically assumes that the government debt level does not grow faster than the interest rate. While conceptually intuitive, an agreed

operational definition of sustainability has proven difficult to achieve. The European Commission uses three indicators of sustainability with different time horizons (*S0*, *S1* and *S2*). They are complemented by a debt sustainability analysis including sensitivity tests on government debt projections and alternative scenarios.

Two-pack: Two European regulations adopted in 2013 to introduce stronger fiscal surveillance including under the *Stability and Growth Pact*. The new mechanisms aim to increase the transparency of Member States' budgetary decisions, strengthen coordination in the euro area starting with the 2014 budgetary cycle, and recognise the special needs of euro area Member States under severe financial pressure.

Unusual event clause: A provision under the preventive arm of the SGP allowing for a temporary deviation from the MTO or the adjustment towards it, in the case of an unusual event outside government control with a major impact on the financial position of the general government. To be granted, the deviation must not endanger fiscal sustainability in the medium term.

Zero lower bound (ZLB): When the short-term nominal interest rate is at or near zero, the central bank is limited in its capacity to stimulate economic growth by further lowering policy rates. To overcome the constraint imposed by the ZLB, alternative methods of stimulating demand are generally considered, e.g. asset purchase programmes. The root cause of the ZLB is the issuance of paper currency, which effectively guarantees a zero nominal interest rate and acts as an interest rate floor. Central banks cannot encourage spending by lowering interest rates, because people would choose to hold cash instead.

STATISTICAL ANNEX

Table A.1: **Gross domestic product at 2010 reference levels (annual percentage change, 2000-2019)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
BE	3.6	0.8	1.8	0.8	3.6	2.1	2.5	3.4	0.8	-2.3	2.7	1.8	0.2	0.2	1.4	1.4	1.5	1.7	1.8	1.7
BG	5.1	3.8	5.9	5.2	6.4	7.1	6.9	7.3	6.0	-3.6	1.3	1.9	0.0	0.9	1.3	3.6	3.9	3.6	3.8	3.7
CZ	4.3	2.9	1.7	3.6	4.9	6.5	6.9	5.6	2.7	-4.8	2.3	1.8	-0.8	-0.5	2.7	5.3	2.6	4.4	3.4	3.1
DK	3.7	0.8	0.5	0.4	2.7	2.3	3.9	0.9	-0.5	-4.9	1.9	1.3	0.2	0.9	1.6	1.6	2.0	2.2	1.8	1.9
DE	3.0	1.7	0.0	-0.7	1.2	0.7	3.7	3.3	1.1	-5.6	4.1	3.7	0.5	0.5	1.9	1.7	1.9	2.2	2.3	2.1
EE	10.6	6.3	6.1	7.4	6.3	9.4	10.3	7.7	-5.4	-14.7	2.3	7.6	4.3	1.9	2.9	1.7	2.1	4.9	3.7	2.8
IE	9.6	5.8	6.3	3.1	6.7	6.0	5.5	5.2	-3.9	-4.6	1.8	3.0	0.0	1.6	8.3	25.6	5.1	7.8	5.7	4.1
EL	3.9	4.1	3.9	5.8	5.1	0.6	5.7	3.3	-0.3	-4.3	-5.5	-9.1	-7.3	-3.2	0.7	-0.3	-0.2	1.4	1.9	2.3
ES	5.3	4.0	2.9	3.2	3.2	3.7	4.2	3.8	1.1	-3.6	0.0	-1.0	-2.9	-1.7	1.4	3.4	3.3	3.1	2.9	2.4
FR	3.9	2.0	1.1	0.8	2.8	1.6	2.4	2.4	0.2	-2.9	2.0	2.1	0.2	0.6	0.9	1.1	1.2	1.8	2.0	1.8
HR	3.8	3.4	5.2	5.6	4.1	4.2	4.8	5.2	2.1	-7.4	-1.4	-0.3	-2.2	-0.6	-0.1	2.3	3.2	2.8	2.8	2.7
IT	3.7	1.8	0.2	0.2	1.6	0.9	2.0	1.5	-1.1	-5.5	1.7	0.6	-2.8	-1.7	0.1	1.0	0.9	1.5	1.5	1.2
CY	5.7	3.6	3.4	2.5	4.6	3.7	4.5	4.8	3.9	-1.8	1.3	0.3	-3.1	-5.9	-1.4	2.0	3.4	3.9	3.6	3.3
LV	5.4	6.5	7.1	8.4	8.3	10.7	11.9	10.0	-3.5	-14.4	-3.9	6.4	4.0	2.4	1.9	3.0	2.2	4.5	3.3	3.3
LT	3.8	6.5	6.8	10.5	6.6	7.7	7.4	11.1	2.6	-14.8	1.6	6.0	3.8	3.5	3.5	2.0	2.3	3.8	3.1	2.7
LU	8.2	2.5	3.8	1.6	3.6	3.2	5.2	8.4	-1.3	-4.4	4.9	2.5	-0.4	3.7	5.8	2.9	3.1	2.3	3.7	3.5
HU	4.2	3.8	4.5	3.8	5.0	4.4	3.9	0.4	0.9	-6.6	0.7	1.7	-1.6	2.1	4.2	3.4	2.2	4.0	4.0	3.2
MT	6.4	0.6	3.0	2.5	0.4	3.8	1.8	4.0	3.3	-2.5	3.5	1.3	2.7	4.7	8.1	9.9	5.5	6.6	5.8	5.1
NL	4.2	2.1	0.1	0.3	2.0	2.2	3.5	3.7	1.7	-3.8	1.4	1.7	-1.1	-0.2	1.4	2.3	2.2	3.2	3.0	2.6
AT	3.4	1.3	1.7	0.9	2.7	2.2	3.5	3.7	1.5	-3.8	1.8	2.9	0.7	0.0	0.8	1.1	1.5	2.9	2.8	2.2
PL	4.6	1.2	2.0	3.6	5.1	3.5	6.2	7.0	4.2	2.8	3.6	5.0	1.6	1.4	3.3	3.8	3.0	4.6	4.3	3.7
PT	3.8	1.9	0.8	-0.9	1.8	0.8	1.6	2.5	0.2	-3.0	1.9	-1.8	-4.0	-1.1	0.9	1.8	1.6	2.7	2.3	2.0
RO	2.4	5.6	5.2	5.5	8.4	4.2	8.1	6.9	8.3	-5.9	-2.8	2.0	1.2	3.5	3.1	4.0	4.8	6.9	4.5	3.9
SI	4.2	2.9	3.8	2.8	4.4	4.0	5.7	6.9	3.3	-7.8	1.2	0.6	-2.7	-1.1	3.0	2.3	3.1	5.0	4.7	3.6
SK	1.2	3.3	4.5	5.4	5.3	6.8	8.5	10.8	5.6	-5.4	5.0	2.8	1.7	1.5	2.8	3.9	3.3	3.4	4.0	4.2
FI	5.6	2.6	1.7	2.0	3.9	2.8	4.1	5.2	0.7	-8.3	3.0	2.6	-1.4	-0.8	-0.6	0.1	2.1	2.6	2.5	2.3
SE	4.7	1.6	2.1	2.4	4.3	2.8	4.7	3.4	-0.6	-5.2	6.0	2.7	-0.3	1.2	2.6	4.5	3.2	2.4	2.6	2.0
UK	3.7	2.5	2.5	3.3	2.4	3.1	2.5	2.4	-0.5	-4.2	1.7	1.5	1.5	2.1	3.1	2.3	1.9	1.8	1.5	1.2
EA-19	3.8	2.1	1.0	0.7	2.3	1.7	3.2	3.0	0.4	-4.5	2.1	1.6	-0.9	-0.2	1.3	2.1	1.8	2.4	2.3	2.0
EU-28	3.8	2.2	1.4	1.3	2.5	2.1	3.3	3.0	0.4	-4.3	2.1	1.7	-0.4	0.3	1.8	2.3	2.0	2.4	2.3	2.0

Note: EA and EU aggregated figures are weighted in common currency.
Source: Commission spring 2018 forecast.

Table A.2: **Harmonised index of consumer prices (percentage change on preceding year, 2000-2019)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
BE	2.7	2.4	1.5	1.5	1.9	2.5	2.3	1.8	4.5	0.0	2.3	3.4	2.6	1.2	0.5	0.6	1.8	2.2	1.6	1.6
BG	10.3	7.4	5.8	2.3	6.1	6.0	7.4	7.6	12.0	2.5	3.0	3.4	2.4	0.4	-1.6	-1.1	-1.3	1.2	1.8	1.8
CZ	3.9	4.5	1.4	-0.1	2.6	1.6	2.1	2.9	6.3	0.6	1.2	2.2	3.5	1.4	0.4	0.3	0.6	2.4	2.1	1.8
DK	2.8	2.3	2.4	2.0	0.9	1.7	1.8	1.7	3.6	1.0	2.2	2.7	2.4	0.5	0.4	0.2	0.0	1.1	0.8	1.4
DE	1.4	1.9	1.4	1.0	1.8	1.9	1.8	2.3	2.8	0.2	1.1	2.5	2.1	1.6	0.8	0.1	0.4	1.7	1.6	1.8
EE	3.9	5.6	3.6	1.4	3.0	4.1	4.4	6.7	10.6	0.2	2.7	5.1	4.2	3.2	0.5	0.1	0.8	3.7	2.9	2.5
IE	5.3	4.0	4.7	4.0	2.3	2.2	2.7	2.9	3.1	-1.7	-1.6	1.2	1.9	0.5	0.3	0.0	-0.2	0.3	0.8	1.1
EL	2.9	3.6	3.9	3.4	3.0	3.5	3.3	3.0	4.2	1.3	4.7	3.1	1.0	-0.9	-1.4	-1.1	0.0	1.1	0.5	1.2
ES	3.5	2.8	3.6	3.1	3.1	3.4	3.6	2.8	4.1	-0.2	2.0	3.0	2.4	1.5	-0.2	-0.6	-0.3	2.0	1.4	1.4
FR	1.8	1.8	1.9	2.2	2.3	1.9	1.9	1.6	3.2	0.1	1.7	2.3	2.2	1.0	0.6	0.1	0.3	1.2	1.7	1.4
HR	4.5	4.3	2.5	2.4	2.1	3.0	3.3	2.7	5.8	2.2	1.1	2.2	3.4	2.3	0.2	-0.3	-0.6	1.3	1.4	1.5
IT	2.6	2.3	2.6	2.8	2.3	2.2	2.2	2.0	3.5	0.8	1.6	2.9	3.3	1.2	0.2	0.1	-0.1	1.3	1.2	1.4
CY	4.9	2.0	2.8	4.0	1.9	2.0	2.2	2.2	4.4	0.2	2.6	3.5	3.1	0.4	-0.3	-1.5	-1.2	0.7	0.7	1.2
LV	2.6	2.5	2.0	2.9	6.2	6.9	6.6	10.1	15.3	3.3	-1.2	4.2	2.3	0.0	0.7	0.2	0.1	2.9	2.7	2.6
LT	1.1	1.5	0.3	-1.1	1.2	2.7	3.8	5.8	11.1	4.2	1.2	4.1	3.2	1.2	0.2	-0.7	0.7	3.7	2.7	2.3
LU	3.8	2.4	2.1	2.5	3.2	3.8	3.0	2.7	4.1	0.0	2.8	3.7	2.9	1.7	0.7	0.1	0.0	2.1	1.5	1.7
HU	10.0	9.1	5.2	4.7	6.8	3.5	4.0	7.9	6.0	4.0	4.7	3.9	5.7	1.7	0.0	0.1	0.4	2.4	2.3	3.0
MT	3.0	2.5	2.6	1.9	2.7	2.5	2.6	0.7	4.7	1.8	2.0	2.5	3.2	1.0	0.8	1.2	0.9	1.3	1.6	1.8
NL	2.3	5.1	3.9	2.2	1.4	1.5	1.6	1.6	2.2	1.0	0.9	2.5	2.8	2.6	0.3	0.2	0.1	1.3	1.6	2.2
AT	2.0	2.3	1.7	1.3	2.0	2.1	1.7	2.2	3.2	0.4	1.7	3.6	2.6	2.1	1.5	0.8	1.0	2.2	2.1	1.9
PL	10.1	5.3	1.9	0.7	3.6	2.2	1.3	2.6	4.2	4.0	2.6	3.9	3.7	0.8	0.1	-0.7	-0.2	1.6	1.3	2.5
PT	2.8	4.4	3.7	3.2	2.5	2.1	3.0	2.4	2.7	-0.9	1.4	3.6	2.8	0.4	-0.2	0.5	0.6	1.6	1.2	1.6
RO	45.7	34.5	22.5	15.3	11.9	9.1	6.6	4.9	7.9	5.6	6.1	5.8	3.4	3.2	1.4	-0.4	-1.1	1.1	4.2	3.4
SI	9.0	8.6	7.5	5.6	3.7	2.4	2.5	3.8	5.5	0.8	2.1	2.1	2.8	1.9	0.4	-0.8	-0.2	1.6	1.9	2.0
SK	12.2	7.2	3.5	8.4	7.5	2.8	4.3	1.9	3.9	0.9	0.7	4.1	3.7	1.5	-0.1	-0.3	-0.5	1.4	2.4	2.1
FI	3.0	2.7	2.0	1.3	0.1	0.8	1.3	1.6	3.9	1.6	1.7	3.3	3.2	2.2	1.2	-0.2	0.4	0.8	1.4	1.7
SE	1.3	2.7	1.9	2.3	1.0	0.8	1.5	1.7	3.3	1.9	1.9	1.4	0.9	0.4	0.2	0.7	1.1	1.9	1.9	1.7
UK	0.8	1.2	1.3	1.4	1.3	2.1	2.3	2.3	3.6	2.2	3.3	4.5	2.8	2.6	1.5	0.0	0.7	2.7	2.5	1.9
EA-19	2.2	2.4	2.3	2.1	2.2	2.2	2.2	2.2	3.3	0.3	1.6	2.7	2.5	1.3	0.4	0.0	0.2	1.5	1.5	1.6
EU-28	3.1	3.2	2.5	2.1	2.3	2.3	2.3	2.4	3.7	1.0	2.1	3.1	2.6	1.5	0.5	0.0	0.3	1.7	1.7	1.8

Note: National index if not available.
Source: Commission 2018 spring forecast.

Table A.3: **Net lending (+) or net borrowing (-), general government (as a percentage of GDP, 2000-2019)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
BE	-0.1	0.2	0.0	-1.8	-0.2	-2.8	0.2	0.1	-1.1	-5.4	-4.0	-4.1	-4.2	-3.1	-3.1	-2.5	-2.5	-1.0	-1.1	-1.3
BG	-0.5	1.1	-1.2	-0.4	1.8	1.0	1.8	1.1	1.6	-4.1	-3.1	-2.0	-0.3	-0.4	-5.5	-1.6	0.2	0.9	0.6	0.6
CZ	-3.6	-5.5	-6.4	-6.9	-2.4	-3.0	-2.2	-0.7	-2.0	-5.5	-4.2	-2.7	-3.9	-1.2	-2.1	-0.6	0.7	1.6	1.4	0.8
DK	1.9	1.1	0.0	-0.1	2.1	5.0	5.0	5.0	3.2	-2.8	-2.7	-2.1	-3.5	-1.2	1.1	-1.5	-0.4	1.0	-0.1	0.0
DE	0.9	-3.1	-3.9	-4.2	-3.7	-3.4	-1.7	0.2	-0.2	-3.2	-4.2	-1.0	0.0	-0.1	0.5	0.8	1.0	1.3	1.2	1.4
EE	-0.1	0.2	0.4	1.8	2.4	1.1	2.9	2.7	-2.7	-2.2	0.2	1.2	-0.3	-0.2	0.7	0.1	-0.3	-0.3	0.0	0.3
IE	4.9	1.0	-0.5	0.4	1.3	1.6	2.8	0.3	-7.0	-13.8	-32.1	-12.7	-8.0	-6.1	-3.6	-1.9	-0.5	-0.3	-0.2	-0.2
EL	-4.1	-5.5	-6.0	-7.8	-8.8	-6.2	-5.9	-6.7	-10.2	-15.1	-11.2	-10.3	-8.9	-13.2	-3.6	-5.7	0.6	0.8	0.4	0.2
ES	-1.1	-0.5	-0.4	-0.4	0.0	1.2	2.2	1.9	-4.4	-11.0	-9.4	-9.6	-10.5	-7.0	-6.0	-5.3	-4.5	-3.1	-2.6	-1.9
FR	-1.3	-1.4	-3.1	-4.0	-3.6	-3.3	-2.4	-2.6	-3.3	-7.2	-6.9	-5.2	-5.0	-4.1	-3.9	-3.6	-3.4	-2.6	-2.3	-2.8
HR		-2.1	-3.5	-4.7	-5.2	-3.9	-3.4	-2.4	-2.8	-6.0	-6.5	-7.8	-5.2	-5.3	-5.1	-3.4	-0.9	0.8	0.7	0.8
IT	-2.4	-3.4	-3.0	-3.3	-3.5	-4.1	-3.5	-1.5	-2.6	-5.2	-4.2	-3.7	-2.9	-2.9	-3.0	-2.6	-2.5	-2.3	-1.7	-1.7
CY	-2.2	-2.1	-4.1	-5.9	-3.7	-2.2	-1.0	3.2	0.9	-5.4	-4.7	-5.7	-5.6	-5.1	-9.0	-1.3	0.3	1.8	2.0	2.2
LV	-2.7	-1.9	-2.3	-1.5	-0.9	-0.4	-0.5	-0.5	-4.2	-9.1	-8.7	-4.3	-1.2	-1.2	-1.5	-1.4	0.1	-0.5	-1.1	-1.2
LT	-3.2	-3.5	-1.9	-1.3	-1.4	-0.3	-0.3	-0.8	-3.1	-9.1	-6.9	-8.9	-3.1	-2.6	-0.6	-0.2	0.3	0.5	0.5	0.5
LU	5.9	5.9	2.4	0.2	-1.3	0.1	1.9	4.2	3.3	-0.7	-0.7	0.5	0.3	1.0	1.3	1.4	1.6	1.5	0.9	0.7
HU	-3.0	-4.0	-8.8	-7.1	-6.5	-7.8	-9.3	-5.0	-3.7	-4.5	-4.5	-5.4	-2.4	-2.6	-2.6	-1.9	-1.7	-2.0	-2.4	-2.1
MT	-5.5	-6.1	-5.4	-9.0	-4.3	-2.6	-2.5	-2.1	-4.2	-3.2	-2.4	-2.4	-3.5	-2.4	-1.8	-1.1	1.0	3.9	1.1	1.3
NL	1.9	-0.3	-2.1	-3.0	-1.7	-0.3	0.2	0.2	0.2	-5.4	-5.0	-4.3	-3.9	-2.4	-2.3	-2.1	0.4	1.1	0.7	0.9
AT	-2.4	-0.7	-1.4	-1.8	-4.8	-2.5	-2.5	-1.4	-1.5	-5.3	-4.4	-2.6	-2.2	-2.0	-2.7	-1.0	-1.6	-0.7	-0.5	-0.2
PL	-3.0	-4.8	-4.8	-6.1	-5.0	-4.0	-3.6	-1.9	-3.6	-7.3	-7.3	-4.8	-3.7	-4.1	-3.6	-2.6	-2.3	-1.7	-1.4	-1.4
PT	-3.2	-4.8	-3.3	-4.4	-6.2	-6.2	-4.3	-3.0	-3.8	-9.8	-11.2	-7.4	-5.7	-4.8	-7.2	-4.4	-2.0	-3.0	-0.9	-0.6
RO	-4.6	-3.4	-1.9	-1.4	-1.1	-0.8	-2.1	-2.7	-5.4	-9.2	-6.9	-5.4	-3.7	-2.1	-1.3	-0.8	-3.0	-2.9	-3.4	-3.8
SI	-3.6	-3.9	-2.4	-2.6	-2.0	-1.3	-1.2	-0.1	-1.4	-5.8	-5.6	-6.7	-4.0	-14.7	-5.5	-2.9	-1.9	0.0	0.5	0.4
SK	-12.0	-6.4	-8.1	-2.7	-2.3	-2.9	-3.6	-1.9	-2.4	-7.8	-7.5	-4.3	-4.3	-2.7	-2.7	-2.7	-2.2	-1.0	-0.9	-0.3
FI	6.9	5.0	4.1	2.4	2.2	2.6	3.9	5.1	4.2	-2.5	-2.6	-1.0	-2.2	-2.6	-3.2	-2.8	-1.8	-0.6	-0.7	-0.2
SE	3.2	1.4	-1.5	-1.3	0.4	1.8	2.2	3.4	1.9	-0.7	0.0	-0.2	-1.0	-1.4	-1.6	0.2	1.2	1.3	0.8	0.9
UK	1.4	0.2	-1.9	-3.1	-3.1	-3.1	-2.8	-2.6	-5.2	-10.1	-9.4	-7.5	-8.2	-5.4	-5.4	-4.3	-3.0	-1.9	-1.9	-1.7
EA-19	-0.5	-2.0	-2.7	-3.2	-3.0	-2.6	-1.5	-0.7	-2.2	-6.3	-6.2	-4.2	-3.7	-3.0	-2.5	-2.0	-1.5	-0.9	-0.7	-0.6
EU-28		-1.6	-2.6	-3.2	-2.8	-2.5	-1.6	-0.9	-2.5	-6.6	-6.4	-4.6	-4.3	-3.3	-2.9	-2.3	-1.6	-1.0	-0.8	-0.8

Source: Commission 2018 spring forecast.

Table A.4: **Interest expenditure, general government (as a percentage of GDP, 2000-2019)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
BE	6.7	6.5	5.8	5.4	4.8	4.4	4.1	4.0	4.0	3.8	3.6	3.6	3.6	3.3	3.3	3.0	2.9	2.5	2.3	2.2
BG	4.1	4.2	2.2	2.2	1.9	1.6	1.3	1.1	0.8	0.7	0.7	0.7	0.8	0.7	0.9	0.9	0.9	0.8	0.7	0.7
CZ	0.8	0.9	1.1	1.0	1.1	1.1	1.0	1.1	1.0	1.2	1.3	1.3	1.4	1.3	1.3	1.1	0.9	0.7	0.7	0.7
DK	3.7	3.4	3.1	2.8	2.5	2.1	1.8	1.6	1.4	1.9	1.9	2.0	1.8	1.7	1.5	1.6	1.4	1.1	1.1	1.0
DE	3.1	3.0	2.9	2.9	2.8	2.7	2.7	2.7	2.7	2.6	2.5	2.5	2.3	2.0	1.5	1.3	1.1	1.1	1.0	1.0
EE	0.3	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.1	0.1
IE	1.9	1.4	1.3	1.2	1.1	1.0	1.0	1.0	1.3	2.0	2.8	3.4	4.2	4.3	3.9	2.6	2.2	2.0	1.7	1.7
EL	6.9	6.3	5.6	4.9	4.8	4.7	4.4	4.5	4.8	5.0	5.9	7.3	5.1	4.0	4.0	3.5	3.2	3.2	3.3	3.5
ES	3.2	3.0	2.6	2.3	2.0	1.7	1.6	1.6	1.5	1.7	1.9	2.5	3.0	3.5	3.5	3.1	2.8	2.6	2.4	2.4
FR	2.9	3.0	3.0	2.8	2.8	2.7	2.6	2.7	2.9	2.5	2.5	2.7	2.6	2.3	2.2	2.0	1.9	1.8	1.7	1.6
HR		1.8	1.8	1.8	1.9	1.9	1.9	1.9	2.0	2.3	2.5	2.8	3.1	3.2	3.4	3.5	3.1	2.7	2.5	2.4
IT	6.1	6.1	5.5	5.0	4.6	4.5	4.4	4.8	4.9	4.4	4.3	4.7	5.2	4.8	4.6	4.1	4.0	3.8	3.6	3.5
CY	3.2	3.2	3.0	3.2	3.0	3.2	3.0	2.8	2.6	2.3	2.0	2.0	2.9	3.8	3.4	3.8	3.3	3.2	3.0	2.8
LV	0.9	0.9	0.7	0.7	0.7	0.5	0.4	0.4	0.6	1.5	1.7	1.8	1.7	1.5	1.4	1.3	1.0	0.9	0.8	0.7
LT	1.7	1.5	1.3	1.2	0.9	0.8	0.7	0.7	0.7	1.2	1.8	1.8	2.0	1.8	1.6	1.5	1.3	1.1	0.8	0.8
LU	0.4	0.4	0.3	0.3	0.2	0.2	0.2	0.3	0.4	0.4	0.4	0.5	0.5	0.5	0.4	0.4	0.3	0.3	0.3	0.3
HU	5.3	4.7	4.0	4.0	4.3	4.1	3.9	4.0	4.0	4.5	4.1	4.1	4.6	4.5	4.0	3.5	3.2	2.8	2.6	2.5
MT	4.1	3.7	3.9	3.5	3.7	3.8	3.7	3.5	3.3	3.3	3.1	3.2	3.0	2.9	2.7	2.4	2.1	1.9	1.6	1.5
NL	3.3	2.9	2.6	2.4	2.3	2.2	2.0	2.0	2.0	2.0	1.8	1.8	1.6	1.5	1.4	1.2	1.1	1.0	0.8	0.7
AT	3.6	3.6	3.4	3.2	3.0	3.2	3.1	3.1	2.9	3.1	2.9	2.8	2.7	2.6	2.4	2.3	2.1	1.8	1.6	1.5
PL	3.0	3.1	2.9	3.0	2.7	2.5	2.4	2.2	2.1	2.5	2.5	2.5	2.7	2.5	1.9	1.8	1.7	1.6	1.5	1.5
PT	3.0	3.0	2.8	2.7	2.6	2.6	2.8	2.9	3.1	3.0	2.9	4.3	4.9	4.9	4.9	4.6	4.2	3.9	3.5	3.4
RO	3.9	3.4	2.5	1.6	1.4	1.2	0.8	0.7	0.7	1.4	1.5	1.6	1.7	1.8	1.6	1.6	1.5	1.3	1.4	1.4
SI	2.4	2.3	2.1	1.9	1.7	1.5	1.4	1.2	1.1	1.3	1.6	1.9	2.0	2.6	3.2	3.2	3.0	2.5	2.0	1.7
SK	4.0	3.9	3.5	2.5	2.1	1.7	1.4	1.4	1.3	1.4	1.3	1.5	1.8	1.9	1.9	1.7	1.6	1.4	1.3	1.2
FI	2.7	2.6	2.0	1.8	1.7	1.6	1.5	1.4	1.4	1.3	1.3	1.4	1.4	1.3	1.2	1.2	1.1	1.0	0.9	0.9
SE	3.3	2.6	2.9	2.1	1.7	1.8	1.6	1.7	1.6	1.2	1.0	1.1	0.9	0.8	0.7	0.4	0.4	0.4	0.3	0.2
UK	2.4	2.1	1.8	1.8	1.8	2.0	2.0	2.2	2.2	1.9	2.9	3.2	2.9	2.8	2.7	2.3	2.4	2.7	2.6	2.5
EA-19	3.8	3.7	3.4	3.2	3.0	2.9	2.8	2.9	2.9	2.8	2.8	3.0	3.0	2.8	2.6	2.3	2.1	2.0	1.8	1.8
EU-28		3.4	3.1	2.9	2.8	2.7	2.6	2.6	2.7	2.6	2.7	2.9	2.9	2.7	2.5	2.2	2.1	2.0	1.9	1.8

Source: Commission 2018 spring forecast.

Table A.5: **Structural budget balance, general government (as a percentage of GDP, 2010-2019)**

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
BE	-3.9	-4.0	-3.5	-3.1	-2.9	-2.2	-2.1	-1.3	-1.4	-1.7
BG	-2.7	-2.0	-0.2	-0.1	-1.7	-1.1	0.3	0.9	0.5	0.5
CZ	-3.9	-2.5	-1.4	0.2	-0.7	-0.5	1.0	1.2	0.9	0.2
DK	-0.8	-0.6	-0.2	-1.1	-0.7	-1.8	0.3	1.4	0.3	0.9
DE	-1.9	-1.1	-0.1	0.3	1.1	1.1	1.1	1.5	1.2	1.0
EE	0.2	0.1	0.0	-0.6	0.0	0.0	-0.4	-1.2	-1.3	-0.9
IE	-9.0	-8.1	-6.5	-4.4	-3.6	-1.5	-0.8	-0.1	-0.6	-0.4
EL	-9.8	-5.8	0.5	2.6	2.4	2.2	4.4	4.0	2.5	1.6
ES	-7.0	-6.3	-3.1	-1.7	-1.5	-2.4	-3.3	-3.0	-3.3	-3.2
FR	-5.9	-5.0	-4.3	-3.4	-3.0	-2.7	-2.6	-2.1	-2.1	-3.1
HR	-5.4	-6.8	-3.5	-3.2	-3.4	-2.4	-0.7	0.4	-0.3	-0.6
IT	-3.3	-3.3	-1.3	-0.7	-0.8	-0.6	-1.4	-1.7	-1.7	-2.0
CY	-4.8	-4.9	-3.9	-0.7	3.3	1.7	1.2	1.4	0.8	0.5
LV	-2.3	-2.1	-0.4	-0.9	-1.1	-1.5	-0.3	-1.2	-1.9	-1.9
LT	-3.1	-3.3	-2.3	-1.9	-1.4	-0.7	-0.3	-0.6	-0.7	-0.6
LU	0.5	1.6	2.6	2.8	1.9	1.6	1.8	1.8	0.8	0.3
HU	-3.4	-4.2	-1.3	-1.4	-2.1	-2.0	-1.8	-3.1	-3.6	-3.3
MT	-3.1	-1.9	-2.7	-1.7	-2.6	-2.5	0.5	3.5	0.6	1.1
NL	-3.5	-3.4	-2.0	-0.7	-0.4	-0.9	0.8	0.5	-0.1	-0.3
AT	-3.2	-2.6	-1.9	-1.7	-0.7	-0.1	-0.9	-0.6	-0.8	-0.6
PL	-8.0	-5.9	-3.9	-3.4	-2.8	-2.3	-2.0	-2.0	-2.2	-2.2
PT	-8.5	-6.7	-3.6	-3.1	-1.8	-2.3	-2.0	-1.1	-1.1	-1.1
RO	-5.4	-2.9	-2.5	-0.9	-0.3	-0.2	-2.1	-3.3	-3.8	-4.2
SI	-4.3	-4.5	-1.6	-1.2	-2.1	-1.3	-1.1	-0.6	-1.1	-1.5
SK	-7.1	-4.2	-3.6	-1.6	-2.1	-2.2	-2.0	-1.0	-1.2	-0.8
FI	-1.1	-0.8	-1.1	-1.1	-1.5	-0.9	-0.7	-0.1	-0.8	-0.9
SE	0.8	0.0	0.2	0.1	-0.3	0.3	0.9	1.2	0.7	1.0
UK	-7.1	-5.4	-6.4	-4.2	-5.0	-4.4	-3.3	-2.4	-2.4	-1.9
EA-19	-4.2	-3.5	-2.0	-1.3	-0.9	-0.8	-0.8	-0.6	-0.8	-1.1
EU-28	-4.5	-3.7	-2.6	-1.7	-1.6	-1.5	-1.2	-0.8	-1.0	-1.2

Source: Commission 2018 spring forecast.

Table A.6: **Gross debt, general government (as a percentage of GDP, 2000-2019)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
BE	108.8	107.6	104.7	101.1	96.5	94.7	91.1	87.0	92.5	99.5	99.7	102.6	104.3	105.5	107.0	106.1	105.9	103.1	101.5	100.2
BG	71.2	65.0	51.4	43.7	36.0	26.8	21.0	16.3	13.0	13.7	15.3	15.2	16.7	17.0	27.0	26.0	29.0	25.4	23.3	21.4
CZ	17.0	22.8	25.9	28.3	28.5	27.9	27.7	27.5	28.3	33.6	37.4	39.8	44.5	44.9	42.2	40.0	36.8	34.6	32.7	31.8
DK	52.4	48.5	49.1	46.2	44.2	37.4	31.5	27.3	33.3	40.2	42.6	46.1	44.9	44.0	44.3	39.9	37.9	36.4	33.6	32.3
DE	58.9	57.7	59.4	63.1	64.8	67.0	66.5	63.7	65.2	72.6	80.9	78.6	79.8	77.5	74.7	71.0	68.2	64.1	60.2	56.3
EE	5.1	4.8	5.7	5.6	5.1	4.5	4.4	3.7	4.5	7.0	6.6	6.1	9.7	10.2	10.7	10.0	9.4	9.0	8.8	8.4
IE	36.1	33.2	30.6	29.9	28.2	26.1	23.6	23.9	42.4	61.5	86.1	110.3	119.6	119.4	104.5	76.9	72.8	68.0	65.6	63.2
EL	104.9	107.1	104.9	101.5	102.9	107.4	103.6	103.1	109.4	126.7	146.2	172.1	159.6	177.4	178.9	176.8	180.8	178.6	177.8	170.3
ES	58.0	54.2	51.3	47.6	45.3	42.3	38.9	35.6	39.5	52.8	60.1	69.5	85.7	95.5	100.4	99.4	99.0	98.3	97.6	95.9
FR	58.6	58.1	60.0	64.1	65.7	67.2	64.4	64.4	68.7	82.9	85.1	87.8	90.7	93.5	94.9	95.6	96.6	97.0	96.4	96.0
HR	35.5	36.5	36.6	38.1	40.2	41.1	38.6	37.3	39.0	48.3	57.3	63.8	69.4	80.5	84.0	83.8	80.6	78.0	73.7	69.7
IT	105.1	104.7	101.9	100.5	100.1	101.9	102.6	99.8	102.4	112.5	115.4	116.5	123.4	129.0	131.8	131.5	132.0	131.8	130.7	129.7
CY	54.9	56.5	59.7	63.1	64.1	62.8	58.7	53.5	45.1	53.8	56.3	65.7	79.7	102.6	107.5	107.5	106.6	97.5	105.7	99.5
LV	12.1	13.8	13.0	13.7	14.0	11.4	9.6	8.0	18.2	35.8	46.8	42.7	41.2	39.0	40.9	36.8	40.5	40.1	37.0	37.3
LT	23.5	22.9	22.1	20.4	18.7	17.6	17.2	15.9	14.6	28.0	36.2	37.2	39.8	38.8	40.5	42.6	40.1	39.7	36.0	38.2
LU	7.2	7.3	7.0	6.9	7.3	7.4	7.8	7.7	14.9	15.7	19.8	18.7	22.0	23.7	22.7	22.0	20.8	23.0	22.6	22.5
HU	55.3	51.9	55.3	57.9	58.7	60.5	64.5	65.5	71.6	77.8	80.2	80.5	78.4	77.1	76.6	76.7	76.0	73.6	73.3	71.0
MT	60.9	65.2	63.2	69.0	71.9	70.0	64.5	62.3	62.6	67.6	67.5	70.1	67.8	68.4	63.8	58.7	56.2	50.8	47.1	43.4
NL	51.7	49.1	48.4	49.6	49.8	49.2	44.7	42.7	54.7	56.8	59.3	61.6	66.3	67.8	68.0	64.6	61.8	56.7	53.5	50.1
AT	66.1	66.7	66.7	65.9	65.2	68.6	67.3	65.0	68.7	79.9	82.7	82.4	81.9	81.3	84.0	84.6	83.6	78.4	74.8	71.7
PL	36.5	37.3	41.8	46.6	45.0	46.4	46.9	44.2	46.3	49.4	53.1	54.1	53.7	55.7	50.3	51.1	54.2	50.6	49.6	49.1
PT	50.3	53.4	56.2	58.7	62.0	67.4	69.2	68.4	71.7	83.6	96.2	111.4	126.2	129.0	130.6	128.8	129.9	125.7	122.5	119.5
RO	22.4	25.7	24.8	21.3	18.6	15.7	12.3	11.9	12.4	22.1	29.7	34.0	36.9	37.5	39.1	37.7	37.4	35.0	35.3	36.4
SI	25.9	26.1	27.3	26.7	26.8	26.3	26.0	22.8	21.8	34.6	38.4	46.6	53.8	70.4	80.3	82.6	78.6	73.6	69.3	65.1
SK	49.6	48.3	42.9	41.6	40.6	34.1	31.0	30.1	28.5	36.3	41.2	43.7	52.2	54.7	53.5	52.3	51.8	50.9	49.0	46.6
FI	42.5	41.0	40.2	42.8	42.7	40.0	38.2	34.0	32.7	41.7	47.1	48.5	53.9	56.5	60.2	63.5	63.0	61.4	60.4	59.6
SE	50.8	52.3	50.3	49.8	48.9	49.2	44.0	39.3	37.8	41.4	38.6	37.9	38.1	40.7	45.5	44.2	42.1	40.6	38.0	35.5
UK	37.0	34.4	34.5	35.7	38.7	39.9	40.8	41.9	49.9	64.1	75.6	81.3	84.5	85.6	87.4	88.2	88.2	87.7	86.3	85.3
EA-19	68.1	67.0	66.9	68.1	68.4	69.2	67.4	65.0	68.7	79.2	84.8	87.3	91.7	93.9	94.2	92.1	91.1	88.8	86.5	84.1
EU-28	60.0	59.3	58.8	60.3	60.9	61.5	60.1	57.5	60.8	73.4	79.0	82.0	85.3	87.5	88.3	86.1	84.8	83.1	81.2	79.1

Notes: For EA-19, non-consolidated for intergovernmental loans (bn EUR): 0.9 in 2009, 21.2 in 2010, 69.3 in 2011, 193.4 in 2012, 231.0 in 2013, 240.5 in 2014, 231.0 in 2015, 231.0 in 2016. For EU-28, non-consolidated for intergovernmental loans (bn EUR): 0.9 in 2009, 21.2 in 2010, 69.8 in 2011, 196.4 in 2012, 235.9 in 2013, 245.7 in 2014, 236.4 in 2015, 235.7 in 2016.
Source: Commission 2018 spring forecast.

Table A.7: **Debt dynamic components (as a percentage of GDP)**

						Snow-ball effect (1)						Stock-flow adjustment (2)					
	average 2010-2014	2015	2016	2017	2018	2019	average 2010-2014	2015	2016	2017	2018	2019	average 2010-2014	2015	2016	2017	2018	2019
BE	-0.2	0.5	0.4	1.4	1.2	0.8	0.7	0.4	-0.3	-1.3	-1.1	-1.2	0.5	-0.7	0.6	-0.1	0.7	0.7
BG	-1.5	-0.7	1.1	1.7	1.3	1.3	0.4	-0.6	-0.6	-0.5	-0.8	-0.7	0.8	-1.1	4.8	-1.4	0.0	0.0
CZ	-1.5	0.5	1.6	2.3	2.1	1.6	0.6	-1.5	-0.6	-1.3	-1.3	-0.7	-0.3	-0.2	-1.0	1.5	1.5	1.4
DK	0.1	0.1	0.9	2.1	1.0	1.0	0.6	0.6	0.6	-0.3	0.0	-0.2	0.3	-4.8	-1.7	0.9	-1.8	0.0
DE	1.2	2.2	2.1	2.3	2.2	2.3	-0.5	-1.4	-1.1	-1.4	-1.5	-1.3	2.1	-0.2	0.5	-0.4	-0.2	-0.2
EE	0.4	0.2	-0.2	-0.2	0.0	0.4	-0.4	-0.2	-0.3	-0.7	-0.6	-0.4	1.5	-0.3	-0.5	0.1	0.4	0.4
IE	-8.8	0.7	1.7	1.6	1.5	1.5	0.6	-24.3	-1.5	-3.1	-2.3	-1.7	-0.8	-2.5	-0.9	-0.1	1.4	0.8
EL	-4.2	-2.1	3.9	4.0	3.7	3.7	14.3	5.9	5.4	-0.4	-1.6	-2.8	-8.1	-10.1	2.5	2.2	4.6	-1.0
ES	-5.6	-2.2	-1.7	-0.5	-0.2	0.4	3.4	-0.8	-0.6	-1.3	-1.6	-1.4	0.5	-2.3	-1.5	0.1	0.7	0.1
FR	-2.5	-1.6	-1.5	-0.8	-0.6	-1.1	0.7	-0.1	0.6	-0.7	-1.3	-1.5	-0.8	-0.8	-1.1	0.3	0.1	0.0
HR	-3.0	0.0	2.2	3.4	3.3	3.2	3.0	1.6	0.6	-0.4	-1.2	-0.9	1.2	-1.7	-1.6	1.2	0.1	0.1
IT	1.4	1.5	1.5	1.5	1.9	1.7	4.0	1.7	1.7	1.1	-0.2	0.3	1.2	-0.4	0.3	0.2	0.9	0.4
CY	-3.2	2.5	3.6	5.0	5.0	5.1	4.2	3.0	0.5	-2.3	-1.7	-2.3	3.3	-0.5	2.2	-1.8	15.0	1.3
LV	-1.7	0.0	1.1	0.4	-0.3	-0.4	-0.3	0.2	0.1	-2.0	-1.5	-1.4	-0.4	-4.3	4.6	2.1	-2.0	1.3
LT	-2.6	1.3	1.6	1.7	1.3	1.2	-0.3	0.6	0.0	-1.9	-1.4	-0.9	0.2	2.7	-0.8	3.2	-1.1	4.4
LU	1.0	1.7	1.9	1.9	1.3	1.0	-0.7	-0.6	0.0	-0.5	-0.8	-0.7	3.0	1.6	0.8	4.6	1.7	1.6
HU	0.8	1.6	1.6	0.8	0.1	0.3	1.1	-0.3	0.8	-2.7	-2.1	-1.9	-0.5	2.1	0.0	1.1	2.0	-0.1
MT	0.5	1.3	3.1	5.8	2.7	2.8	-1.2	-4.7	-1.7	-2.8	-2.1	-1.7	0.9	1.0	2.4	3.2	1.2	0.9
NL	-1.9	-0.8	1.4	2.1	1.6	1.7	0.8	-0.8	-0.7	-1.6	-1.7	-1.7	-0.5	-3.4	-0.7	-1.4	0.0	0.0
AT	-0.1	1.3	0.5	1.1	1.2	1.3	0.3	-0.4	0.0	-1.8	-1.8	-1.3	0.4	2.3	-0.5	-2.2	-0.7	-0.5
PL	-2.3	-0.9	-0.6	-0.1	0.1	0.1	0.1	-0.5	0.1	-1.8	-1.4	-1.4	-2.2	0.4	2.3	-1.8	0.5	0.9
PT	-2.9	0.2	2.2	0.9	2.7	2.8	4.7	-0.3	0.2	-1.2	-0.9	-0.6	1.8	-1.4	3.1	-2.1	0.4	0.5
RO	-2.2	0.8	-1.5	-1.6	-2.0	-2.4	0.1	-0.8	-1.0	-2.8	-1.7	-1.2	1.1	0.2	-0.8	-1.1	0.0	0.0
SI	-5.0	0.4	1.1	2.5	2.5	2.0	1.8	0.7	-0.2	-2.7	-3.0	-2.5	2.3	2.0	-2.8	0.3	1.3	0.3
SK	-2.6	-1.0	-0.6	0.4	0.4	0.9	0.2	-0.2	0.2	-0.9	-1.9	-1.9	0.6	-2.0	-1.3	0.3	0.4	0.4
FI	-1.0	-1.6	-0.7	0.4	0.2	0.7	0.1	0.0	-0.7	-1.2	-1.5	-1.4	2.6	1.8	-0.5	0.0	0.6	1.2
SE	0.1	0.6	1.6	1.6	1.1	1.1	-0.5	-2.4	-1.6	-1.5	-1.6	-1.3	1.4	1.7	1.2	1.6	0.0	0.0
UK	-4.3	-1.9	-0.5	0.8	0.6	0.9	0.0	-0.1	-0.9	-0.5	-0.5	0.1	0.3	-1.0	0.4	0.8	-0.2	-0.2
EA-19	-1.1	0.3	0.6	1.1	1.2	1.1	1.3	-0.9	-0.2	-1.1	-1.5	-1.3	0.6	-0.9	-0.2	-0.1	0.3	0.1
EU-28	-1.6	-0.1	0.5	1.0	1.0	1.0	0.7	-2.3	1.5	-0.3	-1.3	-1.2	0.8	0.0	-2.3	-0.4	0.4	0.1

Notes: (1) The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator); (2) The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.
Source: Commission 2018 spring forecast.

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